Neutral Citation Number: [2013] EWCA Civ 63

Case No: A3/2012/0966

IN THE COURT OF APPEAL (CIVIL DIVISION)
ON APPEAL FROM Upper Tribunal
TAX AND CHANCERY CHAMBER
MANN J

Royal Courts of Justice
Strand, London, WC2A 2LL

Date: 12/02/2013

Before :

LORD JUSTICE LAWS
LADY JUSTICE ARDEN
and
LORD JUSTICE LLOYD

- -

Between :

HER MAJESTY'S REVENUE AND CUSTOMS	**Respondent**
- and -	
GEORGE ANSON	**Appellant**

- -
- -

Jonathan Peacock QC (instructed by **Ernst & Young LLP**) for the **Appellant**
David Ewart QC & James Henderson (instructed by **HM Revenue and Customs**) for the **Respondent**

Hearing date : 17 October 2012

- -

Judgment

Lady Justice Arden:

1. The appellant, Mr George Anson, is a member of a Delaware limited liability company or "LLC", known as HarbourVest LLC ("HV"). This is a very profitable entity. HV is treated as "tax transparent" in the USA, meaning that its members pay tax on their share of its profits and the LLC pays no tax. This is because under the relevant federal and state law the profits of such entities are treated as the profits of the members for fiscal purposes unless the members have elected otherwise in the prescribed way. That election was not made in this case. At the time that these profits arose, Mr Anson was resident but not domiciled in the UK for tax purposes and he was liable to pay UK tax only on income remitted to the UK but that included his share of the profits of HV for the fiscal years 1998 to 2004, the years with which we are concerned, unless any double tax relief ("DTR") or domestic unilateral relief was available. The issue on this appeal relates only to DTR.

2. The respondent, Her Majesty's Revenue and Customs ("HMRC"), seeks to levy tax on Mr Anson's share of HV's profits. In its decision dated 3 August 2011, the Upper Tribunal (Tax and Chancery Chamber) (Mann J) upheld HMRC's contentions.

3. Mr Anson's case is that he is entitled to DTR. Accordingly, the question to be decided on this appeal is whether Mr Anson is entitled to DTR under the terms of the UK/US Double Tax Convention of 31 December 1975 (SI 1980/568) (applying to all the fiscal years in issue save the last) ("the 1975 Convention") and UK/US Double Tax Convention of 24 July 2001 (SI 2002/2848) (in relation to 2003/4) ("the 2001 Convention").

4. The question in issue falls to be determined by reference to the relevant provisions of the 1975 Convention and the 2001 Convention. There is no material difference between the two Conventions.

5. It is common ground that, to obtain DTR, Mr Anson must establish that his share of HV's profits is the same profits as those by reference to which he was taxed in the US. These words are set out in article 23 of the 1975 Convention, which I have set out in the annex to this judgment.

6. In essence, HMRC contends that Mr Anson's share of HV's profits represents income received by him from his investment in HV, and that these are not the same as the profits which HV made. It does not seek to levy tax on Mr Anson on the basis that profits of HV can be attributed to him for tax assessment purposes.

7. The First-tier Tribunal (Mr John F. Avery-Jones CBE and Mr Ian Menzies-Conacher FCA) ("FTT") came to a different conclusion from the Upper Tribunal ("the Upper Tribunal"). The FTT considered that the members' arrangements for automatically allocating profits to members meant that the profits of HV had belonged to Mr Anson throughout. The Upper Tribunal considered that the FTT had applied the wrong test and that the profits sought to be taxed in the UK were not the same as those taxed in the US. I examine the members' arrangements as part of the background below.

8. Mr Anson has already paid federal and state tax in the US on his share of HV's profits at the rate of 45%. The practical implications of this question are that, if the Upper Tribunal's decision stands, Mr Anson will be liable to pay tax at the rate of 22% of

the whole out of the remaining 55% of his income, making an effective rate of tax of 67%. If the appeal succeeds he will pay no further tax in addition to that already paid in the US.

