THE HIGH COURT DECISION IN SMALLWOOD

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On 8th April 2009 the High Court overturned the decision of the Special Commissioners in the case of *Smallwood and Others v Commissioners for Her Majesty's Revenue and Customs*[1]. The case raises some interesting and significant issues as to how tax treaties work, and as to the relationship between tax treaties and domestic anti-avoidance legislation.

Background

The background facts are quite simple to state. In 1989, Mr. Smallwood settled property on trust for the benefit of himself and his family. By the year 2000, the trustee of the trust was a corporation resident in Jersey and the principal asset of the trust was a holding of shares in FirstGroup plc, which was standing at a considerable gain to its acquisition value. If the shares were sold by the Jersey trustee, the chargeable gain would be attributed to Mr. Smallwood under s.86 TCGA 1992. To avoid this, Mr. Smallwood and his advisors implemented a scheme generally referred to as the "Round the World" scheme. This involved the Jersey trustee resigning in favour of trustees resident in a jurisdiction which had a suitable double taxation convention with the United Kingdom (in this case Mauritius), the new trustees in the treaty-protected jurisdiction disposing of the shares, and those trustees then resigning in favour of UK-resident trustees before the end of the year of assessment in which the disposal took place. Pursuant to this scheme, the Jersey trustee resigned on the 19th December 2000 and a trust corporation resident in Mauritius was appointed in its place. On 10th January 2001 the shares in FirstGroup were sold. Finally on 2nd March 2001, the Mauritian trustee resigned in favour of Mr and Mrs Smallwood, who became the trustees and were resident in the United Kingdom.

This "Round the World" scheme was quite widely implemented, and it was not surprising that HM Revenue & Customs sought to challenge it. The *Smallwood* case was brought as a test case to challenge the scheme. HMRC sought to tax Mr. and Mrs. Smallwood as trustees of the settlement, and Mr. Smallwood as settlor under s.77 TCGA 1992.

As this section is the basis for the charge to tax, it is set out here:-

> "**77**. *Charge on settlor with interest in settlement.*
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> (1) Where in a year of assessment—
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> (a) chargeable gains accrue to the trustees of a settlement from the disposal of any or all of the settled property, (b) after making any deduction provided for by section 2(2) in respect of disposals of the settled property there remains an amount on which the trustees would, disregarding section 3, be chargeable to tax for the year in respect of those gains, and
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> (c) at any time during the year the settlor has an interest in the settlement,
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> the trustees shall not be chargeable to tax in respect of those but instead chargeable gains of an amount equal to

> that referred to in paragraph (b) shall be treated as accruing to the settlor in that year …"

The point should be made that s.86 TCGA 1992 – which attributes gains of non-resident trustees to a settlor who is interested in the settlement – did not apply as that legislation only applies where the trustees are not resident or ordinarily resident in the United Kingdom during any part of the year of assessment. By contrast, s.77 applies only if the trustees are "either resident in the United Kingdom during any part of the year or ordinarily resident in the United Kingdom during the year". Since the trustees are regarded as a continuing body of persons (see s.69 TCGA 1992), that body of person was resident during part of the year of assessment from 2nd March 2001 when Mr. and Mrs. Smallwood were appointed as trustees.

The argument for the taxpayers was that, as a result of Article 13(4) of the UK-Mauritius Tax Treaty, capital gains from the alienation of the shares "shall be taxable only in the Contracting State of which the alienator is a resident". As the alienator was the trustee, and the trustee was resident in Mauritius at the time of the disposal of the shares, this meant that the amount on which the trustee would be chargeable to tax under s.77(1)(b) was nil. Hence, chargeable gains of nil should be treated as accruing to the settlor under s.77(1). The argument of HMRC was that Article 13(4) of the tax treaty did not operate in this way, and did not prevent the UK charge to tax.

