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Burlington and treaty purpose tests

Originally appeared in Tax Journal – September 16, 2022

Speed read

The First-tier Tribunal in *Burlington Loan Management DAC v HMRC* upheld the taxpayer's appeal, holding that HMRC was wrong to assert that there was a 'main purpose' of taking advantage of the interest exemption in a tax treaty. The judgment is helpful, in that it suggests that knowledge of a tax benefit arising from a taxpayer's status can be merely part of the 'scenery' than a predominant motive, and it provides a dividing line between vanilla sales and more complex structures where the seller retains an economic interest. However, due to the parties having conceded that UK domestic law applied, the confused approach to domestic purpose tests appears now to be extending to treaty purpose tests, the impact of which will be increasingly important in a post-MLI world given its principal purpose test.

Despite the proliferation of 'purpose tests' – which deny tax benefits where transactions were effected for proscribed objectives – the approach of HMRC and the judiciary to their interpretation is still not settled. B*urlington Loan Management DAC v HMRC* [2022] UKFTT 290 (TC) is the first UK case about the interpretation of a purpose rule in a double tax treaty, and extends the recent approach of the judiciary in cases like *HMRC v Blackrock HoldCo 5 LLC* [2022] UKUT 199 (TCC) to the international fiscal arena.

Background

SAAD Investment Company Ltd (SICL), a Cayman company, was owed £142m by Lehman Brothers International (Europe) (LBIE), which was in administration. That principal amount was paid out in the administration but due to a surplus SCIL was entitled to be paid statutory interest, the sum of which amounted to £91m. Concurrently the Court of Appeal had decided that statutory interest accruing during administration was 'yearly interest' and therefore was subject to UK withholding tax (though at that time an appeal was pending before the Supreme Court). Since SCIL, as a Cayman-resident company, was not entitled to any UK exemption from withholding tax, the value of the receivable to it, should the Court of Appeal's decision stand on appeal (which it eventually did), would be some 80 per cent of £91m. As a result it sought to sell its debt claim in the secondary market using a broker.

The broker found a buyer: the taxpayer, Burlington Loan Management DAC, which had purchased a significant number of other LBIE debt claims and was resident in the Republic of Ireland. In a back-to-back trade, the broker bought the debt from SCIL for 90.8 per cent of the £91m face value and then sold it to Burlington for 92 per cent. Relevantly, SCIL was not told of the identity of Burlington until after the terms of the purchase was agreed, only shortly before it signed. The First-tier Tribunal (FTT) did not come to a view on the reason SICL asked for Burlington's identity, but determined as a matter of fact that this was not for tax reasons.

In due course the administrators paid Burlington its £91m of statutory interest, less income tax deducted at source at 20 per cent. Burlington applied to HMRC to have the income tax refunded, on the basis that it was an ROI resident entitled to full relief from UK tax on interest under article 12 of the UK/ROI treaty. HMRC denied the refund, asserting that article 12(5) of the treaty applied, which states:

'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.'

Burlington appealed to the FTT.

Interpretation of article 12(5)

The taxpayer and HMRC differed on a number of preliminary points relating to the interpretation of article 12(5). On the question of whether only Burlington could have a purpose which fell afoul of article 12(5) or if SICL could too, the FTT said the latter was correct; SICL was a 'person' whose intentions could engage the provisions of article 12(5) even if, as a Cayman entity, it could not be directly entitled to benefits from the treaty. This seems to the author as correct; in the context of a treaty-shopping provision, the requisite intention may often be of a third party who would not, absent the shopping, be entitled to treaty benefits.

The parties also disagreed on whether 'take advantage', as the taxpayer asserted, required some form of artifice or structured arrangement, or could apply to ordinary commercial transactions which benefited from treaty relief. The FTT found that the latter was correct: there was no contextual support or extrinsic support for reading a restrictive meaning onto the words 'take advantage', although the FTT found that the phrase did connote some negative intentions.

What sort of purpose trips the article 12(5) alarm? Is it sufficient if a person intends that another has the advantage of article 12, or do they have to intend to benefit from it themselves? Does the person have to intend to benefit from article 12 in particular, or is it sufficient that they intend some sort of relief from UK withholding tax to be available, domestic or treaty-based? To both questions the FTT found in the taxpayer's favour, saying that article 12(5) required that a person must intend to themselves benefit from article 12, and that it is article 12, and not exemptions from withholding tax generally, that are relevant. It would not be sufficient in this case for HMRC to establish that SICL knew that its broker would likely find someone who benefited from some form of exemption from UK withholding tax on interest. HMRC would have to demonstrate at a minimum that SICL or Burlington knew that it was article 12 of the Irish treaty in particular that they were 'taking advantage' of. Again, for an antitreaty shopping rule these conclusions seem correct; in the classic case of treaty shopping the entity inserted to achieve the treaty benefits would know both that it is to (hopefully) receive the treaty benefits and the benefits are under the particular treaty it was interposed to receive.