9. Having considered the submissions of counsel and the decisions of the FTT and Upper Tribunal, I conclude that the decision of the Upper Tribunal discloses no error of law. I shall amplify below my reasons in paragraphs 57 to 86 below, but in summary they are as follows:

   i) The relevant test for determining whether a person is taxed on the same profits or income in both jurisdictions is whether the source of the profits or income in each jurisdiction is the same.

   ii) Where the taxpayer became entitled to the profits of an entity because of some contractual arrangement to which he is a party, he must show that the contract is actually the source of the profit, rather than a mechanism to secure a right to a profit derived from another source. This will in general mean that, as the judge held, he has to show a proprietary right to the profits.

   iii) The Upper Tribunal was right to conclude that the FTT erred in law in so far as it held that the profits of HV belonged to the members.

   iv) The Upper Tribunal was also right to conclude that on the facts of this case the profits of HV did not belong to its members.

10. The UK/US Exchange of Notes dated 24 July 2001 is a quite separate matter. Mr Anson does not have permission to appeal on this matter and accordingly he has first to obtain that permission. I will deal with his application when I have dealt with the appeal. For the reasons given in paragraph 87 to 93 below, I would refuse the appellants permission to rely on the UK/US Exchange of Notes dated 24 July 2001 at this late stage.

11. I have used the term “tax transparent” in paragraph 1 above to denote the arrangements under US federal and state law for imposing tax on certain entities. The parties to this appeal have also used this expression but without defining it. They have similarly used the expression “opaque” as meaning the opposite state of affairs. In line with my first reason in paragraph 9 above, I propose to use the term “tax transparent”, in relation to UK tax, to describe the income of a member of an entity which is to be regarded as having the same source for the purposes of UK tax law as that of the entity from which it is derived. For this purpose, an entity includes a partnership or a trust which does not have a separate legal personality.

12. Before I explain my reasons I will set out the background and briefly summarise the reasoning of the FTT and Upper Tribunal.

BACKGROUND

(a) Relevant features of an LLC

13. The FTT heard expert evidence as to foreign law and made detailed findings on this subject.

14. It is common ground that an LLC is an entity which is separate from its members and that an LLC holds its undertaking and assets separately from its members. This is an indication that profits derived from its trading are those of the LLC and not those of its members. Profits are after all simply the sum which remains after an account of the results of the trading are drawn up.

15. The LLC is a creature of the Delaware LLC Act.

16. The principal characteristic of an LLC is that the statutory framework provides a number of default rules but otherwise enables parties to structure the internal workings of the LLC by agreement. Thus:

    i) Profits and losses of the LLC are allocated to the members either as agreed in "an LLC agreement" or in proportion to the agreed values of their contributions.

    ii) The LLC agreement can regulate members' voting rights but in default the Delaware LLC Act specifies the voting rights of managing and non-managing members.

    iii) Members have interests in the profits and assets of the LLC, which they can assign, but the LLC has no share capital.

    iv) Members have capital accounts to which the LLC's profits are credited and losses debited. Members benefit rateably from any credit for tax purposes.

    v) Distribution and reserving policy is controlled by the "managing members". Accordingly managing members could determine the timing and amount of distributions out of members' capital accounts. It follows that members cannot compel the distribution of their capital accounts to themselves.

(b) HV LLC agreement (28 January 1997)

17. The members of HV entered into an LLC agreement dated 28 January 1997. HV is not a party to the LLC agreement. The provisions principally relevant for the purposes of this appeal are those dealing with capital contributions and capital accounts.

18. The members made initial capital contributions and agreed to make additional capital contributions when required by the managing members.

19. Article IV provided for the crediting to members' capital accounts of capital contributions and all gross income and capital gains, and for the debiting to such accounts of distributions and all losses and expenses. There were complex provisions for determining the basis of allocation as between different members but we are not concerned with these provisions.

20. Article V then dealt with distributions of net profits. This had four parts dealing with respectively: distributions; set off of sums due from members to HV; the creation of reserves, and the withholding of taxes. The first part begins as follows:

> "Subject to the provisions of this Article V, to the extent cash is available, distributions of all of the excess of income and

> gains or losses, deductions and expenses allocated in accordance with Section 4.2 with respect to any calendar year will be made by the Company at such time within seventy-five (75) days following the end of such calendar year and in such amounts as the Managing Members may determine in their sole discretion. The Managing Members may from time to time in their discretion make additional distributions in accordance with the provisions of this article V."

21. There were then provisions dealing with the order of priority of different types of distributions to members, but we are not concerned with the detail of these.