The Special Commissioners' decision: treaty residence and the POEM Tie-breaker

The Special Commissioners' decision is unusual in having been decided on a basis that was contended for by neither of the parties. The central issue concerned residence for purposes of the tax treaty at the time of the disposal of the shares. It will be seen from the summary of facts that there were three periods of residence during the UK year of assessment 2000-01: the "Jersey period" up to the 19th December 2000, the "Mauritius period" from 19th December 2000 to 2nd March 2001, and the "UK period" from 2nd March 2001 to the end of the tax year on 5th April 2001.

The taxpayer contended that it was only necessary for purposes of the tax treaty to determine residence on the date when the disposal of shares took place. On that date, a "snapshot" was taken: the trustee was then resident only in Mauritius, and entitled to the protection of the tax treaty.

HMRC, on the other hand, argued that there were two consecutive periods of residence: the Mauritius period and the UK period at the end of the tax year. During the Mauritius period, Mauritius might tax the capital gains realised by residents of that country (but, in practice did not do so here). During the UK period, however, the UK might tax gains of persons resident in the UK: the UK did that by virtue of s.77(1) which applied because the trustees were resident in the United Kingdom for part of the year of assessment.

Neither of the parties argued for a period of concurrent residence when the trustees were resident in both Mauritius and the United Kingdom. This was, however, the approach taken by the Special Commissioners. They considered that, for treaty purposes, during the Mauritius period the trustees were concurrently resident for treaty purposes in the United Kingdom. Periods of concurrent residence require application of the treaty tie-breaker provision in Article 4(3) which applied the concept of "Place Of Effective Management" (POEM). After a discussion of the meaning of that concept, and a thorough analysis of the facts, the Special Commissioners concluded that the place of effective management during the period of concurrent residence was in the United Kingdom, with the consequence that the trust was not regarded as resident in Mauritius for treaty purposes, and so did not get the protection of Article 13(4).

It is inherent in the decision of the Special Commissioners that residence for treaty purposes is not necessarily co-extensive with factual residence in the United Kingdom, and that one may use the benefit of hindsight and take account of subsequent events to determine whether a person is treaty resident at a time prior to those events. Put another way, between 19th December 2000 and 2nd March 2001, the trustee was resident only in Mauritius. However, once trustees resident in the United Kingdom were appointed on 2nd March 2001, it was appropriate to take account of that fact and treat the trustees as having been resident in the United Kingdom for treaty purposes for the whole of the year of assessment 2000-01 starting from 6th April 2000. This is considered further below.

The Decision of the High Court

Before Mann J in the High Court, both parties maintained their previous position that there was no period of concurrent residence. The taxpayer maintained the "snapshot" approach, and HMRC maintained its argument based on consecutive periods of residence. Although they had won before the Special Commissioners, HMRC did not seek to support the Special Commissioners' decision on the grounds on which it was reached[2].

Mann J agreed with both parties that there was no period of concurrent residence in Mauritius and the UK: in his view, there was no warrant in the UK domestic legislation to extend the UK residence of the trustees back prior to 2nd March 2001 when they were appointed. The implication is that one could not take account of hindsight and subsequent events in determining whether a taxpayer became a resident for treaty purposes at an earlier date from the time that factual residence commenced: it also implies that the concept of residence for treaty purposes is closely linked to the meaning of residence under domestic law. If this view were correct (which the author of this article considers is not the case) it would have very significant consequences for the application of tax treaties. To take an example cited by the Special Commissioners (at paragraph [102] of their decision) as follows: suppose an individual starts to visit a country, but it is not yet clear whether he will spend sufficient time there to become resident. Assuming that "sufficient time" is 183 days; until the taxpayer has spent 183 days it is not possible to say that he is resident. However, after he has spent 183 days, it must then become clear, with the benefit of hindsight, that he has been resident from the start of the year of assessment. No answer to this example is given in the judgement of Mann J.

Treaty Residence and Article 4(1)

It is important to remind oneself of two basic provisions of most tax treaties found in the OECD Model and in the UK-Mauritius treaty:

> "Article 1 – Personal Scope
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> This Convention shall apply to persons who are residents of one or both of the Contracting States."