Approach to determining purpose

Having determined who could have the purpose, and what purpose was relevant, the key question was how the FTT should go about determining that person's purpose. The FTT records that the parties were agreed that the phrase 'main purpose or one of the main purposes', as it was undefined by the treaty, could be interpreted in accordance with the provisions of the tax law of the UK as a result of the application of article 3(2) of the treaty, which provides:

'As regards the application of this Convention by a Contracting State any term not otherwise defined shall, unless the context otherwise requires, have the meaning which it has under the laws of that Contracting State relating to the taxes which are the subject of this Convention.'

Applying UK case law, the parties agreed that determining a person's main purpose involved determining his or her subjective purpose, which was a question of fact (see *IRC v Brebner* [1967] 1 All ER 779 (HL)). However, they disagreed on whether, as HMRC appeared to assert based on the summary of the principle of *Mallalieu v Drummond* [1983] STC 665 in *Vodafone v Shaw* [1997] STC 734, the 'inevitable and inextricable consequences' of the transaction predominated.

The FTT found neither of the parties' approaches helpful and instead found guidance in the recent Upper Tribunal unallowable purpose decision in *Blackrock*. The FTT decided that *Blackrock* stood for the proposition that subjective purpose was not solely determined by reference to the inevitable and inextricable consequences of a transaction, but that those consequences formed part of the suite of evidence that a tribunal would consider to determine the real subjective purpose. As the unallowable purpose test was 'not dissimilar' to article 12(5), the FTT felt it should follow that approach.

Determining purpose

Applying that approach to the facts, the FTT then asked whether Burlington had a main purpose of taking advantage of article 12, and concluded that it did not. The benefit of the treaty was 'an accepted fact' and 'an inevitable consequence of being resident in the ROI', as well as being 'merely part of the scenery' in which Burlington made its decision to purchase the debt from SCIL.

Burlington was a long-established company, not one set up to access the treaty for the purposes of this transaction specifically. The sole purpose of Burlington was to profit from the difference in the price it paid for the loan and the amounts it ultimately received from the administrators, and the fact that a component of that profit resulted from Burlington being entitled to the benefit of article 12 did not make it any part of its subjective purpose.

Conversely, in asking whether SICL had a main purpose of taking advantage of article 12, the FTT found it helpful to focus on what SICL knew of Burlington. Because SICL did not know Burlington was the ultimate purchaser at the time an agreement in principle as to price and other terms was agreed and therefore did not know the ultimate purchaser was Irish and could benefit from the UK/ROI treaty, it could not have had, at that point, the purpose of relying on article 12. The fact that SICL subsequently became aware of this fact did not give a new main purpose of taking advantage of article 12. The position advanced by HMRC would mean that, in any scenario where a seller did not benefit from any UK withholding tax exemptions but potential buyers did, and therefore there was a market price paid which reflected these different tax treatments, the availability of the tax relief to the purchaser would depend on whether the seller happened to know why the buyer was entitled to that UK withholding tax exemption. As a result, the FTT said that SICL did not gain a new main purpose of taking advantage of article 12(5) when it became aware Burlington was the ultimate purchaser.

The FTT went further than this, saying that, whilst it did not consider that there was any basis for introducing any gloss on what 'take advantage' means, for someone to have a 'main purpose of taking advantage' of the treaty there must be something more than a simple sale. The FTT cites cases where the seller retains some economic interest in the interest payments (such as 'conduit' financing) as situations where it may have a main purpose of 'taking advantage.' Arguably, then, even if SICL had approached Burlington directly from the outset, knowing of its entitlement under article 12, it would not have had the requisite purpose.

Comment

The FTT's decision is welcome in many respects. The conclusion is clearly the correct one: it must be right that unconnected buyers and sellers can agree to pay somewhere between 80 per cent and 100 per cent of the value of interest if the buyer can benefit from a withholding tax exemption and the seller cannot; if they could not, it would not be profitable for either to trade with the other.

While the FTT was unable to agree with the taxpayer that 'taking advantage' should be read down so it only encompassed arrangements involving some element of artificiality, it did end up coming to a similar conclusion where it determined that to have a 'main purpose of taking advantage' a person needed to intend something more than share the tax benefit through a purchase price reached at arm's length with an independent purchaser. This is a helpful conclusion and many institutional purchasers of debt on the secondary markets will be reassured by this part of the judgment.

Although the conclusion reached seems to be right, the approach taken to the interpretation of article 12(5) presents some difficulties. The parties appear to have conceded that article 3(2) meant that the UK domestic law approach to 'main purpose' could be applied directly to article 12(5), but it is not obvious that article 3(2) has that necessary implication and it would have been helpful to have seen argument on that point. Article 3(2) only applies if the context does not require otherwise; in other cases, as in the meaning of 'beneficial ownership' of interest in article 12, the 'international fiscal meaning' is something quite different to the UK domestic meaning. As the OECD model commentary to article 3(2) states, 'the context is determined in particular by the intention of the Contracting States when signing the Convention.' Is it therefore correct that case law concerned with whether an expense was incurred wholly and exclusively for the purposes of a trade (such as *Mallalieu and Vodafone v Shaw*) and whether a loan relationship has been entered into for an unallowable purpose (*Blackrock*) are directly applicable to the interpretation of an OECD model form anti-avoidance rule determining the availability of an interest exemption in a bilateral tax treaty between the UK and the Republic

of Ireland? If the interpretation of domestic tax legislation is, as it is frequently said to be, now more purposive and context-sensitive how can these interpretations be applied wholesale to article 12(5)? Although the FTT was not asked by counsel to address these questions, they seem important ones to be answered.

