Tax treaty interpretation, conflicts of entity classification and the curious case of *George Anson*

Conor Delaney,
Milestone International Tax Consultants Limited, London

The following article re-examines the tax treaty analysis in the recent judgment of the Upper Tribunal in *Anson v Revenue and Customs Commissioners*.

It is the author's view that the judgment failed to appreciate fundamental differences between the old and new UK/US tax treaties. In particular the court appears to have overlooked a provision buried within the Exchange of Notes to the new treaty that extends the scope of the double taxation relief article in certain instances of double taxation caused by conflicts of entity classification. If applicable, the provision contained in the Exchange of Notes would potentially entitle Mr Anson to claim double tax relief for US federal tax in respect of periods covered by the new treaty.

I. Decision in *Anson*

To recap, in *HMRC v George Anson*, the Upper Tribunal agreed with HMRC that a Delaware LLC should be treated as opaque for UK tax purposes. The judgment overturns the decision of the First-tier Tribunal (that had held the LLC to be transparent for UK tax purposes) and in so doing vindicates HMRC's previously published view as to the entity classification for UK tax purposes of a Delaware LLC. (This case was reported at the First-tier Tribunal on an anonymous basis as *Swift v Revenue and Customs Commissioners*).

Mr Anson was UK resident but non-UK domiciled for UK tax purposes and sought double tax relief by way of credit for US tax paid against UK tax payable on distribution from the LLC. The LLC was treated as fiscally transparent for US tax purposes with Mr Anson subject to US tax on the LLC's profits on an arising basis (because the LLC had US effectively connected income). Since HMRC consider an LLC to be opaque for UK tax purposes, Mr Anson was also subject to UK income tax upon remittance of distributions from the LLC to the UK.

The UK/US tax treaty obliges the UK to give double tax relief by way of credit for any US source income against UK tax computed by reference to the "*same profits or income*". The consequence of holding the LLC to be opaque for UK tax purposes denies Mr Anson's claim for double tax relief on the basis that the distribution (in relation to which UK income tax was charged) was not the same item of income as the

Conor Delaney works for Milestone International Tax Consultants Limited, London

profit allocation of the LLC (in relation to which US income tax was charged).

II. Effect of Double Taxation on Mr Anson

The financial effect of double taxation on Mr Anson is that out of profit of 100, roughly 45 has been paid in US federal and state tax, 55 has been distributed to him and 22 has been charged in the UK.[1] Absent any double tax relief pursuant to the UK/US tax treaty, Mr Anson suffers double taxation and an overall effective tax rate of c.67 percent.

III. Relevance of new Treaty

The new UK/US tax treaty is effective in respect of UK resident individuals for the 2003-04 and subsequent tax years.

The *Anson* case related to tax assessments for the years 1997-98 through to 2003-04[2]. In other words the *Anson* case covered tax assessments relating to seven different tax years, of which the first six tax years were covered by the old treaty with the final tax year (2003-04) covered by the new tax treaty. It is also worth stating that, for the relevant years in question, Mr Anson remitted all of the LLC profits to the UK by way of distribution.[3] So while only the final tax year is governed by the new treaty it is assumed that the double tax relief claimed in relation to that final tax year is significant.

IV. Failure to consider new treaty

Both the First-tier Tribunal and the Upper Tribunal focused on the "*same profits or income*" requirement that appears in the text of the provision on double tax relief in the old treaty (Article 23(2)(a)) and in the new treaty (Article 24(4)(a)). Both judgments then proceed to analyse the case on the basis of the old treaty as, surprisingly, they state "there is no material difference between their terms".[4]

However, the Exchange of Notes to the new treaty contains a provision that specifically extends the scope of double tax relief in certain instances of double taxation caused by conflicts of entity classification (the "*new treaty provision*"). The new treaty provision operates to allow a credit to a resident person for tax on income derived through an entity that is treated as fiscally transparent under the laws of either state, in respect of "tax paid or accrued by the entity". At first glance this may appear to be of limited assistance, since the US tax for which Mr Anson was seeking a credit was suffered by him personally whereas the new treaty provision only allows credit for "tax paid or accrued by the entity". However, the remainder of this article considers how, upon closer analysis of the facts of the *Anson* case and the international law rules of treaty interpretation, Mr Anson might seek to argue that the new treaty provision should entitle him to successfully claim a tax credit for the 2003-04 tax year (being the only tax year covered by the new treaty).

