HERBERT SMITH FREEHILLS

TAX TREATY INTERPRETATION: THE LIMITS OF FICTION

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Legal Briefings

In *Fowler v HMRC* [2020] UKSC 22, the Supreme Court determined that a statutory fiction created by a deeming provision of UK tax law did not affect how the terms of a bilateral tax treaty should be applied. In particular, the Supreme Court held that although the UK deeming provision in question applied to treat the (employed) taxpayer in question as if they were carrying on a trade, it did not change the fact that, for the purposes of the treaty, the taxpayer derived "income from an employment" (and hence that the employment income article of the treaty was engaged).

FACTS

Mr Fowler was a qualified diver, resident in South Africa at all relevant times (including for the purposes of the double taxation treaty between the UK and South Africa, the "**Treaty**").

During the 2011/12 and 2012/13 tax years, Mr Fowler undertook diving engagements in the waters of the UK continental shelf.

It was common ground as between Mr Fowler and HMRC that if Mr Fowler was self-employed in the relevant tax years, then his diving income would only be taxable (if at all) in South Africa. However, the parties were not in agreement as to whether:

- Mr Fowler was in fact self-employed (as Mr Fowler contended); or
- if Mr Fowler was in fact an employee, his income was taxable in the UK.

That second issue was litigated as a preliminary issue (on the assumption that Mr Fowler was an employee).

LAW

Section 6(5) (as amended) of the Income Tax (Earnings and Pensions) Act 2003 ("**ITEPA**") provides that employment income is not charged to tax under Part 2 of ITEPA if it is charged to tax as trading income by virtue of section 15 of the Income Tax (Trading and Other Income) Act 2005 ("**ITTOIA**").

Section 15(2) ITTOIA specifies that, for certain diving activities performed by an employed diver, the performance of those activities is treated for income tax purposes as the carrying on of a trade in the UK rather than as an employment generating employment income subject to tax under Part 2 ITEPA.

Section 6 of the Taxation (International and Other Provisions) Act 2010 provides that "[d]*ouble taxation arrangements have effect in relation to income tax … so far as the arrangements provide*" for certain specified outcomes.

Article 3(1) of the Treaty contains a number of definitions, some exclusive and some non-exclusive. Article 3(2) states that a term not defined in the Treaty will, unless the context otherwise requires, have the meaning that it has under the law of the State that is seeking to apply the Treaty, with the meaning of the relevant term under the State's tax law having preference over any meaning given to the relevant term under other laws of the relevant State.

Article 7 of the Treaty is entitled "*Business Profits*". Article 7(1) of the Treaty provides that the profits of an enterprise of the UK or South Africa (being the "**Contracting States**" to the Treaty) are taxable only in the Contracting State where the enterprise is established unless the enterprise carries on business in the other Contracting State through a permanent establishment situated in that other Contracting State.

Article 14 of the Treaty is entitled "*Income from Employment*". Article 14(1) of the Treaty states that (subject to certain exceptions which were not relevant in this case) salaries, wages and other similar remuneration derived by a resident of a Contracting State from a particular employment are only to be taxed in that State unless the employment is carried out in the other Contracting State. If the employment is carried out in the other Contracting State, any remuneration derived from that employment may also be taxed in that other State. If both South Africa and the UK sought to tax the same amount of employment income in the circumstances contemplated by Article 14(1), the provisions of the "elimination of double taxation" article of the Treaty would be engaged.

Earlier decisions

The First-tier Tribunal ("**F-tT**")[1] held that section 15(2) ITTOIA treated Mr Fowler's income as being derived from the carrying on of a trade in the UK "for income tax purposes". The F-tT held that this statutory fiction extended to determining how the Treaty applied in circumstances where the UK was seeking to levy income tax. As a result, the F-tT considered that the effect of the UK deeming provision was that Mr Fowler's income (derived from his diving activities in the years in question) constituted profits within Article 7(1) of the Treaty (rather than employment income within Article 14(1) of the Treaty). In consequence, it was taxable exclusively in South Africa.

