Analysis

The Court of Appeal favours form over function in *GE Financial*

Speed read

In *GE Financial Investments Ltd*, the Court of Appeal has overturned the Upper Tribunal's decision that the taxpayer was entitled to treaty relief. It held that the taxpayer being subject to worldwide taxation as a result of a US rule on stapled shares wasn't enough, and that a further direct link to the US was required. The court favoured something like the territorial interpretation. The difficulty remains, however, that this interpretation does require the court to look at precisely how the state imposes tax. Such difficulties are hopefully solved by a future court looking to an international fiscal meaning of 'residence'.

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If it looks like a resident, and it is taxed like a resident, is it a resident? The Court of Appeal, in *HMRC v GE Financial Investments Ltd* [2024] EWCA Civ 797, says no, overturning the judgment of the Upper Tribunal (UT) that I discussed this time last year ('*GE Financial*, treaty residence, and the meaning of "business"' (K Rainsford), *Tax Journal*, 28 July 2023).

The taxpayer, GE Financial Investments Ltd (GEFI), was a UK company. For US tax planning purposes (which were defeated by a change in law), it was a limited partner in a limited partnership and its shares were stapled with the shares in the general partner of that same partnership, GE Financial Investments Inc. That stapling meant GEFI was treated for US tax purposes as a 'domestic corporation' and subject to US tax on its worldwide income. The US would impose this tax regardless of whether it was entitled to under the treaty (the infamous 'treaty override'). GEFI was also, as a UK-incorporated company, subject to UK tax on its worldwide income. The question was whether GEFI was US resident for the purposes of the UK/US double tax treaty. If it were, the UK would have to give credit for the US tax GEFI had paid and refund some £124m of UK tax.

One might naively assume that the answer is yes. This is a double tax treaty intended to give relief where there are conflicting claims of full taxing rights. It should operate to allocate those rights between the UK and the US and choose one to tax GEFI's worldwide income.

But the answer is, as ever, more involved. As Lady Justice Falk observed, if HMRC were successful, under the treaty GEFI would be solely UK resident; the US would have no right to tax the income in dispute. The fact that the US would override the treaty, and impose US tax anyway, was not relevant. The treaty should be interpreted on its terms, and on its terms there would be no double taxation however the court decided. Either the taxpayer wins and the treaty says the UK must give relief or the taxpayer loses and the treaty says the US must not tax.

Approaches to interpreting treaty residence

The UK/US treaty defines residence in article 4 like this:

> 'the term "resident of a Contracting State" means, for the purposes of this Convention, any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature.'

The gist of GEFI's argument was that this definition was gesturing ostensively at things which give rise to 'full', or 'worldwide' liability to tax. So anything else which gave rise to liability on a similar basis would satisfy the definition. In particular, the US rule treating companies stapled to domestic companies as domestic companies would count. This was called the 'functional interpretation'.

HMRC's argument was that the items identified ('domicile', 'place of management') were all links the taxpayer had with the jurisdiction in which it was purportedly resident. So not just any basis on which a local jurisdiction imposed worldwide taxation would be satisfactory. There could be domestic residents who were not treaty residents if they didn't have the relevant connection with the state. HMRC said that GEFI was one of these: its only connection with the US was stapling to the US company; this was too far removed. This was the 'territorial interpretation'.

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What does treaty residence require?

The territorial interpretation has been repeated in the academic commentary on the OECD model tax convention (MTC). HMRC put several of these commentaries before the court, as they did the tribunals below. GEFI also relied on these commentaries, arguing that the differences between the MTC and the UK/US treaty supported its argument rather than HMRC's.

This argument went as follows. The MTC has a similar definition to the one in the UK/US treaty, but omits 'citizenship' and 'place of incorporation'. Sure, GEFI might concede, the territorial interpretation could apply to the MTC. But citizenship and place of incorporation aren't substantive territorial links like the ones in the MTC; they are legal or technical links. So, by including these in the UK/US treaty's version of article 4, the territorial interpretation becomes inappropriate. The phrase 'other criterion of a similar nature' is necessarily more expansive in the UK/US treaty than the MTC because the nature of the criteria that precede it is different.

It is worth noting here that the UT did not proceed along these lines. The UT found for GEFI because it said the functional interpretation was correct for both the MTC and the UK/US treaty. As I detailed in last year's article, the UT drew support for this view from the OECD commentary on the MTC and the Canadian Supreme Court judgment in *Crown Forest Industries v Canada* [1995] 2 SCR 802. In particular, the UT quoted the OECD commentary saying that treaties 'do not lay down standards' for what counts as residence and 'take their stand entirely on the domestic laws'. It therefore preferred the functional interpretation.

The Court of Appeal proceeds differently. It starts by dismissing the reliance the taxpayer (and the UT) placed on the OECD commentary. The quote above about taking their

stand from domestic law indicates an 'ability to deal with cases at the margins', but not necessarily more. It stressed that the words of the UK/US treaty, and not the MTC, were the starting point, and criticised the UT for starting, as it were, back-to-front.

