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A legal update from Dechert's International and Domestic Tax Group

An Update on the Availability of Relief under the US/UK Double Tax Treaty

The UK Courts have recently passed judgment in the latest stages of two significant cases regarding the availability of relief under the US/UK Double Tax Treaty. The first case, *Swift*, overruled an earlier decision allowing a UK investor in a US LLC to claim relief against US tax paid on the profits of the LLC. The second, *Bayfine*, confirmed that the UK Courts will apply a purposive approach to interpreting the US/UK tax treaty to prevent claimants seeking to apply treaty provisions in a manner contrary to their intention. This DechertOnPoint provides further information on the recent decisions and explains possible consequences for those relying on the treaty.

Swift (*HMRC v Anson*)

In *Swift*, the Upper Tribunal (overturning a 2010 decision of the First Tier Tribunal) ruled that double tax relief is not available for a UK taxpayer's share of the profits of a Delaware LLC.

Double taxation arises where the same income or gains are taxed in two jurisdictions. The US/UK Double Tax Treaty provides that US tax is allowable as a credit against any UK tax computed by reference to the same profits or income. To determine whether a participant in a non-UK entity is entitled to treaty relief on tax incurred on that entity's income, it is necessary to establish whether, for UK tax purposes, the entity is "transparent" (in which case the participant is entitled to relief) or "opaque" (in which case, the person is not entitled to relief). HM Revenue & Customs ("HMRC") apply a number of different tests to determine whether an entity is transparent or opaque.

Historically, HMRC have taken the view that US LLCs are opaque, taxable entities. As a consequence, the UK taxes members of a LLC by reference to distributions of profits made by the LLC and not by reference of the income of the LLC as it arises. Credit is only available for tax paid in the US on the profits of the LLC if the UK participator is a company that controls at least 10% of the voting power of the LLC.

The UK taxpayer in *Swift* was a member of a Delaware LLC. All of the LLC's profits were required to be distributed to its participants. As the LLC had not elected to be treated as a corporation for US tax purposes each member (rather than the LLC itself) was subject to US federal and state tax on their share of the profits. The UK taxpayer claimed double tax relief in respect of his income from the LLC. HMRC denied the claim for relief. The taxpayer appealed to the UK's First Tier Tax Tribunal and the Tribunal found, in favour of the taxpayer, that he was entitled to relief under the treaty. The Tribunal held that members of the LLC were entitled to its profits as they arose and therefore double tax had been paid on the same source of income.

HMRC appealed against the decision and the Upper Tribunal recently allowed the appeal. The Upper Tribunal considered that it was crucial to establish whether the taxpayer had a proprietary right in the underlying assets of the LLC. It was a matter of US law that the taxpayer did not have such a proprietary interest in the assets and it followed that the taxpayer could not therefore have a proprietary interest in income from those assets. The mere contractual obligation of the LLC to distribute its profits did not make those profits of the same source as the LLC's underlying income.

Notwithstanding the decision of the First Tier Tribunal, HMRC continued to apply its historic practice to LLCs pending the resolution of its appeal. As a consequence, the Upper Tribunal's decision should not change HMRC's policy in this area. Even so, the decision of the Upper Tribunal should restore some clarity to the rules regarding the treatment of Delaware LLCs in the UK.

Bayfine (*Bayfine v HMRC*)

Bayfine concerned two UK-resident companies which entered into self-cancelling forward contracts so that one was bound to make a profit and the other was bound to make an equal loss. The contracts were one stage of a chain of transactions designed to produce a tax loss in the UK.

The profit making company was a disregarded entity for US tax purposes meaning its profit was subject to both UK corporation tax and US tax (through its US parent). It was intended that the profit making company would claim credit for US tax under the US/UK double tax treaty.

The case was decided differently on each hearing and was appealed on a number of occasions. Most recently, the Supreme Court refused the taxpayer permission to appeal against the Court of Appeal's decision. As a consequence, the Court of Appeal's decision outlined below remains law.

In overview, the High Court overturned the Tribunals' decision that no double tax relief was available. Subsequently the Court of Appeal allowed HMRC's appeal and overturned the decision of the High Court. The Court of Appeal considered that to apply the tax treaty as interpreted by the taxpayer would require both the US and the UK to give relief for tax paid in the other state. Such an application would be circular and contrary to the purpose of giving relief for double taxation. Its effect would be to give double relief.

This purposive interpretation of the treaty was arrived at taking into account the most fundamental principle behind the treaty—to avoid double tax and fiscal evasion. However, to interpret the treaty in such a way could be viewed as setting a precedent for overruling the terms of a treaty to ensure that its operation is consistent with its purpose. This may be particularly relevant in circumstances where HMRC consider a taxpayer's actions to have a tax avoidance or evasion motive. It is to be hoped that HMRC will not seek to apply the *Bayfine* decision in such a way. The outcome of the Government's recent consultation on possible legislation to counter tax avoidance schemes designed to exploit double tax treaties may provide further indication of HMRC's intentions in this area.

Practice group contacts

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