The Upper Tribunal[2] came to the opposite conclusion. It did so on the basis that section 15(2) ITTOIA does not supplant the meaning of "employment" under ITEPA, but only the meaning of "employment income". As such, for the purposes of the Treaty the term "employment" takes its ordinary meaning (as supplied by ITEPA). The result, on the facts, was that Article 14(1) of the Treaty was engaged. In consequence, the UK was entitled to impose income tax on Mr Fowler's income from the relevant diving engagements.

The Court of Appeal[3], in a majority decision, reversed the decision of the Upper Tribunal. It referred to the Court of Appeal's statement in *Marshall v Kerr*[4] (in the leading judgment of Peter Gibson J) that, when construing a deeming provision, "*because one must treat as real that which is only deemed to be so, one must treat as real the consequences and incidents inevitably flowing from or accompanying that deemed state of affairs, unless prohibited from doing so*." It followed from this that the effect of the deeming provision in section 15(2) ITTOIA also extended to the application of the Treaty, such that the profits from Mr Fowler's deemed trade fell within the scope of Article 7(1) of the Treaty and were therefore taxable only in South Africa.

SUPREME COURT DECISION

In a unanimous decision, the Supreme Court overturned the decision of the Court of Appeal. In essence, the Supreme Court approached the matter by considering (a) as a matter of Treaty interpretation, the extent to which the Treaty permits domestic deeming provisions to affect the meaning of terms in the Treaty and (b) as a matter of domestic law, the extent to which the relevant deeming provision was intended to alter the meaning of terms relevant to the Treaty.

Lord Briggs (with whom Lord Hodge, Lady Black, Lady Arden and Lord Hamblen agreed) commenced his analysis by observing that "[n]*othing in the Treaty requires articles 7 and 14 to be applied to the fictional, deemed world which may be created by UK income tax legislation. Rather they are to be applied to the real world, unless the effect of article 3(2) is that a deeming provision alters the meaning which relevant terms of the Treaty would otherwise have*."

In support of this statement, Lord Briggs referred to the OECD Commentary accompanying the OECD Model Tax Convention. The relevant paragraphs of the OECD Commentary indicate that, under a double taxation agreement, deeming provisions in the domestic law of a Contracting State do not require employment services to be treated as services provided by an enterprise (or vice versa) for the purposes of a double taxation agreement where:

1. this is not required by the context of the relevant double taxation agreement; or

2. there are no "objective criteria" which would permit a formal contractual relationship of a particular kind to be characterised as another type of relationship.

Lord Briggs also cited Lord Reed's judgment in the Supreme Court decision in *HMRC v Anson*[5], where the following observation was made:

> "*As Robert Walker J observed at first instance in* Memec *[1996] STC 1336 at 1349, 71 TC 77 at 93, a treaty should be construed in a manner which is 'international, not exclusively English'.*
>
> *That approach reflects the fact that a treaty is a text agreed upon by negotiation between the contracting governments*."

This principle underscored that applying the Treaty to the fictional scenario created by section 15(2) ITTOIA "*would be contrary to the requirement to treat the Treaty as a bilateral international agreement*".

Lord Briggs' analysis then turned to the question of whether the deeming provision in section 15(2) ITTOIA was intended to alter the meaning given to key terms in the Treaty (namely, "*profits*", "*enterprise of a Contracting State*", "*salaries, wages and other similar remuneration*" and "*employment*"). According to Lord Briggs, no such intention could be discerned from the language of section 15(2). Instead, that section merely "*erects a fiction which, applying those terms in their usual meaning, leads to a different way of recovering income tax from qualifying divers.*"

The same conclusion also followed from a consideration of the purpose of the deeming provision in section 15(2) ITTOIA. Relying upon the finding made by the F-tT, Lord Briggs held that the purpose of this provision was narrow: to permit divers to benefit from a more generous regime for the deduction of expenses, rather than to resolve any confusion as to whether such divers were or were not employees. At the time when the provision (which was subsequently rewritten to section 15(2) ITTOIA) was introduced, the class of employed divers falling within that section tended to incur their own costs, and were therefore considered to deserve the more generous expenses treatment prescribed in statute for the self-employed, in contrast to that prescribed for employees.

