UK tax treaties anti-avoidance

Proposed legislative changes countering the use of avoidance schemes to obtain benefits pursuant to the UK’s network of double tax treaties

SUMMARY

On 1 August 2011, HM Revenue & Customs ("HMRC") published a technical note on a proposed change to the law governing the availability of relief from double taxation pursuant to the UK’s network of double tax agreements ("DTAs", commonly referred to as “double tax treaties”).

If implemented in its present form, the proposed draft legislation would deny relief from UK tax pursuant to a DTA where there is a “tax avoidance scheme” in place. The concept of a tax avoidance scheme is wide, and covers any kind of scheme, arrangement or understanding (formal or informal) of which the main purpose, or one of the main purposes, is to secure the application of a DTA to applicable income (being income, profits and gains in the case of UK-resident taxpayers, and certain types of UK-source income in the case of non-UK resident taxpayers), where that DTA would not have applied to the applicable UK income absent the scheme.

The proposal is at an initial stage in which HMRC are seeking views before enacting appropriate measures in the UK Finance Bill 2012, which is expected to become law in July 2012.

As drafted, the proposals seem stricter than current law and practice, and several areas remain to be clarified by HMRC. In particular, it is unclear whether DTA clearances granted before any change in law will continue to be valid. Therefore, it is advisable that any pending applications for relief from UK tax pursuant to a DTA are submitted to HMRC without delay in order to take advantage of the current regime, particularly since obtaining a UK DTA clearance can be a lengthy process.
I. BACKGROUND

The UK Government announced measures in the 2011 Budget to combat the use of the UK’s DTAs as a means of avoiding UK tax. The technical note sets out two main principles of the proposed changes:

- A DTA should not limit the UK’s right to tax its residents; and
- Non-UK residents should not be able to use UK DTAs as a means of reducing their UK tax (a practice generally referred to as “treaty shopping”), except where such reduction is properly due.

The Commentary to Article 1 of the OECD Model Tax Convention on Income and Capital, on which most UK DTAs are based, provides that countries “do not have to grant the benefit of [a DTA] where arrangements that constitute an abuse of that [DTA] have been entered into”. Certain (but not all) UK DTAs contain anti-abuse provisions\(^1\), especially in the DTA articles dealing with passive income. Most treaties restrict the benefit of reduced rates of tax to the “beneficial owner” of the relevant income. Following the Court of Appeal decision in Indofood\(^2\), the “beneficial owner” concept is to be read in a non-technical way so as to combat “treaty shopping”. Where schemes are not caught by anti-abuse provisions in the particular DTA, HMRC has typically taken an ad hoc approach to closing down such schemes by enacting specific anti-avoidance legislation. The proposed new Section 129A(8) of the Taxation (International and Other Provisions) Act 2010 (“TIOPA”) gives a list of existing DTA anti-avoidance provisions, and clarifies that the new legislation will not limit the operation of those provisions. However, HMRC considers that a “broader anti-avoidance measure” is now required, and has proposed new Sections 129A and 133A of TIOPA addressing the two questions set out above.

II. RESIDENCE

The proposed legislation will apply differently to UK-resident and non-UK-resident taxpayers, although the anti-avoidance conditions to be satisfied (see Section III below) apply equally to both categories of taxpayer.

A. UK-RESIDENT TAXPAYERS

1. Test of UK residence

For the purposes of the new legislation, whether a person is a UK resident is determined by reference to the UK domestic residence test\(^3\). Therefore, taxpayers treated as non-UK-resident under the provisions of a “tie-breaker” clause in a DTA may still be caught by the provisions applying to UK

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\(^{1}\) E.g. the “anti-conduit” provisions in Article 23 of the UK/US DTA that came into force on 30 March 2003.

\(^{2}\) [2006] STC 1195

\(^{3}\) Draft Section 129A(5) TIOPA
residents if they are resident in the UK under the domestic test. HMRC have indicated in informal discussions that they do not intend to bring non-resident companies within the charge to UK corporation tax, but rather to catch temporary non-residence by individuals seeking to avoid a charge to UK capital gains tax⁴, and generally to implement a wide deterrent to structures that are not caught by existing anti-avoidance provisions.

2. Scope of legislation

The provisions apply to any income, profit or gain within the scope of income tax, corporation tax or capital gains tax (being “relevant UK tax”) if, in the absence of the DTA provision, the income, profit or gain would be:

- Chargeable to relevant UK tax;
- Chargeable to relevant UK tax at a higher rate; or
- Treated as income of a UK resident and chargeable to relevant UK tax⁵.

Where the relevant avoidance conditions (see III below) are satisfied, the DTA does not prevent the income being fully chargeable to UK tax⁶.

B. NON-UK-RESIDENT TAXPAYERS

1. “Relevant UK income”

The regime applicable to non-UK-resident taxpayers (i.e. the “treaty shopping” scenario) is narrower than that applicable to UK-resident taxpayers. Only certain types of passive UK-source income fall within the draft provisions, being interest; other income from debt-claims; dividends; royalties; and any other income that does not fall within any specific description of income for which provision is made in the relevant DTA⁷. Such income must be payable by a UK-resident company, or otherwise arise in the UK as determined by reference to the relevant DTA⁸.