> "Article 4 – Residence
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> (1) For the purposes of this Convention the term 'resident of a Contracting State' means, subject to the provisions of paragraph (2) and (3) of this Article, any person who, under the law of that State is liable to taxation therein by reason of his domicile, residence, place of management or any other criterion of a similar nature..."

Thus the UK-Mauritius treaty, like all treaties based on the OECD Model, uses the phrase "resident of a Contracting State". That is defined in the tax treaty in Article 4(1) in terms that relate its meaning to liability to taxation under the law of a particular state, and that liability has to arise by reason of domicile, residence, place of management or any other criterion of a similar nature.

It is important to note that, though the treaty definition is linked to liability under domestic law, the term "resident" is not simply defined as having the same meaning as under the domestic law of each Contracting State. That would have been possible and would have been the result under the general interpretation rule in Article 3(2) of the OECD Model, under which undefined terms take their meaning under the domestic law of the state applying the treaty. Article 4(1), to the contrary, does not base the meaning of the term "resident of a Contracting State" on the definition of the term "resident" under the domestic law of each state. There are good reasons why tax treaties do not adopt that approach. There are states which do not employ the term "resident" but nevertheless have the concept of a person who has general or unlimited liability to tax (that is liability to tax not restricted to tax only on income arising from sources in the Contracting State concerned), and attach that general or unlimited liability to a person whose residence, domicile or place of management (or other criterion) is in that state. Thus, it is fundamental to tax treaties based upon the OECD Model that there is a concept of residence for treaty purposes, which may have a meaning different from the term "resident" under the law of one or both of the Contracting States.

It is clear that the domestic law of each Contracting State determines whether a person is resident: it must also be the case that this domestic law determines the period during which the person is liable to tax by reason by residence[3].

It is inherent in Mann J's judgement that there is no concept of residence for treaty purposes as such. Instead, the term "resident" appears to take its meaning from domestic law. Under UK domestic law, residence was not deemed to begin any earlier than the appointment of trustees resident in the UK. This approach fails to appreciate that there was liability to tax in the United Kingdom on disposals from 6th April 2000 onwards, by virtue of the appointment of trustees resident in the United Kingdom on 2nd March 2001 (before the end of that year of assessment).

What is somewhat surprising is that HMRC argued that residence for treaty purposes began only from the time that the UK-resident trustees were appointed. This seems simply wrong, and is inconsistent with statements in the OECD Commentary to which the UK government has made no objection or reservation (see the Special Commissioners' decision at paragraph [89]. The Commentary cites an example of an individual who becomes resident in a State, State B, on 1st April in a year, but is nevertheless regarded by domestic law as resident from the 1st January: this example clearly supports the view that, with hindsight, an individual can be regarded as liable to tax - and, hence, resident - from a period prior to the factual commencement of residence.

How Article 13 Works

What is also particularly interesting in this case is how HMRC argued that Article 13 worked. Both parties, it will be recalled, contended that there were consecutive periods of residence, first in Mauritius and then in the United Kingdom, and no concurrent period of residence. The taxpayer argued that you applied Article 13 at the time the disposal took place and as the trustee was resident only in Mauritius, only Mauritius could tax the gain. HMRC argued, however, that Article 13 operated in a somewhat different way. It operated by allocating tax jurisdiction between the residence and the situs state. During the "Mauritius period" the trustee was resident only in Mauritius, so that state alone had jurisdiction to tax: Mauritius could, therefore, tax the gain on disposal of the shares, but Mauritius elected not to do so. During the "UK period", however, the UK was the state of residence and, as such, had jurisdiction to tax gains in accordance with its domestic law. Under UK domestic law, gains realised throughout the year of assessment were taxable in the UK as the country of residence of the trustees during the UK Period.