Earlier in his judgment, Lord Briggs had indicated that a statutory fiction should have effect only as far as the intended purpose of the relevant deeming provision. He also indicated that a court should, in the absence of a clear statutory requirement, be reluctant to apply a deeming provision in a way that produces an anomalous result. As such, when properly considered, the effect of section 15(2) ITTOIA was limited in Lord Briggs' view to its purposes of securing computational benefits for a prescribed class of (employed) taxpayers and did not extend to altering the meaning of terms used within the Treaty. It could not be applied in such a way so as to render "*a qualifying diver immune from UK taxation*".

As a result, Lord Briggs determined the preliminary issue in terms that if Mr Fowler was an employed diver during the relevant tax years, his income from diving engagements in the waters of the UK continental shelf would be taxable in the UK.

COMMENT

The unanimous decision of the Supreme Court brings clarity to an issue of treaty interpretation which saw conflicting judgments from the F-tT and the majority of the Court of Appeal on the one hand and the Upper Tribunal and the minority of the Court of Appeal on the other.

In the context of a double taxation treaty, the Supreme Court's decision confirms that the interaction between a deeming provision under domestic law and the relevant articles of the double taxation treaty will be determined by (a) whether the deeming provision, construed purposively, is sufficiently broad in scope to alter the manner in which the double taxation treaty is applied (and the definition of terms used within it) and (b) whether, on a proper reading, the treaty permits the deeming provision to have such an effect. It is to be hoped that in most cases there will be a tolerably clear answer to this question. In certain situations, however, the purpose of a particular deeming provision may prove difficult to discern, such that the effect of the relevant deeming provision will remain unclear.

Turning to the international dimension, the Supreme Court's decision once again confirms that interpreting double taxation treaties requires something more than determining the meaning of relevant terms under domestic law. A proper interpretation may require a consideration of the bilateral context which generated the relevant treaty and may also take into account the obligations imposed, and the interpretative methods prescribed, by the Vienna Convention on the Law of Treaties as well as any guidance contained in relevant parts of the OECD Commentary.

As a final observation, *Fowler* may point to the potential pitfalls of opting to have an issue in an appeal to the F-tT determined as a preliminary issue. As *Fowler* demonstrates, where an issue is complex or difficult to determine, it can take a number of years and multiple appeals before a preliminary issue is determined. Even then, other issues in the case may still need to be resolved after the preliminary issue has been decided. In this case, for example, the question of whether Mr Fowler was in fact employed during the relevant tax years has yet to be determined. Each tax appeal turns on its own facts, and it would not be correct to second guess the decisions taken in other appeals. It may be, however, that if other taxpayers are faced with appeals where two separate issues could each be determinative of the appeal, opting to have only one of those issues heard as a preliminary issue may only be desirable if there are compelling reasons to do so.

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[1] [2016] UKFTT 0234 (TC)

[2] [2017] UKUT 0219 (TCC)

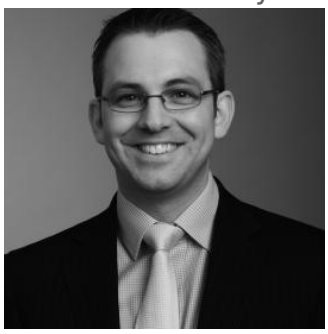
[3] [2018] EWCA Civ 2544

[4] (1993) 67 TC 56

[5] [2015] STC 1777

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.



NICK CLAYTON
PARTNER, LONDON

+44 20 7466 6409
Nick.Clayton@hsf.com

STEVEN WENHAM
ASSOCIATE, LONDON

steven.wenham@hsf.com

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