V. Principles of Tax Treaty Interpretation

Before focusing on the wording of the new treaty provision, it is worthwhile providing a brief recap on the international law rules of treaty interpretation. The principles of interpretation that apply to all international treaties are codified in the Vienna Convention on the Law of Treaties (the "*Vienna Convention*"). Article 31 of the Vienna Convention is entitled the "General Rule of Interpretation" and provides as follows:

(1) A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.

(2) The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:

a. Any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty;

b. Any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.

(3) . . . .

Article 31(1) dictates that treaty interpretation is a matter of considering the literal or "ordinary meaning" of the terms of the treaty, their "context" and their "object and purpose". Article 31(1) is not specific as to how much weight should be given to the literal meaning and how much to object and purpose. However, for present purposes, the following will consider both the literal interpretation and the purposive interpretation of the new treaty provision.

Article 31(2) is relevant to the question of the status to be given to the Exchange of Notes. The Exchange of Notes takes the form of a note of proposals from the UK to the US which is then accepted by a reply from the US on the basis that the reply "shall be regarded as constituting an agreement between the two Governments in this matter, which shall enter into force at the same time as the Convention". One may conclude that the Exchange of Notes is both:

1 an "agreement relating to the treaty" within Article 31(2)(a) of the Vienna Convention. This means that the Exchange of Notes should be considered to be part of the context in which the terms of Article 24 of the new treaty should be interpreted; and
2 a treaty in its own right. As Vogel states, "International law does not require a specific means or form of concluding a treaty, any common expression of the parties' intentions suffices to bind them."[5]

The Exchange of Notes is clearly expressed to be "regarded as constituting an agreement" and so its interpretation is governed by the general rule of interpretation at Article 31(1) of the Vienna Convention.

This article therefore now considers how the new treaty provision in the Exchange of Notes should be interpreted under Article 31(1) of the Vienna Convention, considering both the literal interpretation and the purposive interpretation in turn.

VI. Literal Interpretation of the new treaty provision

To the casual eye, it would seem that a literal interpretation of the new treaty provision is fatal to Mr Anson's argument. The new treaty provision obliges one state to provide double tax relief in respect of an item of income only in respect of "tax paid or accrued" by a fiscally transparent entity on the same item. The tax for which Mr Anson was trying to claim credit was US income tax on the profit allocation of the LLC which, since the LLC is transparent for US tax purposes, is suffered by him personally. However, a closer look at the facts of the *Anson* case reveals that there may still be an argument that credit should be available based on a literal interpretation of the text of the new treaty provision.

The US tax for which credit was sought consisted of both federal tax and Massachusetts state tax. In respect of the federal tax, the LLC was required to withhold tax at 39.6 percent under section 1446 of the US tax code and pay this tax to the IRS.[6] So, in a literal sense, the LLC did in fact "pay" the federal tax. In particular, section 1446(a)(2) stipulates that a partnership "*shall pay* a withholding tax" in respect of income allocable to a foreign partner. The obligation to pay the tax therefore falls directly on the LLC. Further, it is understood that the LLC did in fact pay this withholding tax in respect of all distributions to Mr Anson.[7]

In respect of the Massachusetts state tax, the LLC was not under any legal obligation to pay a withholding tax. Instead, Mr Anson paid the state tax directly to the Massachusetts Department of Revenue.[8]

One may conclude that the LLC was under a legal obligation to pay, and did in fact pay, the federal tax (but not the state tax). Turning to the conditions of the new treaty provision:

1. "Under such circumstances" – i.e.