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⁴ KPMG Weekly Tax Matters 12 August 2011
⁵ Draft Section 129A(1) TIOPA
⁶ Draft Section 129A(2) TIOPA
⁷ Draft Section 133A(5) TIOPA
⁸ Draft Section 133A(6), (7) TIOPA
2. Scope of legislation
The provisions apply to any relevant UK income (as defined above) if, pursuant to a DTA, such income is:

- Not chargeable to UK income tax; or
- Not chargeable to UK income tax at a rate higher than the rate set in the DTA (i.e. the DTA achieves an effective reduction in the applicable rate of UK income tax).\(^9\)

Where the relevant avoidance conditions (see III below) are satisfied, the DTA does not prevent the relevant UK income being chargeable to UK income tax, or being chargeable to UK income tax at the higher non-DTA rate.\(^10\)

III. AVOIDANCE CONDITIONS
Three avoidance conditions must be satisfied in order for the proposed new rules to apply.\(^11\) These conditions apply equally to UK-resident and non-UK-resident taxpayers:

- A scheme is put into place by one or more persons;
- Absent the scheme, the DTA provision would not apply to applicable income (being income, profits and gains in the case of UK-resident taxpayers, and specified types of UK-source income in the case of non-UK-resident taxpayers); and
- The main purpose, or one of the main purposes, is to secure the application of the DTA provision to applicable income (being income, profits and gains in the case of UK-resident taxpayers, and specified types of UK-source income in the case of non-UK-resident taxpayers).

The concept of a “scheme” includes any kind of scheme, arrangement or understanding (formal or informal), whether or not intended to be legally enforceable.\(^12\) In addition, a scheme can be caught under the main purpose test whether or not the relevant DTA provision was in existence at the time the scheme was put into place, although it is unlikely that the main purpose condition will be met in such a situation.

IV. IMPACT
The proposed legislation will apply to any income arising, or capital gain accruing on a disposal occurring, on or after Royal Assent to the UK Finance Act 2012 (anticipated to be in July 2012). This is regardless

\(^9\) Draft Section 133A(1) TIOPA
\(^10\) Draft Section 133A(2) TIOPA
\(^11\) Draft Sections 129A(3) and (4) and 133A(3) and (4) TIOPA
\(^12\) Draft Sections 129A(7) and 133A(8) TIOPA
of when the scheme was put into place or when the DTA provision took effect. Existing schemes can therefore be caught. Since the regime can effectively apply retrospectively, existing DTA relief arrangements (e.g. financing structures) should be checked for compliance with the new rules.

Applications for relief pursuant to a UK DTA will be subject to scrutiny on the basis of the proposed legislation, and where there are arrangements falling within the anti-avoidance provisions, DTA relief will not be available. It is unclear whether existing DTA clearances (e.g. to pay income gross) will remain valid. It has been reported that HMRC have indicated during informal discussions that they do not generally intend to revisit existing clearances on the basis of the new legislation. However, no formal guidance to this effect has been published. It is advisable that any pending applications for relief from UK tax pursuant to a DTA are submitted to HMRC without delay in order to take advantage of the current regime, particularly since obtaining a UK DTA clearance may take several months.

V. COMMENT

In addition to the anti-abuse measures already present in UK DTAs and (to a limited extent) in UK domestic law, the proposed legislation will add further grounds for HMRC to challenge arrangements seeking to obtain a better result under a UK DTA than would have been the case under UK domestic law. While this principle is not entirely without precedent (e.g. US DTAs – including the UK-US DTA – typically contain provisions that residents of either contracting state cannot obtain a more favourable result under DTAs than pursuant to domestic law, subject to certain exceptions), another layer of complexity to an already unwieldy procedure for claiming DTA relief will not be welcomed by UK taxpayers.

The proposed changes coincide with the recent UK Court of Appeal decision in Huitson\textsuperscript{13} which upheld the judgment of the UK High Court that earlier retrospective legislation aimed at preventing misuse of DTAs by UK residents does not contravene the European Convention on Human Rights (“ECHR”). The UK Court of Appeal cited the “fair balance principle” pursuant to which a national taxing authority must strike a fair balance between the general interests of the community and the protection of the taxpayer’s fundamental rights. In that case, the UK-resident taxpayer argued that disallowing his DTA-based claim to relief from UK tax interfered with his right under Article 1 of the First Protocol to the ECHR to peaceful enjoyment of his possessions (which included receipt of a tax relief). However, the UK Court of Appeal agreed unanimously with the judgment of the UK High Court that the retrospective anti-avoidance provisions by UK residents were justified. The general principle cited by Mummery LJ (at para 34) is embodied in Section 129A TIOPA in the current proposals:

“DTAs respect the principle of taxation by the State of residence. They aim to avoid the taxation of residents twice over on the same income. What DTAs do not aim to do is to facilitate the

\textsuperscript{13} R (Huitson) v HMRC [2011] EWCA Civ 893
avoidance of tax, or its reduction below the level of tax ordinarily paid by residents. In those circumstances it is a legitimate aim of the public policy of the State in fiscal matters to ensure that DTAs relieve double taxation of residents rather than serve as an instrument used by taxpayers who choose to participate in artificial arrangements to avoid or reduce their level of taxation. In principle retrospective legislation may be justified for the purpose of implementing that policy”.

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-7-

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LON:412433v3