Analysis

GE Financial, treaty residence, and the meaning of 'business'

Speed read

The Upper Tribunal in *GE Financial Investments Ltd v HMRC* allowed the taxpayer's appeal, holding that the treaty's purpose of preventing double taxation was a key factor in the interpretation of who benefitted from its protections and that HMRC was wrong to suggest that a direct connection to the taxing state was required in addition to worldwide taxation. It upheld the First-tier Tribunal's decision that the taxpayer did not carry on a business in the US, finding that it was open to the tribunal to come to that conclusion on the basis that the taxpayer was effectively a conduit.

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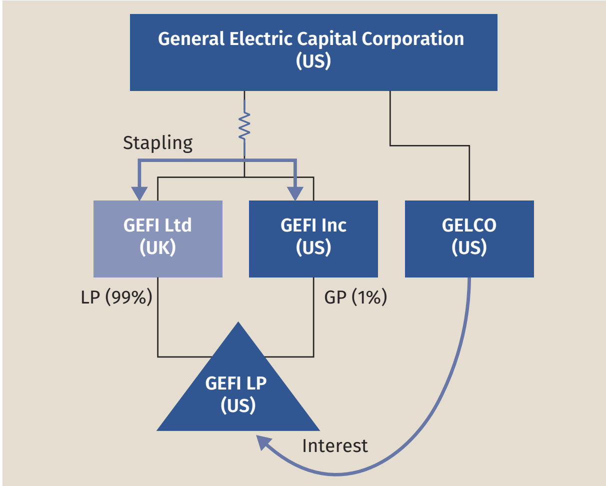
GE Financial Investments Ltd (GEFI Ltd) was resident in both the US and the UK. It paid US tax of US$303m and UK tax of £124m on the same interest receipts. It asked the UK and US authorities to agree where it was resident; they failed to do so. The issue before the Upper Tribunal (UT) in *GE Financial Investments Ltd v HMRC* [2023] UKUT 146 was whether the US/UK tax treaty could resolve the issue by requiring the UK to give relief for this double taxation. As part of this, the tribunal was asked to contend with two questions which are fundamental to both domestic and international taxation: the meaning of 'residence' and the meaning of 'business'.

Background

GEFI Ltd was a UK-incorporated company. It had a sister company, GE Financial Investments Inc (GEFI Inc), a US-incorporated company. Both of these companies were partners in a Delaware limited partnership (GEFI LP) which received interest income from another US company in the General Electric group, GELCO. The shares in GEFI Ltd and the stock of GEFI Inc were stapled (that is, they were required by the constitutional documents of both companies to be traded together). The structure was established to obtain US tax benefits which, as it happens, did not eventuate.

The US imposes tax on the worldwide income of 'domestic corporations', those incorporated in the US. It also treats as a domestic corporation a foreign corporation which is not foreign-owned and whose shares are stapled to those of a domestic corporation. By virtue of the stapling to GEFI Inc and its ownership by the US GE group GEFI Ltd was treated as domestic corporation for US tax purposes and subject to US federal tax on its worldwide income, which included its 99% share of the interest income received by GEFI LP.

Since it was incorporated in the UK GEFI Ltd was tax resident in the UK. As a result, GEFI Ltd was also subject to UK tax on its worldwide income. In its UK tax returns GEFI Ltd claimed credit for the US tax it had paid. HMRC disallowed this and GEFI Ltd appealed, first to the First-tier Tribunal (FTT) and then to the UT.



The issues in dispute

Most states levy tax on the worldwide income of their residents; for non-residents they impose taxation only on locally sourced income.

The OECD model tax convention (on which the US/UK treaty is based) allocates taxing rights between the two states which are party to it based on this distinction between residence and source. The source state (that is, the state from which the income arose) is allowed certain limited rights to tax the residence state's residents in particular cases – most notably where the resident is carrying on a business through a permanent establishment in the source state. The residence state has primary taxing rights on the worldwide income of its residents but must give relief for double taxation where the other state has exercised its taxing rights in accordance with the treaty.

What happens if both states assert that a company is their resident? The competent authorities in the two states are supposed to determine the position by mutual agreement. If they fail, treaty benefits are generally not available. In the US/UK treaty, one of the only exceptions is paragraph 4 of article 24, which requires the UK to provide relief against double taxation. GEFI Ltd did ask for the mutual agreement procedure to be applied here and HMRC and the IRS did not reach agreement.