- where the Contracting State of which a person is a resident [i.e. the UK]
- is permitted to tax an item of income, profit or gain [i.e. the distribution from the LLC]
- derived through another person (the entity) which is fiscally transparent under the laws of either Contracting State, [i.e. the LLC which is fiscally transparent under the laws of the US]
- and may permit the other Contracting State [i.e. the US]
- to tax the same person [i.e. Mr Anson]; the entity [i.e. the LLC]; or a third person with respect to *that item*.

2. "the tax paid or accrued by the entity" – as we have established, the LLC was liable to pay and did in fact pay the federal withholding tax on the partnership allocation; and

3. "shall be treated as if it were paid or accrued by the first-mentioned person [i.e. Anson] for the purposes of determining the relief from double taxation to be allowed by the State of which the first-mentioned person is a resident [i.e. the UK]."

It may be questionable whether the US federal withholding tax is levied on "that item". The logic of the Upper Tribunal with respect to the interpretation of the treaty double tax relief article is that, because there is a conflict of entity classification, then it necessarily follows that the "item" of income received by Mr Anson was not the "same profits or income" as the profit allocation on which US tax is charged. However, as shall be demonstrated below, such logic does not necessarily follow in considering the new treaty provision in its context and in light of its object and purpose.

In conclusion, the only question mark over whether the new treaty provision should apply to allow credit for the US federal withholding tax is whether the tax is charged on the same "item".

VII. Purposive interpretation of the new treaty provision

The broad purpose of the new treaty provision is to relieve double taxation arising as a result of conflicts of entity classification. Such double taxation may occur because a double tax relief article based on the OECD Model only obliges a state to provide double tax relief to its residents in respect of income of that resident that may be taxed by a source state. Where there is a conflict of entity classification, the problem can arise that income is taxed to different persons so that relief would not be available under the OECD Model double tax relief article. Absent any special provision, where there is a conflict of entity classification, a resident of one jurisdiction may suffer unrelieved double taxation. So it was for Mr Anson who suffered a combined rate of taxation of c.67 percent.

The very nature of a conflict of entity classification is that one jurisdiction will characterise an entity as transparent and tax the partner's allocation on an arising basis, whereas the other jurisdiction will characterise that same entity as opaque and tax the partner only upon distribution. If, however, the operation of the new treaty provision is restricted by considering that an allocation is not the same "item" as a distribution, then the effect would be that the new treaty provision would be emasculated.

Therefore, it follows that the reference to the "that item" in the new treaty provision should be interpreted in light of its object and purpose such that federal tax paid by the LLC in relation to a partner's allocation should be allowed as a credit against tax charged upon receipt of a distribution of that allocation by the partner in question.

VIII. US Technical Explanation

Before looking at the US Technical Explanation, it is necessary to first consider the extent to which the rules of treaty interpretation permit reference to such documents. The US Technical Explanation is clearly not itself a treaty (since it is a document that is issued unilaterally by the US Department of the Treasury in connection with the publication of the treaty). The question then arises whether it may be referred to under the principles of treaty interpretation set out in the Vienna Convention.

The Technical Explanation is clearly not an "agreement relating to the treaty" within Article 31(2)(a) since it is not agreed by the UK. It is also doubtful whether it could be considered to be "an instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty" since the UK has not explicitly "accepted" the terms of the US Technical Explanation.

Aspects of the US Technical Explanation may or may not become "subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its application". If they do, Article 31(3)(b) allows that subsequent practice to be

TPIR ISSN 0309-7900

"taken into account". However, there is no evidence of any "agreed practice" in the application of the new treaty provision.