22. The third part of Article V dealt with reserves. In effect, it enabled the LLC to withhold amounts which were otherwise distributable by the company to the members to make such provision as it thought desirable to meet liabilities, including future or contingent liabilities:

> "The Company may withhold amounts otherwise distributable by the Company to the Members, pro rata from all members in accordance with the amounts otherwise distributable, in order to make such provision as the Company, in its discretion, deems necessary or advisable for any and all reasonably anticipated liabilities, contingent or otherwise, of the Company and to maintain the Company's status as a qualified professional asset manager within the meaning of the [a statutory provision] …"

23. The fourth part of Article V dealt with withholding tax. HV could retain out of profits the sums which it required to pay withholding tax as a result of a member's status as a member or former member.

24. Article XI dealt with dissolution and provided that surplus assets should be distributed to members in accordance with Article V. We are not concerned with the detail of this provision.

DECISION OF THE FTT

25. The FTT decided that the same profits were taxed in both the UK and the United States and that therefore Mr Anson was entitled to DTR. The FTT found that the LLC was a separate legal entity, that its business was carried on by its members, that it owned its assets and that the members did not own its assets, that the LLC was liable for its debts, that the LLC did not have anything akin to share capital and that its capital was more like the partnership capital of an English partnership, and finally that the members of the LLC had an entitlement to profits as they arose.

26. The FTT's conclusion was expressed in the opening sentences of paragraph 21 of its decision as follows:

> "21. The factor we are mainly concerned with in relation to the Treaty is whether the profits belong to the members as they

> arise. We have concluded that this is the effect of the LLC … Agreement and the Act…. "

DECISION OF THE UPPER TRIBUNAL

27. The Upper Tribunal concluded that in paragraph 21 of its decision the First Tier Tribunal (paragraph 26 above) had held that the members of HV had not merely a contractual but a proprietary entitlement to profits, and that this was an error of law as the evidence did not support this conclusion. In those circumstances the Upper Tribunal held that it could address the question of the nature of the members' entitlement afresh. It concluded that the profits on which Mr Anson was taxed in the US:

> "were in law, reality and substance the profits of [HV]…it was a contractual entitlement to money, like the plc's interest in the silent partnership in *Memec*… the profits were [HV's] and the contractual obligation to credit and distribute did not make them the members' at least for English tax purposes. The position of the members is nothing like the position of an English partner…" (decision, paragraph 53).

28. Those profits were accordingly not the same as those on which Mr Anson was liable to tax in the UK, and the Upper Tribunal allowed the appeal from the FTT.

29. I now turn to the task of developing the reasons outlined in paragraph 9 above, describing the submissions of the parties on the various points.

AMPLIFICATION OF MY REASONS OUTLINED ABOVE

(i) The relevant test for determining whether a person is taxed on the same profits or income in both jurisdictions is whether the source of the profits or income in each jurisdiction is the same

30. *Memec plc v IRC* (1998) 71 TC 77 is the leading authority on this point and on other points in this appeal. That case involved a provision similar to article 23 of the 1975 Convention appearing in the UK/Germany Double Tax Convention. A parent company (M) had entered into a *stille Gesellschaft*, or silent partnership agreement under German law, with a subsidiary (an intermediate holding company) to receive the lion's share of the profits received by that subsidiary from its subsidiaries, in return for making a substantial investment.

31. M sought to say that the profits received by the intermediate holding company (which were taxable in Germany) were the same as those received by M so that there could be DTR in the UK against the tax payable by M. M thus contended that the silent partnership created no new source of income, and that the source of the income was not the contractual provisions of the silent partnership arrangement so that the arrangement was tax transparent for the purposes of UK law.

32. The special commissioners, the High Court and this court all rejected that claim.

33. Robert Walker J (as he then was) accepted that, to be tax transparent, the income had to have the same source as that taxed in the foreign jurisdiction because of the schedular nature of UK income and corporation tax:

> "The schedular character of income tax (on which corporation tax is based: see s 9 of the 1988 Act) means that the court has always placed great importance on the concept of the *source* of taxable income (see for instance the anthology of citations provided by Lord Hanworth MR in *Leeming v Jones* (*Inspector of Taxes*) 15 TC 333, 349-350). The concept of source is a more or less coded subtext to income tax and corporation tax statutes." (page 93)

34. The schedular character of income tax derives from the fact that historically the legislative approach was not to define income but to provide that income from sources specified in a number of schedules (Schedules A to F) to the legislation should be subject to income tax. If income could not be brought within the schedules, it was not taxable. Income tax is still imposed by reference to categories of income even though schedules are not generally used, and so the point made by Robert Walker J remains good.

35. When M appealed to this court, this court also adopted the approach that they had to determine whether the sources of the income of M and the silent partnership were the same.