Falk LJ said that *Crown Forest* did not support GEFI's arguments. *Crown Forest* was a case about whether a Bahamian resident who carried on business in the US was entitled to the protection of the US/Canada treaty. The Supreme Court of Canada said no; it was only taxed on US-sourced income, which was insufficient to establish treaty residence. The FTT in *GE Financial* said that *Crown Forest* established that worldwide taxation was necessary but not sufficient to establish treaty residence. The UT said that *Crown Forest* stood for the proposition that worldwide taxation was sufficient for treaty residence. The Court of Appeal says that the question of sufficiency never came up: the taxpayer in *Crown Forest* stumbled at the first hurdle and failed to establish worldwide liability to tax, and so the Canadian Supreme Court never considered whether something else might be required.

Nevertheless, the Court of Appeal considered that there were such additional requirements; it favoured something like the territorial interpretation. Worldwide taxation was needed, but it had to arise from some sort of close connection between the taxpayer and the jurisdiction.

What of GEFI's argument that the territorial interpretation couldn't apply to the UK/US treaty because of the addition of 'citizenship' and 'place of incorporation'? The view of some academic commentators were that these were technical legal links, not real factual ones, and so (argued GEFI) their inclusion in the UK/US treaty meant that a territorial approach to the MTC would not translate.

The Court of Appeal rejected this argument, although not (to this reader's eye) terribly convincingly. It said that 'place of incorporation' might actually be a territorial link, not a technical legal link; and in any event, place of incorporation might already be included in the MTC list of criteria as an aspect of corporate domicile. Ultimately, it decided that the treaty required both worldwide taxation and a link of some sort (whether formal-legal or real-factual) between the taxpayer and the state. GEFI lost on its argument that only worldwide taxation was required. This takes up the bulk of the judgment.

There is then a small section (only two substantive paragraphs) dealing with whether the stapling rule counted as an 'other criterion of a similar nature'. The court said that it did not. The requirements to fall within the US stapling rule were (a) the stapling of the foreign corporation's shares with the shares of a domestic corporation, and (b) the foreign corporation being at least 50% owned by US persons. These were conditions which related to the ownership of GEFI, not any link it might have itself with the US. Whilst that is a neat distinction to draw, it does not feel like one that is fundamental to the concept of treaty residence. It would have been interesting to see the court elaborate on why, in principle, a tax treaty might want to derecognise taxation rights based on the control of a company.

Implications of the decision

In last year's article, I said that HMRC's argument, if successful, would raise wider concerns. In particular, I was talking about the point raised in the UT about many of the UK's treaties not including 'place of incorporation' amongst the list of criteria used for treaty residence. If the territorial interpretation is right, does this mean that the UK imposing worldwide taxation by reason of a company's place of incorporation is not sufficient to establish treaty residence?

There are, I think, two ways in which the Court of Appeal would say that this is not a problem, though it does not explicitly comment on this point like the UT did. The first is the point mentioned earlier about the argument that 'place of incorporation' might actually be a territorial link, and not a purely legal one. Falk LJ says that as a legal person, a company is given legal existence by the place it is incorporated, and that is a 'rather obvious' link with the state. It would be interesting if this were tested by a court which needed to decide this point, as it goes against the views of a number of commentors who put it on the wrong side of the territorial interpretation.

The second one draws together a couple of strands from different places in the judgment. In several places, the court hints that it is up to the contracting states to define residence, but only to a certain extent. It also quotes from another Canadian Supreme Court case, *Canada v Alta Energy Luxembourg SARL* [2021] SCC 49, discussing 'international norms' of defining treaty residence. I think the court could say that it is up to the UK to define residence, and it has chosen to do so through a combination of place of management and place of incorporation. So long as this is within international norms, or within a customary international meaning of residence, that choice should be respected.

The concept of an international fiscal meaning of residence would also give more coherence to another part of the Court of Appeal's judgment. The court quotes the Supreme Court decision in *Fowler* [2020] UKSC 22 (the deep-sea diver who was deemed to be self-employed for UK tax purposes) for support in its statement that domestic deeming rules are generally ignored for treaty purposes, saying the treaty is 'applied to the real world'. That makes sense in *Fowler*, where tax law deemed self-employment could be disregarded in favour of the employment law analysis. But tax residence isn't a concept that has any 'real world' meaning. It is a concept that only exists for tax purposes. The *Fowler* approach of disregarding tax fictions would leave the court with nothing left for the treaty to apply to. An international fiscal meaning of residence would give the court a yardstick against which to measure a deeming rule and give it a justification for disregarding it if it gave an approach which fell outside that settled meaning.

That would seem to plug the obvious gap of a UK court taking the territorial interpretation. The difficulty remains, however, that this interpretation does require the court to look at precisely how the state imposes tax. Take Jurisdiction A, which has the following rule: 'companies incorporated here pay tax here on their worldwide income', and Jurisdiction B, which has the rule 'companies incorporated here are resident here, and residents pay tax here on their worldwide income'. Should the treaty treat Jurisdiction A any differently from Jurisdiction B? Do the words 'by reason of ... residence' mean that Jurisdiction B's test counts as treaty residence but Jurisdiction A's doesn't? Or what if the US had drafted its stapling rule differently, and said that US resident corporations were those incorporated there or those controlled by US persons and stapled to a US-incorporated company?

As I said last year, it would seem odd if treaty relief depended on liability to tax being couched in a particular legislative idiom. The functional interpretation has the comparative virtue that this is not necessary. But, unless we see an appeal to the Supreme Court, the territorial interpretation is the approach to be adopted in the UK. ■

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- Cases: *HMRC v GE Financial Investments* (24.7.24)
- *GE Financial*, treaty residence, and the meaning of 'business' (K Rainsford, 28.7.23)