Article 32 of the Vienna Convention allows recourse to "supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of article 31, or to determine the meaning when the interpretation, according to article 31: (a) leaves the meaning ambiguous or obscure; or (b) leads to a result which is manifestly absurd or unreasonable". Vogel considers that the US Technical Explanations as well as other types of explanations, which are created following conclusion of the treaty, "are materials in the sense of Art. 32 only to the extent that these items reproduce the contents of notes or letters exchanged between initialling and final signature."[9] It would therefore appear doubtful as to whether the Technical Explanation may be considered in interpreting the new treaty provision. However, subject to these caveats, one could ask whether the US Technical Explanation would have any persuasive influence on a court were it to be included in submissions? It is the author's view that it would. The Technical Explanation states that:

The notes contain special rules for the application of Article 24 to fiscally transparent entities in order to allocate primary and residual taxing rights between the two Contracting States. Clarifications are necessary because the Contracting States may have different views regarding the identity of the taxpayer. Under paragraph 4 or 8 of Article 1, a Contracting State may tax an entity as a resident even though the other Contracting State views the entity as fiscally transparent (e.g. as a partnership) and taxes its own residents on the same income. In such cases, the tax generally will be treated as being paid by the citizen or resident of the first-mentioned Contracting State for purposes of Article 24. The effect is to give primary taxing rights to the State in which the entity is a resident, and ensure that double tax is relieved by having the other State give a foreign tax credit for the taxes paid by the entity.

For example, a U.K. company pays interest to a U.K. unlimited liability company ("ULC") with U.S. resident partners. The ULC has elected to be treated for U.S. tax purposes as a partnership. Under Article 11 (Interest), the U.S. partners claim an exemption from U.K. withholding tax with respect to that interest. However, because the United Kingdom treats the ULC as a company resident in the United Kingdom for U.K. tax purposes, the saving clause of paragraph 4 of Article 1 ensures that the United Kingdom may continue to tax the company as a U.K. resident. Pursuant to the notes, the United States will treat the tax paid by the ULC as having been paid by the partners for purposes of providing a foreign tax credit to the U.S. partners with respect to the interest income.

The example given concerns a situation where the resident state of the partner considers the entity to be transparent whereas the resident state of the entity considers the entity as opaque. In such scenario, the income will necessarily be of the same "type" (i.e. the interest).

By contrast, *Anson* concerns a situation where the resident state of the partner considers the entity to be opaque (UK), whereas the resident state of the entity considers the entity as transparent (US). In such scenario, the income taxed by the resident state of the partner will typically be upon distribution, whereas the resident state of the entity will be taxing such income on allocation.

In spite of the contrast between the example provided in the Technical Explanation and the *Anson* case, the Technical Explanation is helpful in so far as it confirms that the purpose of the provision is to give primary taxing rights to the state in which the entity is resident *and* ensure that double tax is relieved by having the other state give a foreign tax credit for the taxes paid by the entity.

It may also be observed that the new treaty provision refers to income derived through another person which is fiscally transparent under the laws of *either* state (i.e. the new treaty provision is not limited to situations where the resident state of the *partner* considers the entity to be transparent as in the example). If the intention was to limit the new treaty provision to cases such as in the example, the provision should have been limited to situations where the entity was regarded as fiscally transparent "under the laws of the first contracting state".

IX. Conclusion

Based upon a literal interpretation of the new treaty provision in its context and in light of its object and purpose, there is a case for arguing that US federal tax paid by an LLC (by way of withholding tax) should be allowed as a credit against UK tax payable by a partner of the LLC upon distribution. This argument was not considered by the Upper Tribunal and we recommend that it should be raised by Mr Anson in the event the case is appealed. Even if, on the facts, it were held that Mr Anson could not avail of the new treaty provision, it would be of great interest to receive judicial consideration of the interpretation of the new treaty provision – particularly given the scope for conflicts of entity classification in UK/US structures and the fact that it appears to be a unique provision which, as far as the author is aware, has not been included in any other tax treaty.

Conor Delaney works for Milestone International Tax Consultants Limited in London. He is a solicitor qualified in England and Wales, and has a Masters degree in International Taxation from Leiden University. He may be contacted by email at: conor@milestonetax.com

NOTES

[1] Swift, paragraph 2
[2] Swift, paragraph 1
[3] Swift, paragraph 4.3
[4] Anson, paragraph 9
[5] "Klaus Vogel on Double Taxation Conventions" Introduction paragraph 82c
[6] Swift, paragraph 3.7
[7] Swift, paragraph 3.8
[8] Swift, paragraph 3.13
[9] Vogel, Introduction para 71