36. Both parties accept that Mr Anson has to show that the profits on which he was or is sought to be taxed in the two jurisdictions had the same source, though they differ as to the identity of the source.

37. In my judgment, the court has to determine the source for the purposes of UK tax law of Mr Anson's income: was the source of his income the profits of HV or merely a distribution out of its profits?

38. I will explain further under the next sub-heading how the exercise of establishing the precise source of his income is to be carried out. There is no issue as to the source of HV's profits: those profits were plainly derived from its own trading.

(ii) Where the taxpayer became entitled to the profit of an entity because of some contractual arrangement to which he is a party, he must show that the contract is actually the source of the profit, rather than a mechanism to secure a right to a profit derived from another source. This will in general mean that, as the judge held, he has to show a proprietary right to the profits

39. This is the proposition of law which I would distil from *Memec*. (Under this sub-heading I am dealing only with the law.) It is not enough to show a contractual right to receive a profit. The profit must always have belonged to the party claiming DTR. To explain this point, I need to examine *Memec* in more detail.

(a) Memec at first instance before Robert Walker J

40. The parties in *Memec* were agreed that the formation of the silent partnership meant that there was a new source of income. The issue was whether the silent partnership was tax transparent.

41. Robert Walker J reviewed the authorities on trusts. He noted that the income paid to a life tenant under an interest in possession trust would be tax transparent because the life tenant has an interest in the trust property, and the income as it comes into the trustees' hands. He further held that this could be contrasted with a discretionary trust, where no beneficiary was entitled to any income unless and until the trustees exercised their discretion in his or her favour. M challenged this point in this court and Peter Gibson LJ left it open (page 111).

42. The issue that arose in *Memec* was whether the silent partnership could be treated like an English, Jersey or Scottish partnership. The Commissioners of Inland Revenue ("the Revenue") had accepted that all of these were "tax transparent". Indeed this court has held that the profits of an English partnership are the profits of the partners as the business is carried on by the partners as principals and as agents for each other (see per Fox LJ in *Padmore v Commissioners of Inland Revenue* 62 TC 352).

43. Counsel for the Revenue in *Memec* (Mr Launcelot Henderson QC, as he then was) submitted that the silent partnership did not share the important characteristics of an English partnership which made it tax transparent: those three characteristics were (1) no separate legal personality, (2) the carrying on of a business in common with a view to profit and (3) that partnership assets are owned by the partners beneficially.

44. Robert Walker J observed that the question was not whether the silent partnership was a partnership for English law purposes but whether the arrangements were tax transparent so as to make the source of M's share of the subsidiaries' profits the same as that of the profits distributed to the intermediate holding company.

45. Robert Walker J held that the decisive point was that M had no proprietary right in the shares of the subsidiaries or to the distributions by them. They belonged to the intermediate holding company. Accordingly they had to be regarded as a separate source of income and the arrangement was not tax transparent. M appealed.

(b) Memec in this court

46. This court came to the same conclusion that the silent partnership arrangement was a separate source for income tax purposes but emphasised different matters.

47. Peter Gibson LJ, giving the first judgment, held that the task to be carried out in that case was to see to what extent the characteristics of an English or Scottish partnership were shared by a silent partnership. He carried out a detailed analysis and concluded that, unlike an English or Scottish partnership, the business was carried on by the intermediate holding company alone and the interest of M in the profits of the subsidiaries was purely contractual. Peter Gibson LJ drew an analogy with the case of a lender who makes an advance for a return varying with profits where that does not give rise to a partnership.

48. He held that a silent partnership was crucially different from an English or Scottish partnership:

> "A silent partnership, whilst being similar to an English partnership in not being a separate legal entity, differs from both English and Scottish partnerships in a number of respects. The judge considered the decisive point to be the absence of any proprietary right, legal or equitable, enjoyed by Plc in the shares of the Subsidiaries or in the dividends accruing on those shares. That is certainly a strong point of distinction from an English partnership, though it is less obviously so in the case of a Scottish partnership. But even a Scottish partner has an (indirect) *interest in the profits of the partnership as they accrue* as well as in the assets of the partnership. In a real sense the profits and assets are the profits and assets of the partners, the firm, their collective alter ego, merely receiving those profits and holding those assets for the partners who are the firm. They are jointly and severally liable for the firm's debts. In contrast, though a silent partner is indirectly interested in those profits, in that his entitlement to a share of the profits (or his obligation in respect of the losses) will be computed by reference to the profits of the owner at the end of the year, his interest is purely contractual. A clearer distinction is the point advanced by Mr Henderson that unlike in an English or Scottish partnership in the silent partnership no business is carried on by Plc and GmbH in common with a view to profit. The business is that of GmbH as sole owner. Plc is not jointly liable with GmbH to creditors of GmbH for the debts and obligations of GmbH. The liabilities of the business are those of GmbH alone, though Plc can be called on by GmbH to bear its share of losses computed at the end of the year to the extent of its capital contribution. To a third party, Plc's role in the silent partnership is irrelevant and may not be known." (page 113) (emphasis added)

