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What is the main purpose of a transaction?

Jonathan Schwarz (Temple Tax Chambers; King's College London) · Thursday, November 3rd, 2022 · article 3(2), burden of proof, OECD Commentary, treaty interpretation, UN Commentary

Even before introduction of the BEPS PPT, the UK has had purpose-based provisions in various forms, designed to limit access to treaty benefits in its double tax treaties since the 1960's. Its standard formulation first appeared in 1992. Surprisingly, the first case in which the meaning and application of this wording in a tax treaty involved Article 12 (Interest) in the Ireland-UK treaty. Article 12(1) grants exclusive taxing rights over interest to the residence state subject to Article 12(5) which reads:

“The provisions of this Article shall not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the debt-claim in respect of which the interest is paid to take advantage of this Article by means of that creation or assignment.”

In *Burlington Loan Management DAC v HMRC* [2022] UKFTT 290 (TC), an Irish investment company, the main vehicle for a US-based asset manager, purchased debt claims in the administration of Lehman Brothers International (Europe), a UK resident company. Under English insolvency law, interest is payable in respect of such claims once the administration is completed. Much of the Lehman debt was owed to non-UK creditors. One of the issues in the administration was whether this post-administration interest was subject to UK withholding tax. That issue was finally resolved by the UK Supreme Court which ruled that withholding tax was due (*HMRC v Joint Administrators of Lehman Brothers International (Europe)* [2019] UKSC 12).

Burlington acquired the debt from a Cayman Island company via an intermediary to whom almost all the principal amount of the debt had already been paid. Plainly, the value of the debt claim for interest would be greater for a purchaser who benefitted from treaty relief from the UK withholding tax than a Cayman Island creditor. The asset managers knew that the claim was being sold for withholding tax reasons and the purchase price was 92% of the interest payable.

“Main purpose or one of the main purposes”

Although HMRC initially denied the claim on the basis that Burlington was not the beneficial owner of the interest, the dispute ultimately turned only on the meaning and application of Article 12(5). The parties agreed that:

- (1) the phrase “main purpose or one of the main purposes” was not defined in the Treaty;

- (2) it was legitimate to interpret the phrase in accordance with relevant UK case law pursuant to Article 3(2) of the Treaty, which specified that undefined terms were to be interpreted in accordance with the provisions of the tax law of the relevant contracting state (in this case, the UK);
- (3) determining a person's main purpose was a question of fact;
- (4) the conclusion of fact was to be made "upon a consideration of all the relevant evidence...and the proper inferences to be drawn from that evidence";
- (5) the test required consideration of the subjective intentions of the relevant;
- (6) the word "main" did not mean "more than trivial". Instead, it had the connotation of importance; and
- (7) in order for this test to be satisfied, it was not necessary for the relevant matter – in this case, taking advantage of Article 12(5) – to be the sole purpose or the only main purpose. It was sufficient for the relevant matter to be one of several main purposes.

How is purpose determined?

The Tribunal concluded that subjective purpose is determined by reference to all of the evidence before it, including, by implication, those inevitable and inextricable consequences of entering into those loans. It was not appropriate, however, to identify a subjective purpose by reference to the inevitable and inextricable consequences of entering into the loans.

Although the Tribunal considered that "taking advantage" should bear its ordinary (dictionary) meaning of "to take an opportunity provided by favourable circumstances; to avail oneself of a person or thing. Frequently in a negative sense: to seize an opportunity of unfairly profiting by a person or thing..." it decided that the negative sense did not require taking artificial steps or making artificial arrangements to obtain a treaty benefit which would not ordinarily follow as a consequence of the relevant person's residence, which it referred to as treaty-shopping.

In the present context, merely knowing that the purchaser is entitled to an exemption from UK withholding tax but without knowing the precise basis for that exemption is insufficient to engage Article 12(5) even if, as it transpires, the purchaser's exemption stems from Article 12(1).

Whose purpose?

The question of whose purpose was a central issue in the case. The Tribunal did not accept that "any person" was confined to persons who are within the personal scope of the treaty by operation of article 1. Consequently, the Cayman Island company, as seller of the debt could have a purpose in assigning the debt of "taking advantage" of Article 12 by means of the assignment. Thus, the purposes of both the Irish buyer and Cayman Island seller of the debt were relevant. Can the seller or the purchaser be "taking advantage" of a treaty provision in a treaty between the purchaser's state of residence and a third state in relation to a sale of a debt for a price which reflects the purchaser's exemption from withholding tax pursuant to that provision.

The Irish company was found not to have a main purpose of taking advantage of Article 12(1) by means of the assignment. The sole purpose of the Irish company was to make a profit by on the

difference between its purchase price and the cash flows that it received as result of its acquisition of the debt.

The tribunal found as a fact that at the time the debt claim was sold in principle, the Cayman seller did not know the identity of the end-purchaser. They did when the sale and price was eventually agreed. This was required for regulatory purposes and to confirm that the tax status of the end-purchaser had been adequately reflected in the agreed price with a view to their re-opening price negotiations if it had not. The tribunal ruled that it was insufficient for the Cayman company to have had a main purpose of “taking advantage” of a provision of UK domestic law or a treaty which was unknown to it. The main purpose had to be to take advantage of Article 12(1) itself. In addition, a company cannot take advantage by making the advantage available to someone else.

Burden of proof

Although the taxpayer has the burden of proving that it is entitled to the treaty relief, the tribunal ruled that HMRC had to show that the condition in Article 12(5) applies and not for the taxpayer to show that it did not.

Treaty interpretation

While the conclusion, on the facts is undoubtedly correct with sound reasoning, the approach to treaty interpretation by both parties left much to be desired.

In particular, recourse to Article 3(2) to determine the meaning of “main purpose or one of the main purposes” which was not defined in the treaty, as the basis for relying on UK case law. The real reason is that UK decisions in common with those of other jurisdictions are intrinsically sources of international law as establishing general principles of law or are themselves sources (See, eg Article 38 of the Statute of the International Court of Justice).

Uncritical reliance on later OECD and UN Commentary to interpret the preamble to a treaty concluded decades before the Commentary was published is dubious and indeed was the conclusions on the meaning and role of the preamble.

These issues are for another day and another blog. Given the importance of the decision, an appeal is likely

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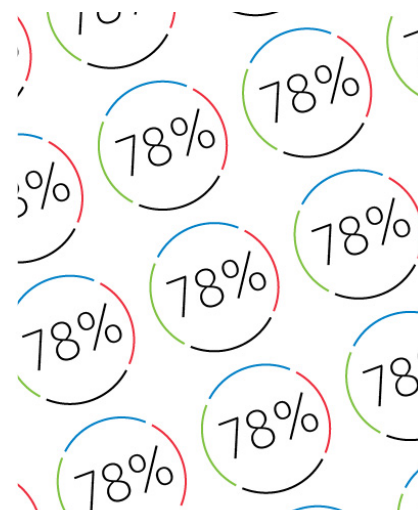
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