Tax Treaty Case Law around the Globe 2014

Editors:

Eric Kemmeren
Daniël Smit
Peter Essers
Michael Lang
Jeffrey Owens
Pasquale Pistone
Alexander Rust
Josef Schuch
Claus Staringer
Alfred Storck

Linde

IBFD

IBFD

Visitors' address:
Rietlandpark 301
1019 DW Amsterdam
The Netherlands

Postal address:
P.O. Box 20237
1000 HE Amsterdam
The Netherlands

Telephone: 31-20-554 0100
Fax: 31-20-622 8658
www.ibfd.org

ISBN 978-90-8722-298-7 (print)
ISBN 978-3-7073-3084-7 (Linde)
ISBN 978-90-8722-299-4 (eBook)

Chapter 4

United Kingdom: *Michael Macklin v. Commissioners for Her Majesty's Revenue and Customs**

Philip Baker

4.1. Introduction

This contribution concerns a decision of the First-tier Tribunal (Tax Chamber) delivered on 10 October 2013. The Tribunal members were Judge John Walters QC and Mr Derek Speller. It concerned the interpretation of provisions in article 17 of the United Kingdom-United States Double Taxation Convention of 24 July 2001.[1] The case concerned the meaning of a pension scheme "established in a Contracting State".

4.2. Facts of the case

The background facts are relatively straightforward. Mr Maplin is a UK-resident individual. From 1976 to 1998 he worked for the World Bank in the United States. While employed by the World Bank, he participated in the World Bank's Staff Retirement Plan (referred to in the case as the "SRP"). After he ceased working for the World Bank he returned to live in the United Kingdom and began drawing his pension. He claimed that the pension was exempt from tax in the United Kingdom under article 17(1)(b) of the United Kingdom-United States Double Taxation Convention, which provided as follows:

> **Article 17: Pensions, Social Security, Annuities, Alimony, and Child Support**
>
> 1.a) Pensions and other similar remuneration beneficially owned by a resident of a Contracting State shall be taxable only in that State.
>
> b) Notwithstanding sub-paragraph a) of this paragraph, the amount of any such pension or remuneration paid from *a pension scheme established in*

* UK: First-Tier Tribunal, Tax Chamber, 22-24 Jan. 2013, TC/2011/03655.

1. The case is reported at (2013) 16 ITLR 355 (with a commentary by J.F. Avery Jones) and also in [2014] Simon's First-tier Tax Decisions (SFTD) 290.

> *the other Contracting State* that would be exempt from taxation in that other State if the beneficial owner were a resident thereof shall be exempt from taxation in the first-mentioned State. [emphasis added]

The term "pension scheme" was also defined in the general definitions article of the Treaty as follows:

> **Article 3: General definitions**
>
> o) the term "pension scheme" means any plan, scheme, fund, trust or other arrangement *established in a Contracting State* which is:
> (i) generally exempt from income taxation in that State; and
> (ii) operated principally to administer or provide pension or retirement benefits or to earn income for the benefit of one or more such arrangements. [emphasis added]

Thus, under both the definition of "pension scheme" under article 17, which provided for the exemption, and under article 3(1)(o), the scheme had to be "established in a Contracting State". The sole issue for determination under the Treaty was whether or not the SRP was "established in [the United States]".

Here, certain further facts are necessary.

The World Bank (technically the International Bank for Reconstruction and Development) is established by articles of agreement drawn up under the aegis of the United Nations. Under those articles, the principal office of the World Bank is and always has been in the United States, and its headquarters has always been located at Washington DC. Two thirds of the World Bank staff is based in Washington DC. In 1948, the World Bank established the SRP under a trust deed, of which the World Bank is itself the trustee. All meetings of the committees of the SRP are held in Washington DC and most of its assets are in the custody of a New York bank. All the administration and management of the SRP is in the United States.

However, the SRP is not a pension scheme established in accordance with US tax law. The SRP is immune from taxation in the United States on its investment income not by virtue of US law, but by virtue of the immunities of the World Bank. There was uncontested evidence, however, that the US Internal Revenue Service treated the SRP as equivalent to a US pension scheme and exempted all US-resident pensioners from US taxation on their pensions from the scheme. Thus, if one turns back to the definition of a pension scheme in article 3(1)(o) of the Treaty, the SRP was generally exempt from income taxation in the United States and was operated to administer or provide pension or retirement benefits. The sole issue was whether it was established in the United States.