49. He agreed with the following conclusion of Robert Walker J:

> "Metaphorical language is not a substitute for analysis, but it may help to explain the conclusion: adopting Lord Asquith's phrases [in *Stainer's Executors v Purchase* [1952] AC 280 at p 291], I conclude that Plc's rights under the [Agreement] did have independent vitality and were not mere incidental machinery. Without those rights under the [Agreement] Plc would continue to receive dividends from GmbH, and nothing from the [Subsidiaries]." (at 98)

50. Sir Christopher Staughton gave the only other reasoned judgment. He also relied on the fact that under German law the intermediate company owned the assets and ran the business.

(c) Revised Revenue guidance

51. On the basis of *Memec*, the Revenue issued revised guidance (see Tax Bulletin 39 of February 1999). This lists six factors, which were put to the experts in this case. These factors include ownership of profits as they arose, but, as pointed out on behalf of Mr Anson, the guidance does not state that ownership of profits is a necessary precondition to claiming DTR. The guidance adopts a multi-factorial approach to determining whether an entity is opaque or transparent. Some of the factors may

point in one direction and some in another. The guidance states that an overall conclusion is required.

(d) Submissions

52. Mr Anson's case is that the same-source requirement is satisfied by showing that his entitlement to profits was an automatic one, not dependent on the act of any third party. Thus Mr Jonathan Peacock QC, for Mr Anson, submits that his case is supported by the fact that there is no necessary requirement in the case law or the revised Revenue guidance that there should be ownership of the assets of the business as well. He relies on the paragraph from the judgment of Peter Gibson LJ which I have set out in paragraph 48 above, and the Revenue guidance described in paragraph 51 above.

53. On Mr Peacock's submission, there did not have to be a right to a profit; there had simply to be an entitlement to profits *as they arose*. He goes on to argue that, in the case of HV, there was no intervening entitlement in HV as there would be if there were a requirement for a directors' resolution to pay a dividend. Accordingly, he submits that the requirement of entitlement was fulfilled. (I will discuss the application of the appropriate principle separately under subheading (iv) below).

54. Mr David Ewart QC, for HMRC, submits that a mere contractual right is not enough. There has to be a right to the profits, not merely a right to receive them as they arose.

55. Mr Ewart submits that in *Memec* this court essentially made the same point as Robert Walker J. The partnership in that case was not carrying on business in common. The same question arises in this case as in *Memec*: what was the source of the income? To be the same profits they must, on Mr Ewart's submission, emanate from the same source and relate to the same period.

56. Mr Ewart also submits that the source in tax terms is the taxpayer's immediate source. A shareholder gets his dividend from his shares, and in that case the shares are the source. So, in *Memec*, the dividends declared by the trading subsidiaries were the source of the income.

(e) My analysis

57. In my judgment, *Memec* establishes the approach to be adopted in determining whether the profits of a member of an entity are the same as those of the entity itself. If profit is earned by an entity, and the source of the profit to the taxpayer as a member of that entity is a contract as between him and other members, then in the usual case it follows that the source of his income must be a different source of income from that of the entity itself. The fact that there is a contract generally suggests that there is a disposition of a right to the profits from one person to another. That result can be avoided if the member had a proprietary right to the profits as they arose. This would as I see it generally be the case where income accrues to a trust under which an income beneficiary has an interest in possession, or to a unit trust or collective investment scheme, if the investors have a beneficial interest in the assets that are subject to the unit trust or scheme.

58. What the court is looking for is whether the member had a right to the profits when the profits were created, or, in the words of Peter Gibson LJ in *Memec*, as they accrue. In answering that question, the court will look at factors which throw light on the answer to that question, such as whether the entity is a separate legal entity, whether the entity has a share capital, whose business is actually being carried on, whether the profits depend on the decision to allocate, liability for debts of the entity and ownership of the assets of the entity. Provisions in the agreement between the members which make it possible to assign an interest may also throw light on whether the profits are those of the members. The member's interest could amount to a share of the profits from the moment they arose, or it could simply be a right to receive a share of the profits.