Article 24 only requires the UK to give relief from double taxation where the US has exercised taxing rights in accordance with the treaty. Although it is not clear from the judgments, HMRC appeared to argue that it was not obliged to give relief because GEFI Ltd (a) was not resident in the US for treaty purposes and (b) did not carry on a business through a permanent establishment (PE) in the US. Provided this was the case, the UK retained sole taxing rights for interest income under the treaty; the payment of US tax on that interest by GEFI Ltd was not 'in accordance with the treaty' and so the UK did not have to give credit for it.

I deal with each of these issues, US residence and carrying on a business through a PE, separately below.

Treaty residence

HMRC argued that GEFI Ltd was not resident in the US for treaty purposes because the concept of 'residence' for the purposes of the treaty required something more than GEFI Ltd having to pay tax on its worldwide income by reason of its share stapling. What was their basis for this? Article 4(1) of the OECD model tax convention provides, so far as is relevant:

> '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, place of management, or any other criterion of a similar nature.'

Some academic commentary on article 4(1) (see, in particular, Klaus Vogel on *Double Taxation Conventions* (2022) p 288, which HMRC put before both tribunals) suggests that these criteria all have a 'territorial' link with the jurisdiction in question, so that any criterion of a similar nature also had to have such a territorial link before using it as a basis of domestic residence could lead to treaty residence.

The US/UK treaty includes, as additional criteria in its article 4(1), 'citizenship' and 'place of incorporation'. HMRC accepted that place of incorporation was not a territorial link but said it was still a 'direct' connection between taxpayer and state, and therefore the criterion of a similar nature in the case of the US/UK treaty must also have that direct connection. Because GEFI Ltd's connection to the US was only through its shares being stapled to GEFI Inc's shares, it had no direct link to the US and it was not treaty resident.

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GEFI Ltd's argument was that the similarity between the criteria was only that they were common bases on which states imposed 'full' (i.e. worldwide) liability to tax. Any other basis on which a state chose to impose worldwide liability to tax should therefore also constitute treaty residence.

The FTT and UT both considered a Supreme Court of Canada decision, *Crown Forest Industries v Canada* [1995] 2 SCR 802, but drew opposite conclusions from it, so I pause here to quickly sketch the decision. Norsk, a Bahamian resident, had a US place of management. The US/Canada treaty provided for a lower rate of withholding for US residents than the rate that applied for Bahamian residents. The question was whether Norsk was US resident for the purposes of the treaty: in particular, whether it was liable to tax in the US by reason of its place of management or a criterion of a similar nature to the article 4(1) criteria (which, in this case, as in *GE Financial*, included place of incorporation). The Supreme Court of Canada decided it was not. Norsk paid tax in the US because its income came from being 'engaged in a business in the US', not because it had a place of management in the US; as outlined earlier, the US imposes worldwide tax on the basis of the place of incorporation, not place of management. Being engaged in a business in the US was not a criterion of a similar nature to domicile, residence, place of management, or place of incorporation because they are bases on which worldwide liability to taxation is determined and being engaged in a business in the US only exposed Norsk to US tax on US-source income.

At first instance the FTT held that GEFI Ltd was not entitled to relief. GEFI Ltd's argument would mean that the words 'by reason of' would be of no effect, the listed criteria then becoming mere examples of when someone is 'liable to tax' rather than having real effect in shaping what the 'similar nature' was. It preferred HMRC's interpretation of requiring a direct connection between GEFI Ltd and the US. The FTT drew support from this, somewhat puzzlingly, from Crown Forest. It said that this case, 'properly understood in context', suggested that 'worldwide taxation is a necessary feature' but is not sufficient of itself for a criterion to be of a similar nature; some other connection was needed. Finally, the FTT was persuaded that the (minor) differences in the ways in which a foreign stapled corporation was treated by the US tax system as compared with a domestic corporation meant that any connection that did exist was not a connection between GEFI Ltd and the US but a connection between GEFI Ltd and GEFI Inc.

On appeal, the UT found for GEFI Ltd. Unlike the FTT, it started by reminding itself of the correct approach to the interpretation of a tax treaty, including that:

- in line with the Vienna Convention, its terms are to be interpreted in good faith and in light of its purpose;
- the contemporary background to the treaty can be taken into account, including the legal position prior to its conclusion; and
- (tellingly) views expressed in textbooks are of 'some interest' but are 'not in any sense authoritative'.