Indeed, in other parts of the judgment, the FTT appears to take a view of article 3(2) which is at odds to the position the parties agreed. In its discussion of the admissibility of Parliamentary statements to the interpretation of article 12(5), it says that article 3(2) only applies where the relevant term has a 'particular meaning' in domestic law, and in its view 'take advantage' had 'no distinct and special meaning as a matter of UK domestic law'. But neither does 'main purpose': whilst 'main purpose' is certainly used as a concept in UK domestic legislation, it is not a term of art with a special meaning that must be imported to make sense of the UK/ROI treaty (like 'body corporate', or 'dividends') but rather an ordinary term given its usual meaning by looking at the subjective intention of the relevant person.

The FTT's reliance on the Upper Tribunal's decision in *Blackrock* is also unhelpful. *Blackrock* has been criticised, including in these pages (see 'Purpose-based rules: have we hit BlackRock-bottom?' (C Christofi), Tax Journal, September 2, 2022), for not giving a workable approach to purpose tests. In addition, the judgment in Blackrock was given on July 19, 2022, and published on July 22, whilst oral arguments in Burlington were heard between 19 to 21 July, so it is unlikely that the FTT had the advantage of counsels' oral submissions on that decision, and they certainly would not have been able to address it in their skeletons.

The FTT quotes *Blackrock* in support of not being constrained at looking at inevitable and inextricable consequences as the 'sole benchmark' of the subjective purposes of a person. But the courts were not, in fact, so constrained in *Mallalieu* or *Vodafone v Shaw* in any event. The reason the taxpayers faced difficulties in those cases is because they turned on whether expenses were incurred 'wholly and exclusively' for the purposes of a trade, and so any additional purpose the courts found was fatal to their cases. Not so with the unallowable purpose test in *Blackrock* and not so with article 12(5), which both look at what the 'main purposes' were. The taxpayers in these situations can therefore accept that inevitable and inextricable consequences may have been their unconscious purposes because they can still argue these did not amount to main purposes, and did not supplant the conscious purpose for which they entered into the transaction. As a result, Blackrock does not appear to be much assistance: Mallalieu does not have the implication that seemed to have been suggested in argument by HMRC.

There are other difficulties with the FTT using *Blackrock* for support. In *Blackrock*, the taxpayer argued that in any case where interest is incurred it will be deductible; it does not follow that the interest was incurred for tax avoidance purposes. The Upper Tribunal disagreed, saying that the group would not have put the taxpayer in place 'in the absence of the UK tax benefits of doing so'. Absent the tax benefits, the loan would not have been entered into. As a result, the taxpayer in that case had a main purpose of obtaining a tax advantage.

This does not sit easily with the conclusions of the FTT in Burlington that the UK tax benefits were 'part of the scenery' and were 'an inevitable consequence of being resident in the ROI'. If one were to apply a similar 'but for' test as that applied by the Upper Tribunal in *Blackrock*, it would be easy to say that Burlington would not have entered into the assignment were it not for the provisions of article 12 exempting it from UK withholding tax – as it then would not have paid 92 per cent of the value of any interest but only a maximum of 80 per cent. For what reason did the Upper Tribunal in *Blackrock* engage in counterfactual analysis but the FTT in Burlington not do so if it is taking the same approach to the 'main purpose' test? In fact, it seems as though the FTT has taken an approach to the 'main purpose' test which is informed by its context in the double tax treaty, and for that reason diverged from the 'but for' test used by the Upper Tribunal in *Blackrock*, but there would be clearer justification for this different approach if the FTT had been directed by counsel to say that article 3(2) does not apply and an international fiscal meaning of 'main purpose' must be developed.

Conclusion

The decision of the FTT is reassuring, and it provides a helpful line in the sand between straightforward loan sales on the one hand and transactions where the seller retains some economic interest as a way to indirectly benefit from the treaty. In addition, it is helpful that despite Burlington being clearly aware of its entitlement to treaty benefits, the FTT found that this did not give it a main purpose of achieving those benefits: they were merely the 'scenery' in which it made its decisions.

It seems likely that HMRC will appeal and, whilst in principle the FTT's finding that Burlington did not have a main purpose of taking advantage of article 12 is a finding of fact which on appeal is subject to the high threshold in *Edwards v Bairstow* [1956] AC 14, as the Upper Tribunal's decision in Blackrock itself demonstrates this bar can easily be hurdled by a motivated tribunal.

Taxpayers and their advisers will await any appeals with interest given their wide-ranging ramifications.

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