59. I recognise that profits do not arise until an account is struck for a particular period showing that there has been a profit, and that in general an entity will not have particular assets that can be said to be assets which represent the profit which it has made. For these reasons, in order for a member of an entity to show that he was entitled to profits from the moment that the profit arose he will have to show that he has an interest in the assets to the value of the profit. This will necessarily be a proprietary interest.

60. A partner in an English partnership has an equitable interest in the partnership assets and thus he will be able to show that he has a proprietary interest to the extent of his profit and share in the partnership.

61. Likewise an income beneficiary under an interest in possession trust will be able to show an equitable interest in the income in question.

62. It is not therefore sufficient to find that there is a contract if that contract is in reality simply the means whereby the entity transfers its right to receive or retain the profits to the member. In that event, the contract will not be the source of the profit as from the moment of its creation. To say that the member must be entitled to profits as they arise or from the moment they are created is merely the converse of this proposition.

63. Mr Ewart submits that it is impossible for the profits of a business to belong to a person other than the person carrying on the business. I agree that it is difficult to think of examples where this would be the case, save perhaps in one case. That is the case of an agency company, that is, a company which carries on its own business so far as its dealings with the outside world are concerned but which in fact holds its assets as agent for another (usually another group company) and draws up its own accounts on that basis. But even in that example, the agency company may be little more than a nominee. There may be other cases.

64. In my judgment, it would be unusual but not impossible for an entity with a separate legal personality, such as a company, to be tax transparent for English law purposes. One example would be the Scottish partnership where the partnership is a separate legal entity and holds the assets of the business, but the partners have an (indirect) interest in the assets and carry on business in common: this has been held by this court to be tax transparent and Mr Ewart assured the court that nothing in his submissions was intended to undermine that position.

(iii) The Upper Tribunal was right to conclude that the FTT was in error in so far as it held that the profits of HV belonged to its members

65. Under this subheading I need to deal with two submissions made by Mr Peacock, one as to foreign law and one as to the scope of the FTT's holding in paragraph 21 of its decision.

(a) Threshold question - was the FTT's finding (paragraph 21 of its decision) a finding of foreign law?

66. A threshold question arises as to the basis on which this court can review the material part of paragraph 21 of the FTT's decision (paragraph 26 above), which was a fundamental step in the Upper Tribunal's reasoning.

67. Mr Peacock submits that the question of who is entitled to the profits of HV falls to be determined as a matter of Delaware law, and is thus a question of fact. Moreover, the FTT made its findings having heard the evidence of two experts. Accordingly, on his submission, the Upper Tribunal should not have set aside the FTT's finding in paragraph 21 of its decision that HV's profits belonged to its members.

68. Mr Peacock relies on *MCC Proceeds Inc v Bishopsgate Investment Trust* [1999] CLC 417. In that case, this court held that it would be slow to set aside findings as to foreign law based on oral evidence though it would do so more readily where it was a question of statutory interpretation, on which there was no evidence of particular rules of interpretation, or of a special meaning, under the foreign law.

69. Mr Ewart submits that paragraph 21 of the FTT's decision is in material part a holding on the application of English law to the features of the members' interests in HV which had been established on the evidence as to foreign law. In those circumstances, paragraph 21 constituted a holding on domestic law, not a decision as to foreign law.

70. I accept Mr Ewart's submission on this point. As to the role of foreign law, Robert Walker J (at first instance) in *Memec* summarised the effect of the authorities (including authority binding on this court) as follows:

> "When an English tribunal has to apply the provisions of an United Kingdom taxing statute to some transaction, arrangement or entity which is governed by a foreign system of law, the tribunal must take account of the rules of that foreign system (properly proved if not admitted) in order to determine the nature and characteristics of the transaction, arrangement or entity. But having informed itself in this way, the tribunal must then apply the taxing statute as part of English law." (page 172)

71. Accordingly, in the present case, Delaware law governs the rights of the members of HV as the law of the place of its incorporation, and the LLC agreement is expressly made subject to that law. However, the question whether those rights mean that the income of HV is the income of the members is a question of domestic law which falls to be determined for the purposes of domestic tax law applying the requirements of domestic tax law, including those discussed under subheadings (i) and (ii) above.