This approach has the potential for causing double taxation: if for example, Mauritius had taxed the gain and the United Kingdom had also done so. HMRC's solution to that lay not in the tie-breaker but in Article 24 of the UK-Mauritius treaty which provided for relief from double taxation by a credit. However, it is impossible in practice to apply Article 24 in a situation like this where there are, according to HMRC, two resident states, both of which is obliged to give relief from double taxation by credit for the other state's tax. Mauritius would be required to give credit for UK tax; and the UK would be required to give credit for Mauritius tax. In theory, this might be resolved by, for example, Mauritius taxing first and the UK giving credit and then possibly Mauritius giving credit for any UK tax charge in excess of the Mauritian tax. However, it would require a very strained interpretation to reach this result. Of course, HMRC might have pointed to the mutual agreement procedure and argued that that procedure could be prayed in aid where double taxation arises which is not relieved under Article 24.

HMRC's approach of identifying Article 13 as resolving conflicts between taxation based on residence and taxation based on situs, is not inaccurate. There may be rare circumstances where there are truly consecutive periods of residence and both states tax on a basis of residence. An example may be where State A regards a disposal as taking place at the time that a contract is entered into, while State B regards a disposal as taking place at the time of completion. Suppose that an individual is resident in State A at the time of entering into the contract of disposal, but ceases to be a resident of that state and becomes for the first time a resident of State B prior to completion of the contract. In that case, there is genuinely no period of concurrent residence, both states taxing purely on a basis of liability by reason of residence in the jurisdiction. Double taxation would arise. It is best to regard that problem as one that requires to be relieved by the competent authority procedure and not by the elimination of double taxation article.

Mann J, however, accepted the taxpayer's argument which is a more straightforward one: it is necessary to apply Article 13(4) only as at the date when the disposal took place (ignoring the possibility – of which there was none here as Mauritius did not tax – that the two countries might have different concepts of the date at which the disposal took place). This simplistic approach may be appropriate where one is looking at a capital gain and at a disposal which takes place at a single point in time. However, how does one apply this approach to business profits, for example, where income and expenditure accrues and is incurred over a period of time, and one can only determine if there has been a profit when an account is struck? Equally, even in the case of capital gains a taxpayer in the United Kingdom is liable to tax on net capital gains, after setting off allowable losses. Thus, a "snapshot" approach may not always explain how different articles in tax treaties are to be applied.

The Temporal Application of Tax Treaties

The problem discussed in *Smallwood* is an example of the temporal application of tax treaties, where there are changes in the factual background over the period of time for which the treaty has to be applied. This issue has been little discussed in the literature, though there is a short section in the author's book on *Double Taxation Conventions*. Mann J kindly cites from that book a section which, in full, is as follows:-

> "*The Temporal Application of the Residence Rule and the Tie-breakers*
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> The Convention and the Commentary give little guidance to the temporal application of Article 4(1) and the tie-breaker tests in Article 4(2) and (3),[4] that is the scenario where a person changes residence during the relevant period of time. Suppose, for example, that a taxpayer resides in State A until 1st September 20X1, and then moves to reside in State B. Suppose that State A has a tax year which runs from 1st January to 31st December, while State B has a tax year which runs from 6th April to the subsequent 5th April. Suppose that both states consider that a person who is present for 180 days or more in a tax year is resident for tax purposes. And suppose, finally, that the taxpayer alienates an asset on 15th September 20X1.[5]
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> The starting point to resolve this issue is Article 4(1). Domestic law determines whether a person is a resident of a Contracting State; it must also determine *the period* during which the person is a resident. Thus, for example, if both states adopt a split-year approach - dividing the tax year into a resident part and a non-resident part - there is no difficulty: the taxpayer is resident in State A until 1st September and in State B thereafter.
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> However, if both states regard the person as resident throughout the respective tax year, then there is a period of dual residence - from 6th April to 31st December 20X1 - and the tie-breakers come into play. The question which then arises is the period of time over which one applies the tie-breakers.
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> Take, for example, the first tie-breaker in Article 4(2)(a) - the availability of a permanent home. Does one ask in which state the taxpayer had a permanent home:
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> (a) only on the date when the alienation took place (i.e. on 15th September 20X1); or
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> (b) throughout the period of dual residence (i.e. from 6th

April to 31st December 20X1); or

(c) throughout the two states' tax years which overlap (i.e. from 1st January 20X1 to 5th April 20X2)?

