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Burlington Loan Management DAC v HMRC: the right decision for the wrong reasons?

For the first time, the FTT has been asked to consider a principal purpose test in a double tax treaty. With a win for the taxpayer at this stage – which one might consider to be the right outcome, albeit not necessarily for the reasons advanced in the judgment – it remains to be seen whether HMRC will launch an appeal. But for now, at least, it is a little clearer how domestic courts will interpret such treaty provisions; and with principal purpose tests now commonplace in light of the widespread adoption of the MLI, the significance of this for taxpayers and HMRC alike should not be underestimated.

Background

Prior to entering administration in 2008, Lehman Brothers International (Europe) (***LBIE***) owed money to SAAD Investments Company Ltd (***SICL***). SICL subsequently entered liquidation. In August 2016, a deed of settlement was entered into between LBIE's administrators and SICL's liquidators confirming the principal amount of the debt as £142m. LBIE’s administrators discharged that debt in full in September 2016, with SICL retaining the right to receive all other amounts which might be payable in respect of the debt-claim – namely £90m of interest.

SICL's liquidators engaged Jefferies as a broker to arrange the sale of that remaining debt on the secondary market, and in February 2018 it was sold to Burlington Loan Management (***BLM***) (via an interim assignment to Jefferies) for £83.55m. LBIE's administrators paid £90m to BLM in July 2018, fully discharging the debt. A 20% withholding on account of UK income tax was applied to that payment under section 874 ITA 2007.

It was BLM's entitlement to a refund of that withholding tax that was in issue here – more specifically, whether the principal purpose test in Article 12(5) of the UK/Ireland double tax treaty (the ***DTT***) applied to that payment of interest such that the exemption from UK withholding tax contained in Article 12(1) was precluded from applying.

Interpretation of Article 12 of the DTT

So far as is relevant for these purposes, Article 12(1) of the DTT exempts from UK tax interest derived and beneficially owned by an Irish resident. Article 12(5) contains a principal purpose test restricting the relief offered by that provision: "*[t]he 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*."

The sole issue between the parties was whether the "*main purpose*", or "*one of the main purposes*", of "*any person concerned with*" the assignment of the £90m claim from SICL to BLM was to "*take advantage*" of Article 12.

(Interestingly, there was no discussion as to whether there actually was “*an assignment of a debt-claim in respect of which… interest is paid*”. One wonders why BLM did not advance an argument that, because the underlying £142m debt-claim was not itself assigned, Article 12(5) could not be in point. From a policy perspective, this may have been an incoherent way of the FTT limiting the scope of the principal purpose test, but considering the language of the provision in isolation, such an argument appears difficult to resist.)

It was common ground between the parties that Article 12(5) had to be interpreted in good faith in accordance with the ordinary meaning of the terms used and in light of the DTT’s object and purpose, but there was no consensus as to how such principles should be applied. Taking each part of the provision in turn:

“The main purpose or one of the main purposes”

It was common ground between the parties that the approach in *Brebner* and *Travel Document Services* should be followed here: i.e. that this was a question of fact to be assessed upon a consideration of all the relevant evidence and the proper inferences to be drawn from that evidence; that the “*subjective intentions*” of the relevant person must be considered; and that "*main*" connotated

some degree of importance rather than merely "*more than trivial*". The only point the FTT was asked to consider was whether assessing a person's "*subjective intentions*" was limited to considering their "*conscious motives*". HMRC argued that the FTT was not so limited because, applying *Vodafone Cellular Ltd v Shaw*, some consequences are so inevitably and inextricably involved in an action that unless merely incidental they must be taken to be a purpose for which that action was taken.

The FTT, relying on obiter comments by the Upper Tribunal in *BlackRock*, found that although it was not the case that the inevitable and inextricable consequences of an action should be regarded as the sole benchmark for determining the subjective purposes of the person taking it, courts should nonetheless treat such consequences as forming part of the overall factual matrix to be considered when answering the question. This is the first judicial comment on this aspect of the *BlackRock* decision, and – helpfully for taxpayers – seems to support the Upper Tribunal's reasoning.

"Any person concerned with the creation or assignment of the debt-claim in respect of which the interest is paid"

BLM argued that SICL was not a "*person concerned with the creation or assignment*" of the debt-claim. This was not because of the back-to-back assignments via Jefferies, but rather because Article 1 states that the DTT applies only to "*persons who are residents of one or both of the Contracting States*", such that "*persons*" in Article 12(5) must be limited to persons resident in the UK and/or Ireland – something SICL, as a Cayman resident company, was not.