(b) What was the scope of the finding in paragraph 21 of the FTT's decision?

72. Mr Peacock submits that, if it was open to the Upper Tribunal to set aside the FTT's finding as to entitlement to profits, the Upper Tribunal was wrong to hold that the FTT made a finding as to entitlement to profits in a proprietary sense. On his submission, the finding was only as to entitlement to profits in a contractual sense.

73. Mr Peacock points out that the FTT reached their conclusion on the basis of the provisions in the LLC agreement providing for the allocation of profits to capital accounts (see paragraphs 10 to 12 of the decision of the FTT).

74. The FTT used the word "belong" in paragraphs 12 and 21 and other paragraphs of its decision but Mr Peacock submits that the FTT simply used this word in the sense of an entitlement: see for example paragraph 18. On his submission the FTT referred not to ownership in a proprietary sense but to the entitlement to profits as they arose and that they decided that point in Mr Anson's favour. The FTT was an expert tribunal and must be taken to know the significance of these concepts.

75. This question was considered at length by the judge and he came to the conclusion that "when the [FTT] said 'belong' in paragraph 21, it meant 'belong'": I agree. As the judge said, the comparison with partnerships (in the FTT's paragraph 20) is a clear indication that this is what the FTT meant. The FTT did not restrict its conclusions to entitlement or to allocation of profits, and it is difficult to think that it would confuse a right of ownership of profits with a right to have profits allocated.

(iv) The Upper Tribunal was right to conclude that the profits of HV did not belong to its members

76. I now turn to the question whether the Upper Tribunal was right on the facts of this case to conclude that the profits of HV (being the gross income allocated to their capital accounts less the expenses debited thereto) did not belong to the members in a proprietary sense. In my judgment, it was. The members' right to have profits allocated to their capital accounts represented a transfer of an entitlement to the profits, and the profits as they arose belonged to HV.

77. Mr Peacock's case is that HV was analogous to a partnership. However, the fact is that HV had a separate legal personality. There is nothing to suggest that it did not have unqualified ownership of its assets or that its members had any interest in those assets (see paragraphs 14 to 16 above).

78. Mr Peacock submits that the Upper Tribunal were wrong to say that the members of HV had to have a proprietary interest in the profits of HV for the following reasons:

i) Profits are conceptually distinct from assets (*Reed v Young* [1986] STC 285, 289 per Lord Oliver, which was quoted by the Upper Tribunal in paragraph 38 of its decision). This much is indeed common ground. Accordingly, the ownership of cash is not determinative of profits as they arise. Mr Peacock submits that this is so in Delaware, as well as in English, law. Thus Delaware law defines the interest of a member as including a share of profits as well as the distribution of assets.

ii) Under Delaware law, the entitlement to profits is contractual where it is governed by the terms of the LLC agreement.

iii) FTT interpreted the provisions in the LLC agreement as imposing an obligation to allocate profits, and was right to do so. This obligation was not undermined by the qualifications on that obligation, such as HV's right to set allocations of profits against amounts owed by the member to HV and its right to establish reserves out of profits.

79. Mr Peacock further submits that HMRC's case is in effect that, once it is understood that the LLC has a separate personality and is answerable for its debts, those factors are conclusive as to entitlement to profits as they arise. That would leave the position of a Scottish partnership exposed. It would mean that Scottish partnerships are non-transparent (or "opaque") and that would seem to have the result that all Delaware LLCs are opaque. So this court would be deciding the point for all Delaware LLCs.

80. Mr Ewart submits that the crucial question is to identify the profits on which Mr Anson was taxed in the United States. The critical question was whether the United Kingdom charged tax on the same profits as the US. Mr Ewart submits that Mr Anson must establish that the charge to tax in the United Kingdom was on his share of profits, not upon a distribution by the LLC. He must also answer the question: why would he be charged in the United Kingdom to tax on those profits?

81. Mr Ewart focuses on the fact that the business was carried on by the LLC and that it owned all its assets just like a company. He submits that:

- Article IV simply set out the process of deciding the amount that Mr Anson could receive in a distribution; and
- Article V deals with what each of the members receives on a distribution. There needed to be a mechanism for determining profits to be distributed.