If the answer is either (b) or (c), it is far more likely that a taxpayer who moves residence will have permanent homes in both states during the period (and may have a centre of vital interests which cannot be determined). If the answer is (a), then where an event such as alienation is concerned, the availability of permanent homes on just one day in the year might determine taxation rights.

The issue is particularly acute for the tie-breaker in Article 4(2)(b) - habitual abode - which refers to the state in which the longer period of residence occurs. Paragraph 19 of the Commentary explains that the comparison must be made over a sufficient period of time for it to be possible to determine where the residence is habitual.

Alienation of a capital asset takes place at a point of time (even though any gain may have accrued over a lengthy period of time). However, other income may be harder to attach to a point in time: business profits, for example. For business profits, presumably, residence in a Contracting State and the application of the tie-breakers must be determined over the period during which the profits accrued (e.g. the accounting period).

Even for the alienation of a capital asset there may be differences in identifying the time of alienation. Suppose State A's domestic law identifies alienation with the conclusion of a binding contract, and State B's law with completion of the contract. If the taxpayer enters into a binding contract before he leaves State A, and completes the contract after arrival in State B, each state will regard the alienation as occurring during the period of residence in that state (even where both operate a split-year approach). This may be a problem which will have to be resolved by Mutual Agreement.[6]"

Mann J very kindly answered the question of the period of time over which one applies the tie-breakers. In his view (see paragraph [43] of the judgment) the answer is (a) – only on the date when the alienation took place. With respect, however, there are, perhaps, different issues that need to be considered. One needs to apply the tie-breaker with regard to the period of time or the point of time when there is concurrent residence, and it is necessary to know whether a person is resident in which Contracting State to apply the substantive article of the treaty. That much is agreed. However, the question raised in my book is whether, in applying the tiebreaker at that point of time or for that period, one looks at the factual background only as at that date, or over a broader period. Take, for example, the third leg of the tie-breaker for individuals, which refers to the place of *habitual abode*. This is explained in the Commentary as the place where the taxpayer spends the greater part of his time. How can one assess an individual's "habitual abode" by reference to only one point in time, or one day? The factual pattern over a longer period of time has to be taken into account in order to determine the application of the tie-breaker as at that particular date. This is, with respect a different issue from the one to which Mann J addressed himself.

Vicarious exemption under tax treaties: the dog that didn't bark

One of the many puzzling things about this case is that HMRC does not appear to have argued that Mr. Smallwood was not entitled to the protection of the UK-Mauritius tax treaty. It should be remembered that Mr Smallwood was never resident in Mauritius: he could only rely upon the exemption in the tax treaty, therefore, vicariously. The argument would be that the Mauritius-resident trustee was exempt from tax in the United Kingdom by virtue of Article 13(4) of the treaty. That exemption also extended to the UK-resident trustees, as the trustees are regarded as a single and continuing body of persons. The next step would be that, as the liability of the trustees to tax was nil, the "amount equal to that referred to in paragraph (b)" in section 77(1) TCGA 1992 was also nil. Thus, vicariously, Mr. Smallwood enjoyed the benefit of its tax treaty while never going anywhere near Mauritius.

Logically, this argument is unimpeachable. However, it seems to run against the decision of the Court of Appeal in *Bricom Holdings Ltd v IRC*[7] and the decision of the Special Commissioner in *IRC v Willoughby*[8].

Following the decision in *Bricom*, there appears to be a distinction made between situations such as s.13 TCGA 1992, where a UK resident is treated as if the chargeable gain accruing to a non-resident had accrued to him. In that situation, if the non-resident was protected by a tax treaty, so was the UK resident. This may be contrasted with the charge to tax under the controlled foreign companies legislation which was at issue in *Bricom*, where the chargeable profits of a non-resident were apportioned to a UK-resident company and a sum equal to corporation tax charged on the apportioned amount of profits. It is very hard to see this as a tenable distinction. Assuming that HMRC accepted that Mr. Smallwood could enjoy the vicarious exemption under the tax treaty, then it would appear that HMRC places the charge to tax under s.77(1) in the same category as s.13 TCGA 1992.