Perhaps unsurprisingly, the FTT emphatically rejected this argument, agreeing with HMRC that such an approach would ignore Article 3(1)(g) (which defines "*person*" without any such territorial restriction) and would render many other provisions of the DTT unworkable.

"Take advantage of this Article"

It was common ground between the parties that this phrase had to take its ordinary meaning, and to do so, both sought to rely on the Oxford English Dictionary definition – i.e. "*to avail oneself of a person or thing… frequently in a negative sense*".

BLM argued that, considering the context in the DTT, the words "*take advantage*" connate the concept of taking artificial steps or making artificial arrangements to obtain a treaty benefit that would not ordinarily follow as a consequence of the relevant person's residence (i.e. treaty shopping) and both artifice and abuse is needed for this element of Article 12(5) to be met.

HMRC disagreed, arguing that there was no basis for such a gloss to confine this principal purpose test to instances of treaty shopping. In context, there is a need for an abuse of Article 12(1) – put another way, this is an example of the phrase "*taking advantage*" meaning to avail oneself of something in a "*negative sense*" – but it does not necessarily follow that artificial steps or arrangements are required.

The FTT held that, although abuse of Article 12(1) was necessary for Article 12(5) to be in point, this did <u>not</u> require artificial steps or arrangements. There is nothing in Article 12(5) which imposes this limitation; the preamble to the DTT does not suggest it should be confined this narrowly; and even if the statements made in Parliament about the enactment of, and the explanatory note to, the 1988 statutory instrument giving effect to the DTT were admissible aids to interpretation, they did not support BLM's arguments here.

The "purpose" which it is necessary for a person concerned with an assignment to have

BLM argued that the "*purpose*" needed to engage Article 12(5) was "*taking advantage*" of Article 12(1) of the DTT specifically, such that even assuming that a person selling for a price which reflected the purchaser's ability to benefit from some sort of withholding tax exemption could be said to have a main purpose of "*taking advantage*" of that exemption, that would not engage Article 12(5) unless it was known that that exemption came from Article 12(1).

HMRC disagreed, arguing that the relevant person does not need to know it is Article 12(1) which provides for the relevant exemption, otherwise it would be possible for taxpayers to deliberately close their eyes to the detail to circumvent these rules.

The FTT found in favour of BLM on this point: the relevant person must have a main purpose of "*taking advantage*" of Article 12(1) of the DTT specifically, and a person cannot have a main purpose of "*taking advantage*" of a provision unless that provision has been specifically identified. As result, merely knowing that a purchaser is entitled to some sort of exemption from UK withholding tax, without knowing the precise basis for it, is insufficient to engage Article 12(5).

The FTT's analysis

Having made those findings of law, and having concluded too that the burden of proof in establishing that Article 12(5) was in point rested with HMRC (citing the general principle that the burden of proof should lie with the party who substantially asserts the affirmative of the issue), the FTT determined it had four questions to answer.

(1) Did BLM have, as a main purpose in the assignment of the debt-claim, taking advantage of Article 12(1) itself?

The FTT answered this question in the negative, concluding that although the availability of relief under Article 12(1) was part of the "*scenery*" against which BLM made its offer to buy the debt-claim from SICL, taking advantage of this provision was not a main purpose of the transaction. It is necessary, the FTT explained, to distinguish BLM's reason for doing something and its implicit understanding of the consequences of doing it. BLM was long-established in Ireland, had received UK source interest many times before, and so it was simply an accepted fact of the decision-makers when determining the price BLM was prepared to pay for the debt-claim that UK withholding tax was not a permanent cost for BLM.

(2) Did BLM have, as a main purpose in the assignment of the debt-claim, enabling SICL to take advantage of Article 12(1)?

Again, the FTT said no. Even if this question needed to be answered (which, on balance, it did not; the better reading of Article 12(5) is that a person must have a main purpose of itself taking advantage of Article 12(1)), BLM entered into the transaction solely for its own benefit. The fact that SICL would indirectly economically benefit from BLM's withholding tax exemption under Article 12(1) (i.e. because this increased the value of the asset to BLM and so the purchase price it was prepared to pay) was a consequence, not a purpose.

(3) Did SICL have, as a main purpose in the assignment of the debt-claim, taking advantage of Article 12(1) itself?

Although noted to be the most finely balanced of the four questions, the FTT answered this in the negative too.

If SICL's liquidators had never enquired about the identity of the end purchaser, and arranged the sale via Jefferies without this information, then on the findings of law discussed above, the answer to this question would inevitably be 'no'. However, it was found as a fact that they did know of BLM's identity and place of residence at the material time.