The UT considered the expert evidence on the US domestic tax treatment of foreign stapled corporations. It found that the differences in US tax treatment from domestic corporations (which the FTT said broke the 'direct link' between the US and GEFI Ltd) either were designed to align foreign stapled corporations with domestic ones or accomplished the same purpose as the rules applicable to domestic corporations.

The UT next traced the history of article 4(1) in the OECD model, saying that in this context it is evident that the criteria listed after 'by reason of' are aimed at capturing concepts which lead to worldwide taxation. It also looked to the OECD commentary, which it summarised by saying that 'double tax conventions "do not lay down standards" in determining who is resident for the purposes of imposing "full" taxation' and 'take their stand entirely on domestic laws'.

The UT dealt with the *Crown Forest* case briefly, saying that it was clear from the decision that '"full" taxation is the connecting factor for the criteria set out in Article 4(1)'. It quotes a further Canadian Supreme Court case, *Alta Energy* [2021] SCC 49, which also confirmed that 'formal criteria for residence are just as well accepted as factual criteria'.

Putting all that together the UT overturned the FTT's finding that the US/UK treaty required an additional direct connection between GEFI Ltd and the US before GEFI Ltd could be US treaty resident. The fact that GEFI Ltd was liable to US tax on its worldwide income as a result of the stapling rule sufficed. Though not stated by the UT the consequence of this appears to be that GEFI Ltd was both UK and US resident for the purposes of the treaty, and with a failed mutual agreement procedure this meant it was not entitled to the benefit of the provisions of the treaty which limited US tax. As a result, the US taxing GEFI's interest income was in accordance with the treaty and so the UK was required to give GEFI Ltd relief for the US taxation it had paid.

The UT's answer seems correct. It does not raise the same concerns that HMRC's approach would, writ large. As the UT pointed out, companies which are UK tax resident only because they were incorporated in the UK could never benefit from UK treaties unless they happened to list 'place of incorporation' as one of the particular criteria of article 4(1) – which is generally not the case for UK treaties concluded prior to 1993. HMRC did not respond to the UT's direct question on this point. Perhaps their response might be that the UK statute does define UK-incorporated companies as resident in the UK, and 'residence' is one of the listed criteria in article 4(1), so there is no problem. But that type of syntactical consideration surely should not be relevant. If the US code happened to use residence as the basis on which it imposed worldwide taxation on companies, and defined domestic corporations and stapled foreign corporations as residents, would the answer be different? What if the UK did not use the concept of residence and instead just imposed worldwide taxation on companies incorporated here or centrally managed and controlled here? The UT's decision sensibly cuts through this. The question must be whether the state imposes full taxation or only local source taxation, not whether full taxation is couched in a particular legislative idiom. It would seem to be contrary to the purpose of double tax treaties – let alone their very name – if relief for double taxation were given or not based on the draftsman's approach to the same rule.

Business through a permanent establishment

That was enough to determine the appeal, but the UT went on to consider the second question, which was (assuming it was not resident there) whether GEFI Ltd carried on a business through a PE in the US. If it did, the US was permitted to tax its income under the treaty and therefore the UK was required to give relief from double taxation. If it did not, then because the treaty did not allow interest of UK residents to be taxed otherwise, any US taxation was not in accordance with the treaty and UK relief would be denied.

The dispute between the parties was not, as is commonly the case, whether there was a PE. It appeared to be common ground that the activities of GEFI LP were carried on in the US. The question was whether those activities were sufficient to constitute a 'business'. It was accepted by both parties that article 3(2) of the treaty requires a reference to the UK domestic law meaning of 'business'.

The FTT decided that GEFI Ltd was not carrying on a business. GEFI Ltd had no activity other than its limited partnership interest, and through that interest held five loans over the course of six years and originated three of them. The FTT said this was 'a passive, sporadic or isolated activity' and, despite the large sums involved, was not a business. It spent some time discussing the level of management involvement, criticising the heavy involvement of GE tax staff and the lack of involvement of the directors of GEFI Inc (which was the general partner of GEFI LP).

On appeal, the UT provided a useful and lengthy summary of the case law relevant to the meaning of 'business'. It swiftly dealt with GEFI Ltd's objections to the FTT, saying that the FTT had applied the correct legal tests. It said that the substantive finding of the FTT was that GEFI Ltd was a conduit company and therefore did not carry on a business, and that this was a finding reasonably open to the FTT.