In the circumstances here, the Mauritian trustee resigned in favour of the UK-resident trustees before the end of the UK year of assessment to ensure that s.77 TCGA applied and not s.86 TCGA. By doing so, the whole issue of concurrent or consecutive periods of residence arose. It was sometimes said that the vicarious exemption under a tax treaty was easier to argue under s.77 than under s.86, though s.86(4)(e) provided that "chargeable gains of an amount equal to that referred to in subsection (1)(e) above shall be treated as accruing to the settlor in the year…". That appears to be a similar formulation to that of s.77(1). The author of this article, for one, has never understood why it was thought that section 77 was more likely to give rise to a vicarious exemption from tax: if the author is right, then HMRC should also accept (and subsequent legislation suggests that is the case) that a settlor may also enjoy a vicarious exemption from a charge to tax under s.86 TCGA 1992. If that is right, then it was unnecessary for the Mauritian trustees to resign in favour of UK-resident trustees (which gave rise to the issue of concurrent or consecutive periods of residence).

Concluding comments

It is understood that the decision of Mann J is to be taken on appeal. If HMRC were now to abandon its position of arguing for consecutive and not concurrent periods of residence then it seems that they should win. If there was a period of concurrent residence when the trustees were resident (under domestic law) in Mauritius and also liable to tax in the United Kingdom by virtue of their subsequent residence in the UK, then the place of effective management tie-breaker would, on the basis of the facts as found by the Special

Commissioners, result in no exemption under the treaty. Since the finding of place of effective management is a finding of fact, the taxpayer would either have to argue that the Special Commissioners had misdirected themselves as to the meaning of the phrase "place of effective management", or that they had reached a decision on the facts that no reasonable tribunal could have reached.

If, on the other hand, HMRC continues to maintain that there were periods of consecutive residence only, then their chances of success must be lower. They would need to point out that it is rare that one determines tax liability based upon a single event such as the disposal of an asset, and that liability is usually determined over a period of time. They may also wish to abandon their argument based upon Article 24 in favour of the possibility of resolving conflicts between two resident states where there is no concurrent period of residence through the competent authority procedure. Alternatively, they may wish to revisit whether, in accordance with *Bricom* Mr. Smallwood really enjoyed vicarious exemption from tax under the UK-Mauritius treaty.

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[1] The High Court decision is [2009] EWHC 777 (Ch) and the decision of the Special Commissioners is reported at [2008] STC (SCD) 629. (Noted in Vol VII No.2 of this *Review* at page 27.

[2] It is a little surprising that HMRC did not support the decision of the Special Commissioners, particularly in the light of the rather surprising nature of HMRC's own argument on the application of Article 13. It may possibly be that HMRC was concerned that this was a test case, and that if the decision turned on the factual place of effective management, then all other cases would need to be examined on their facts. On the other hand if HMRC's position on Article 13 was sustained, the Round the World scheme failed for everyone, as least everyone where the trustees subsequently became resident in the United Kingdom during the year of assessment.

[3] This view is expressed in the author's book on Double Taxation Conventions at paragraph 4B.19. Mann J cited this at paragraph [42] of his judgement. However, he considered that under domestic law there were consecutive periods of residence and no concurrent period. Thus he considered that it was unnecessary to apply the tie-breaker.

[4] Other than a rather un-illuminating example in Para. 10 of the Commentary, and some guidance in Para. 19.

[5] The application of Art. 13 (Capital Gains) is perhaps easier than some other Articles because alienation takes place at a specific point in time - though see further below.

[6] Some of these issues concerning change of residence were discussed in IFA; The tax treatment of transfer of residence by individuals (2002) 87B Cahiers DFI.

[7] [1997] STC 1179.

[8] [1995] STC 143 at page 168