4.3. The Tribunal decision

The First-tier Tribunal heard expert evidence from US lawyers called both by Mr Macklin and by the HMRC. The Tribunal preferred the evidence of the expert for the HMRC, who concluded that under US law, the SRP would not be regarded as established in the United States because it failed both the "court" and the "control" tests: no US court had jurisdiction over the SRP and no US person had control over the trust. The SRP was not governed by US law or established in accordance with US law on pensions or taxation.

The Tribunal then turned to the question of treaty interpretation. As the phrase "established in a Contracting State" was not defined in the Treaty, article 3(2) would be relevant as the general rule for undefined terms:

> **Article 3**
>
> 2. As regards the application of this Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, or the competent authorities agree on a common meaning pursuant to the provisions of Article 26 (Mutual Agreement Procedure) of this Convention, have the meaning which it has at that time under the law of that State for the purposes of the taxes to which this Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.

One issue which the Tribunal does not face squarely is whether the context otherwise requires that the domestic definition should not be applied and, linked with that, the question of whether it should be US law (as the state in which the pension scheme was established, if it was established in any Contracting State) or the law of the United Kingdom (as the country applying the treaty) which should apply.

One area in which it is difficult to fault the Tribunal is in the approach to the interpretation of tax treaties. The Tribunal took a very standard approach, based on the dicta of Mummery J in *Commerzbank*[2] The Tribunal had this to say about the approach to treaty interpretation:

2. [1990] STC 285 at 297 to 298.

> 80. Both Mr Schwarz and Mr Yates submitted that we should follow the approach to the interpretation of tax treaties contained in the judgment of Mummery J in *IRC v Commerzbank* [1990] STC 285 at 297-298, endorsed by the Court of Appeal in *Revenue and Customs Commissioners v Smallwood & Anor* [2010] EWCA Civ 778 at [26] and *Bayfine UK v HM Revenue and Customs* [2011] EWCA Civ 304.
>
> 81. In *Commerzbank*, Mummery J said that the House of Lords in the earlier case of *Fothergill v Monarch Airlines* [1981] AC 251 had indicated the proper approach to be adopted by the court to the interpretation of provisions in a double taxation convention. He made the following points.
>
> First, one looks for the clear meaning of the words used in context, adopting a purposive approach.
>
> Secondly, the language of an international convention should be interpreted, not as an English statute, but "unconstrained by technical rules of English law, or by English legal precedent, [and] on broad principles of general acceptation".
>
> Thirdly, one of the applicable principles of interpretation is that "a treaty should be interpreted in good faith and 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", the "essential quest in the application of treaties" being "the search for the real intention of the contracting parties in using the language employed by them" ...
>
> Fourthly, in cases of ambiguity or manifest absurdity, recourse may be had to "supplementary means of interpretation" including *travaux préparatoires*.
>
> Fifthly, subsequent commentaries or decisions of foreign courts may have persuasive value.
>
> Sixthly, such aids to the interpretation of a treaty are not a substitute for study of the terms of the convention.

This is now a very standard statement of the approach of the UK courts to the interpretation of tax treaties. The first element of this approach is of course to adopt a purposive approach: except in one paragraph, it is hard to see that the Tribunal really sought to understand the underlying purpose behind article 17(1)(b) of the Treaty.

The final decision of the Tribunal is relatively short.[3] The Tribunal took the view that it had to determine the meaning of the phrase "established in a Contracting State" in accordance with UK law for the purposes of income tax or under general, English or UK law. That seems surprising since under no circumstances could it have been the case that the SRP was established in the United Kingdom.