There are elements of the UT judgment which might lead one to suspect that, if it had heard the case at first instance, it would have come to a different answer. Although the UT did not expressly say so, it appeared to apply the test in *Edwards v Bairstow* [1956] AC 14. In other words, since the FTT determined a question of mixed fact and law this could not be overturned on appeal unless either an error was made in the legal test applied by the FTT or it arrived at a decision no reasonable tribunal could have. In addition, in two places, the UT says that it cannot apply a 'hypercritical' reading of the FTT judgment.

The focus on GEFI Ltd as a conduit company is unusual. The activities of GEFI Ltd itself surely cannot be relevant in working out what was happening in GEFI LP, as GEFI Ltd was a limited partner in GEFI LP and so could not have actively participated in the activities of GEFI LP without losing limited liability. Moreover, the interest of the FTT in the level of influence that GE executives higher up the group had and the lack of independent consideration and sign-off by the directors of GEFI Inc, whilst relevant to the location of the central management of GEFI LP and whether its decision-making had been usurped, should not be relevant to the question of whether the activities it did in fact have constituted a business. The logic here suggests that a tax tribunal could treat a taxpayer carrying on an activity that a layperson might ordinarily consider a business – such as a greengrocer – as not carrying on a business if it were puppeteered by its parent company.

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It would have been useful if the UT had referred here, as it did in the residence section, to the purpose of the treaty. The effect of adopting the interpretation of 'business' that it did was that (were the UT to be wrong on the residence issue) the treaty did not prevent double taxation in accordance with its purpose. One might reasonably consider that to be a consideration that the FTT should have added to the mix, or potentially even a reason to decline to apply article 3(2) because the UK analysis gave a result that was contrary to the context and purpose of the treaty (see, for example, *Vogel*, at p 236, where double taxation is said to be a reason to prefer a contextual interpretation rather than referring to the domestic one).

Taxing in accordance with the treaty

There was a third issue, which I deal with briefly as the UT did not express a view on it. Assuming HMRC had won on the first issue, so GEFI Ltd was not resident in the US, but had lost on the second, so GEFI Ltd was carrying on a business through a US PE, the UK only had to give relief if the US had imposed tax in accordance with the treaty. HMRC adduced evidence that the US would have found that GEFI Ltd did not carry on a business in the US but was nevertheless taxable in the US without regard to any US treaty. The US did not tax because the US/UK treaty permitted it to, but for some other reason; the US taxation was therefore not 'in accordance with the treaty'.

The FTT agreed with GEFI Ltd that this was not relevant. It was not necessary to consider the approach taken under US law but instead simply whether the treaty permitted taxation. Since it (ex hypothesi) would have, the

US tax imposed would have been in accordance with the treaty. On appeal the UT did not make any finding on this issue as it was dealt with briefly by counsel and was not relevant to the decision given its findings on the residence and business issues.

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Comment

The decision of the UT on the first issue is helpful. It avoids the creation of an underclass of residents who are in a liminal space between domestic residence and treaty residence. It cogently explains the history of the article 4(1) of the OECD model convention and why its findings are consistent with the treaty's purpose. It does not shy away from a reading of article 4(1) which is at odds with prominent academic commentators.

The comments on the second issue, whilst technically *obiter dicta*, may leave some taxpayers nervous. Whilst most are aware that independent consideration and decision-making at a board level is important to ensure tax residence is maintained, it is unlikely that many of them will have considered that the degree of outsourcing to employees of other group members may have meant that their activities no longer constitute a 'business'. Indeed, this would seem a simple way to get around source-country taxation on business profits: just ensure the board of the entity in question merely rubber-stamps decisions made elsewhere in the group and the entity will not have a permanent establishment. Presumably this is not an argument HMRC will accept from foreign taxpayers.

Those who are considering whether they are carrying on business through a permanent establishment, as well as those looking at roll-over relief on the transfer of a business under TCGA 1992 s 162, transfer of a business as a going concern treatment for value added tax purposes, or even whether HMRC would consider that they have a valid partnership or limited partnership which is 'carrying on business in common with a view to profit', should have regard to the findings of the FTT and the UT here, and ensure that proper board-level and executive-level consideration is given to the activities of the entity (and is properly documented) to avoid a similar outcome. ■

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▶ Cases: *GE Financial Investments v HMRC* (4.7.23)