The FTT considered that if this alone were enough to fall foul of Article 12(5), the result would be that the sale of a debt, the interest on which is subject to UK withholding tax, from a seller in a non-treaty jurisdiction to a purchaser in a treaty jurisdiction would always fall foul of a principal purpose test if: (a) the price reflected a difference in the withholding tax position of the seller and all possible purchasers; and (b) the seller happens to be aware of the identity and residence of the ultimate purchaser. That would have an enormous impact on the secondary debt market, and cannot be what was intended. According to the FTT, there is a meaningful difference between: (a) cases in which a person disposes of a debt-claim bearing interest for a market price which happens to reflect the fact that its purchaser (along with many others) enjoys tax attributes which it does not; and (b) cases involving treaty shopping (a feature of which is typically that the resident of the non-treaty jurisdiction typically retains some sort of indirect economic interest in the debt-claim). On that basis, SICL did not have a main purpose of taking advantage of Article 12(1): its only purpose was to realise the debt-claim at a price which reflects the market, and the fact it knew that BLM benefited from Article 12(1) and so was able to pay the market price, is not relevant.

(4) Did SICL have, as a main purpose in the assignment of the debt-claim, enabling BLM to take advantage of Article 12(1)?

The FTT followed the reasoning in relation to question (2) above here: this was probably not a relevant question, and even if it was, it would be answered in the negative because SICL was acting solely in its own interests.

The right outcome?

The judgment in *Burlington Loan Management* is well-written, detailed and easy to follow. And taking a step back, the outcome reached seems to be the right one from a policy perspective. Despite email evidence that SICL was selling the debt-claim "*for withholding tax reasons*", it seems that there was fairly little here to object to on policy grounds: BLM and SICL were third parties, contracting on arm's length terms; BLM had been resident in Ireland for many years; and once the price had been set, SICL had no interest in whether or not BLM successfully obtained the tax exemption it had assumed it would when it offered to acquire the debt-claim for the agreed price. As the FTT noted, if this fact pattern was enough to trigger Article 12(5), there would be significant upheaval to the secondary debt market. More than that, taking HMRC's argument to its logical conclusion, any time a person took into account their counterparty's tax position in pricing a transaction, they would thereby potentially have a main purpose of taking advantage of a tax exemption and so fall foul of any applicable principal purpose test. Given that is a key feature of so many commercial transactions, the ramifications would be huge.

That said, there are parts of the reasoning which are perhaps difficult to follow.

- Firstly, and arguably most importantly, the FTT's analysis in relation to question (3) above (i.e. whether SICL had a main purpose of itself taking advantage of Article 12(1)) appears to be somewhat inconsistent with the conclusion that no artifice is required in order to "*take advantage of this Article*". It is, one might

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suggest, very difficult to conceive of a case in which question (3) could be answered in the affirmative without some degree of artifice being established – despite the FTT explicitly stating that such a requirement would be an unjustified gloss on the principal purpose test. The right conclusion from a policy perspective, sure; but supported by coherent findings of law, perhaps not.

- Secondly, although nothing ultimately turned on this point in this case, the FTT's conclusion that one could only have a "*purpose… to take advantage of this Article*" if Article 12(1) of the DTT had been specifically identified is a little surprising. Does this not provide an easy, and one might say unprincipled, way for taxpayers to avoid falling foul of principal purpose tests? Engage a middleman to arrange a transaction with a counterparty to split the difference of whatever treaty relief they are entitled to and, so long as you do not ask about their identity or residence, you are on safe ground however egregious the fact pattern.
- Finally, and noting in particular the approach of the FTT to the point above, one might question whether it is right to place the burden of establishing whether Article 12(5) applies with HMRC. If so much can turn on whether the taxpayer knew the identity of the end purchaser, would it not make more sense as an evidential matter for the taxpayer to face this burden? It is arguably not so clear cut that it is HMRC "*affirmatively asserting*" that Article 12(5) applies, rather than the taxpayer "affirmatively asserting" that Article 12(1) applies, to render such policy considerations immaterial.

Regardless of the merits or otherwise of these points, taxpayers should take some comfort from this pragmatic and policy-driven approach to principal purposes tests. Whether the FTT's decision in *Burlington Loan Management* will stand up to the scrutiny of higher courts remains to be seen – but for now, at least, the secondary debt market and its participants can breathe a sigh of relief.

If you have any questions about any of the issues raised in this briefing, please contact the author or your usual Freshfields contact.

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