3. Contained in paragraphs 103 to 111 of the decision.

The Tribunal regarded as "very persuasive" a reference to the Exchange of Notes that was made at the time of the conclusion of the Treaty in 2001. This Exchange of Notes contained the following elaboration of the definition of "pension scheme" in article 3(1)(o) of the Treaty as follows:

> ***Exchange of Notes***
>
> *With reference to sub-paragraph o) of paragraph 1 of Article 3:*
>
> it is understood that *pension schemes shall include* the following and any identical or substantially similar schemes which are established pursuant to legislation introduced after the date of signature of the Convention:
>
> ...
>
> b) under the law of the United States, qualified plans under section 401(a) of the Internal Revenue Code, individual retirement plans (including individual retirement plans that are part of a simplified employee pension plan that satisfies section 408(k), individual retirement accounts, individual retirement annuities, section 408(p) accounts, and Roth IRAs under section 408A), section 403(a) qualified annuity plans, and section 403(b) plans ... [emphasis added]

This Exchange of Notes gives illustrative examples of what the definition of "pension scheme" includes. It does not purport to be a comprehensive list of all the types of pension schemes that fall within the Treaty.

The Tribunal, however, concluded that this provided a sensible and workable definition, and that it was clearly intended by the treaty negotiators that a pension scheme should be "established under and in conformity with a relevant Contracting State's tax legislation relating to pension schemes". Since the World Bank's SRP was not established in accordance with US tax legislation – even though the IRS treated it as if it were – it could not be established in the United States.

The Tribunal established that the SRP was set up physically in the United States, but nevertheless concluded that it did not have a sufficient legal nexus with the United States to support the view that it was established in the United States for relevant purposes.

Lastly, at paragraph 110, the Tribunal makes a nodding gesture towards the purposive approach by stating the following:

> 110. We do not accept that the purpose of the exemption under article 17(1)(b) of the DTA is to provide equal treatment for pensioners resident in either Contracting State with regard to the taxation of pension income. It is, as we discern it, to give exemption in both Contracting States to pension income which

> the parties to the DTA have chosen to exempt from income taxation under their respective domestic laws because they are schemes operated principally to administer or provide pension or retirement benefits, etc.

The reasoning of the Tribunal seems somewhat circular here. Because the purpose of the exemption is to provide exemption for schemes established under a state's tax legislation, therefore it was only compatible with the purpose that it should apply to schemes established under that tax legislation. The Tribunal could just as well have concluded that, as the US treated all US-resident pensioners of the World Bank SRP as exempt from taxation, the United Kingdom should have agreed to provide exactly the same tax treatment.

At the time of writing, it is understood that an appeal has been lodged to the Upper Tribunal and is awaiting hearing. The amount involved in terms of tax is not very large, but it is understood that there are other pensioners from the World Bank (or possibly other international organizations) who are affected by the decision.

4.4. Comments on the Tribunal's reasoning

One must ask, first of all, whether the decision is a sensible one, bearing in mind that the United States (being the country to which most pensioners of the World Bank are likely to reside, given that two thirds of the employees come from the United States) granted exemption for the pensioners. It seems very strange that the United Kingdom should not have granted an exemption. One is inclined to wonder whether the scheme was not operated so as to provide pensions at a certain level on the assumption that the pensioners would be exempt from tax no matter where they were residing.

One point that is somewhat surprising about the case is that the articles of agreement of the World Bank did not appear to provide for an exemption for pensions paid to former employees – or at least, such an exemption is not mentioned in the case (and if there were such an exemption, one would expect it to be mentioned). As an international institution, one might have expected that those articles would provide rules relating to pension recipients. It is a little surprising to find this case being discussed under the United Kingdom-United States Double Taxation Convention at all.

It seems quite clear that the Tribunal misdirected itself so far as article 3(2) of the Treaty is concerned. It is hard to see why the UK meaning of the term "established" could have been at all relevant when, if anything, the scheme was only ever possibly established in the United States.

Equally, it is difficult to see the relevance of the Exchange of Notes that is clearly only illustrative and clarificatory of those types of pensions schemes that are within the definition. It is not a comprehensive definition and does not suggest in any way that schemes other than those approved under US tax law could not qualify.

As a final comment, the judgment records at paragraph [52] that an attempt to invoke the mutual agreement procedure failed. This is really an embarrassing failure on the part of the two competent authorities, both of them authorities with sufficient experience not to let something like that happen. The amounts involved in this case were relatively small and clearly this is an issue of tax treaty interpretation that should have been left to the competent authorities. If the competent authorities cannot resolve a problem like this on a mutually satisfactory basis, it is hard to see why they should ever be trusted with the mutual agreement procedure.

4.5. Conclusions

In several respects, this decision is not entirely satisfactory. It is to be hoped that an appeal hearing will produce a better-reasoned outcome.