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Credit for foreign tax: The LOB and domestic relief

Jonathan Schwarz (Temple Tax Chambers; King's College London) · Monday, May 24th, 2021

The relationship between treaties and domestic tax law ought to be straightforward. The *pacta servanda sunt principle* expressed in articles 26 and 27 of the Vienna Convention on the Law of Treaties itself implies that treaty obligations must be upheld notwithstanding domestic law. A variety of constitutional arrangements around the world mean that there is straightforward proposition is not always so simple.The position is further complicated by domestic legislation that is dependent on treaty provisions for its operation.

Limitation on benefits

An unusual interaction between treaties and domestic law has been the subject of dispute in the United Kingdom for some years in relation to credit for foreign tax, where a treaty does not provide for relief in the source state. *Aozora GMAC Investments Limited v HMRC* [2021] UKFTT 99 (TC) [2021] UKFTT 99 (TC) concerned a subsidiary resident in the United Kingdom of a Japanese resident bank. The UK subsidiary lent money to two sub- subsidiaries resident in the United States. The US Internal Revenue Service denied the benefit of the interest article (Article 11) in the United Kingdom-United States income tax treaty on the basis that the UK company was not a "qualified person" by reason of article 23 (Limitation on benefits).

Discretionary relief

The UK company applied to the IRS for discretionary benefits under article 23(6) but this was refused. It was clear from the evidence that the investment was made via a UK company in order to reduce US tax on the interest. Discretionary benefits are not available if one the principal purposes of the UK resident is to obtain treaty benefits. As a result, US withholding tax at 30% was withheld on the interest payments made by the US resident borrower companies to the UK creditor company.

An additional consequence of the limitation on benefit article was that the UK company was also disqualified from claiming credit for US tax paid against its UK corporation tax liability under article 24 of the Treaty. The effect of this would be that, for treaty purposes, the resulting double taxation was not relieved.

Domestic credit for foreign tax

UK domestic law contains its own unilateral measures to credit foreign tax against the UK tax liability. The domestic law ensures that no double credit is available by giving priority to the

foreign tax credit under a treaty (now Taxation (International and Other Provisions) Act 2010, section 11). If a credit is available under the treaty than no domestic relief is available. In addition, the UK domestic law provides that if the treaty expressly provides that no credit is be given under the treaty in specified circumstances, then no unilateral domestic law credit is allowed either. This limitation was enacted with article 24(3)(c) of the UK-US Treaty in mind, which denies credit in the case of certain hybrid instruments.

HMRC sought to deny the foreign tax credit under domestic law on the basis that the UK company was not a qualified person under article 23 and that this status was a circumstance specified in the treaty. The First-tier Tribunal ruled that the domestic credit was available. The requirement for an express disallowance of the credit meant, firstly, that the disallowance must not be merely implied. Secondly, it must be express "in the sense of definitely formulated, definite, explicit, specifically designated, or specially intended". While the domestic law disallowance was necessary to ensure that the explicit treaty disallowance in Article 24(3)(c) of the UK-US treaty was effective, the Tribunal decided that the domestic law exclusion only applied where the terms of the treaty expressly refer to the cases and circumstances in which credit for foreign tax is not granted. The Tribunal also concluded that the domestic limitation on credit was not a broad anti-treaty abuse provision aimed at treaty shopping.

Administrative law procedures

The dispute has also been the subject of administrative law procedures by way of judicial review of the tax authority's decision making. HMRC initially stated in their published International Manual that the domestic law credit was only unavailable in circumstances such as in Article 24(4)(c) of the UK-US treaty and that, at the time, this was the only treaty provision to which the domestic limitation would apply. This statement was deleted when the manual was updated, some years after the years in which the dispute arose claiming that it was incorrect. The Court of Appeal ruled that the taxpayer could not rely on these statements in the manual (*R (aoa Aozora GMAC Investments Limited) v HMRC* [2019] EWCA Civ 1643). The First-tier Tribunal rejected HMRC arguments that the International Manual was incorrect.

Double taxation

Policy issues can sometimes be difficult to determine in these cases. One policy question, might be what the fair outcome should be in an intermediate country in an admitted case of treaty shopping. Plainly the reduction in US withholding tax was an objective of the structure. That benefit was clearly unavailable. What should the position of an intermediate entity in such a structure be? If credit for the US withholding tax is given in the UK, that would likely eliminate the UK corporation tax on the interest. If credit is not given, then the interest would bear US tax at 30% on the gross interest plus UK corporation tax at 20% of the UK creditor's profit on the transaction.In the case of the ant-hybrid rule, the purpose of the rule is to prevent double non taxation which is not present in this case. On one view, taxpayers engaged in planning of this kind have been said by the courts to be "playing with fire" and should not complain if their fingers burnt (e.g. *Gordon Haig Emery v IRC* (1979-1983) 54 TC 607). Another view might be that any tax paid in the UK is an adventitious gain for the UK fisc, because, absent the plan, no tax would accrue to the UK.

In the post-BEPS environment, where treaties have become more complex, mostly because of limitations on relief, including of the kind considered in the *Aozora* case, such issues are likely to become more common.

The *Aozora* case is one of many new judicial decisions on treaty issues discussed in the 6th Edition of **Schwarz on Tax Treaties** (Wolters Kluwer) due to be published later this year.

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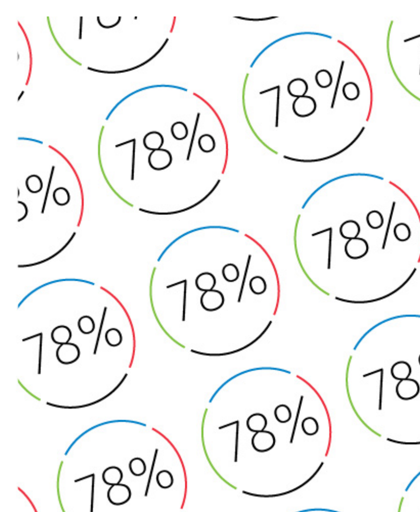

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This entry was posted on Monday, May 24th, 2021 at 6:39 pm and is filed under Double Taxation, Financial institutions, Hybrids, International Tax Law, Limitation on benefits, Principal purpose test, Tax Administration, Tax Credits, Tax Planning, Tax Policy, Tax Treaties, Treaty shopping, United Kingdom, United States, Withholding Taxes
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