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When is tax payable “in accordance with” a double tax treaty?

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G E Financial Investments Limited v HMRC [2021] UKFTT 210 (TC) raised central aspects of the interpretation of double tax treaties. My previous blogs considered the corporate residence under article 4(1) of the UK-US Double Tax Treaty and the existence of a permanent establishment under article 5(1) of the treaty. The First-tier Tribunal decided that the taxpayer (GEFI) was not a US resident within article 4(1) and did not have a US permanent establishment under article 5(1).

This third blog addresses the final element in the case, namely the elimination of double taxation pursuant to article 24 (corresponding to article 23 of the Model treaties). The facts of the case are described in my previous blogs and not repeated here.

GEFI was a UK incorporated company and, as such, liable to UK corporation tax on its worldwide profits. Its shares were stapled to its US incorporated affiliate with the result that for US Federal income tax purposes it was deemed to be a US person and liable to Federal income tax on its worldwide income in the US as well.

Credit for foreign tax

The failure of the competent authorities of the two contracting states to determine by mutual agreement the mode of application of the treaty meant that the taxpayer was not entitled to any relief under the treaty except, among others, as provided by paragraph 4 of Article 24(4) (Relief from Double Taxation) (Article 4(5)).

Article 24(4)(a) requires the UK to give credit for “United States tax payable under the laws of the United States *and in accordance with this Convention*, whether directly or by deduction, on profits, income or chargeable gains from sources within the United States … against any United Kingdom tax computed by reference to the same profits, income or chargeable gains by reference to which the United States tax is computed.” (emphasis added)

A companion provision treats income that may be taxed in the United States in accordance with the Treaty, including specifically interest income, as arising from sources within the United States (Article 24(5). Although GEFI was liable to US tax on its worldwide income, the income in question was interest from loans made to US affiliates.

The tribunal Judge agreed with the taxpayer that the phrase “in accordance with this Convention” means in this case that the US tax is not inconsistent with the UK-US treaty. In other words, the amount of US tax does not exceed that permitted by the treaty or be imposed on sums not taxable

in the US under the terms of the treaty.

However, HMRC argued that, because GEFI was not liable to US tax by reason of article 11(1) (Interest) nor under article 7(1) (business profits), no credit should be granted in the UK against the UK tax liability. The US tax liability was imposed by reason of US law. Since the Judge found there was no permanent establishment in the US, no relief was available.

Double taxation

This seems a surprising result in light of the focus of UK courts on the main purpose of the treaty as illustrated by the Supreme Court in *Fowler v HMRC* [2020] USSC 22 and cited by the First-tier Tribunal Judge. In *Fowler*, the court observed that the purpose of the treaty is "resolving issues of double taxation which arise from the tax treatment adopted by each country's domestic legislation" (at [19]). This purpose was plainly frustrated by the First-tier Tribunal's overall decision. The consequence of the ruling, if it is not overturned on appeal, is significant double taxation (approximately US$ 300 million of US tax paid and a UK liability of £125 million on top of that).

Where should the purpose of the treaty have manifested itself in the First-tier Tribunal decision? The purpose of avoiding double taxation would be served if the UK gave credit for the US tax. That part of the decision cannot be faulted. The conclusion that there was no permanent establishment resulting from a very limited number of transactions would similarly achieve that purpose. It is also a reasonable interpretation that is consistent with the good faith principle in article 31(1) of the Vienna Convention on the Law of Treaties.

The error, in my view is in the interpretation of article 4(1) and the conclusion that GEFI was not also a resident of the US when it is deemed to be a US person and liable to tax on its worldwide income under US domestic law. The conclusion that such a person is not a resident of a contracting state will invariably lead to double taxation if the person is also a resident of the other contracting state. This purpose should therefore inform the interpretation of the term "any other criterion of a similar nature" in article 4(1).

Tie-breaker problems

The decision also highlights the difficulties with treaties that do not have a real residence tie-breaker, but leaves this to the competent authorities' endeavours to agree (as in article 4(3) of the 2017 model treaties, article 4(1) of the MLI and article 4(5) of the UK-US treaty). A failure to reach agreement may have considerable negative consequences for taxpayers.

Article 4(5) of the UK-US treaty has an unusual element where mutual agreement is not reached. The UK is required to give credit for any US tax on income that the US is permitted to tax under the treaty. No such relieving measure is found in the model treaties. The UK-US treaty, in effect, then treats the UK as the residence state, and the US as the source state, in every case. The application of this principle is straightforward where the dual resident person only has US source income, as was the case for GEFI.

That treatment may be more controversial in its application to cases where the person has non-US source income. The distributive articles of the treaty would then permit both contracting states to tax worldwide income Article 24(4) and (5) requires the UK to give credit in such cases. This unusual allocation of taxing rights may make mutual agreement more difficult to attain and cause the UK tax authorities to take more extravagant positions in dealing with the taxpayer.

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