82. Mr Ewart further submits that the decision of the FTT did not depend on Article V. The FTT held that Article V was irrelevant to the issue which the FTT had to determine, which had to stand or fall on Article IV. On his submission, profits belong to the LLC before they are allocated to members. The LLC is merely distributing its cash. Furthermore, there is no difference between a share capital company and this company with respect to dividends. The question is whether it is the same income. On his submission, it is not because it does not have the same source.

83. In my judgment, the key issue is whether the members of HV were entitled to the profits as they arose. The FTT identified this as a relevant question, but was misled into thinking that the matters to which the allocation of profits was subject - the availability of cash, the absence of claims by HV against the member which could be the subject of set off, a decision by the managing members to create reserves to meet HV's cash requirements, and the need to withhold profits to meet withholding tax payable by HV- had no substantial effect on the question whether the members were entitled to the profits from the very beginning. Those were very material reservations, like the reservation in the proverbial question to Mrs Lincoln. The fact was that the profits arose from HV's trading as principal, and the deductions that could be made from profits before they were allocated were powerful indications that confirmed that

the profits did not belong to the members from the moment of their creation. The amount allocated to members was indeed a residual amount after HV had taken the sums that it needed.

84. It is apparent that all that the automatic allocation provisions in Article V of the LLC agreement achieved was to make it unnecessary to have a resolution of the managing members of HV before an allocation was made. Put another way, the members have agreed in advance on those matters that were to prevent or limit a restriction on the distribution of profits (for example, a need to credit profits to a reserve). Accordingly, contrary to the view of the FTT, the automatic allocation provisions did not affect the fact that the profits arose from the business of HV and were its profits. What the members obtained was a distribution out of its profits.

85. Moreover, as Mr Ewart points out, it is not unknown for private companies in the UK to have articles of association that provide for the automatic distribution of profits. There is nothing unique, therefore, in the drafting of the LLC agreement in this regard.

86. Accordingly, in my judgment, the Upper Tribunal came to the correct conclusion that on the facts of this case the profits of HV did not belong to its members.

Application for permission to appeal: UK/US Exchange of Notes dated 24 July 2001

87. Mr Peacock relied on an exchange of notes dated 24 July 2001 between the governments of the UK and the US at the time of the entry into the 2001 Convention:.

> "With reference to Article 24 (Relief from Double Taxation):
>
> it is understood that, under paragraph 4 or 8 of Article (General Scope), the provisions of the Convention may permit the Contracting State of which a person is a resident (or, in the case of the United States, a citizen), to tax an item of income, profit or gain derived through another person (the entity) which is fiscally transparent under the laws of either Contracting State, and may permit the other Contracting State to tax
>
> a) the same person;
>
> b) the entity; or
>
> c) a third person
>
> *with respect to that item*. Under such circumstances, the tax paid or accrued by the entity shall be treated as if it were paid or accrued by the first-mentioned person for the purposes of determining the relief from double taxation to be allowed by the State of which that first mentioned person is a resident (or, in the case of the United States, a citizen), …" (emphasis added)

88. Mr Peacock applies for permission to appeal with respect to the 2001 Convention of 24 July 2001 having regard to this exchange of notes. Mr Peacock submits that it is no

longer necessary to show that tax was paid on the same profits. On the contrary the exchange of notes was intended to resolve that question.

89. Mr Ewart makes a number of points about this exchange of notes but his principal submission for present purposes is that the exchange of notes does not address the question of which income it is that is taxable.

90. Mr Ewart further contends that these notes were incorporated into the 2001 Convention to meet a problem for the US authorities about tax-transparent vehicles. The effect he submits was not with respect to relief by the UK but with respect to relief given by the US. For example, there could be a US individual with an interest in a UK entity where the entity makes the profits and the US treats the entity as transparent whereas the UK taxes the entity. The exchange of notes states that under such circumstances the tax will be treated as paid by the first person so that the US must give relief. This is not a UK problem.

91. Mr Peacock disputes this point. He submits that the explanation given by Mr Ewart does not illustrate how the clause would work the other way around when it was clearly envisaged to work both ways. It is therefore no answer to say that it was only intended to operate from the US point of view.

92. Mr Peacock did not raise this point until after the Upper Tribunal had given its decision. There is clearly some dispute as to the mischief to which the exchange of notes is directed. There would have to be further evidence to resolve that dispute. Moreover, the words "with respect to that item", which I emphasised in setting out the material part of the exchange of notes in paragraph 87 above are, on the face of it, consistent with Mr Ewart's principal submission that no change is made in the requirement for the profits taxed in each jurisdiction to be the same profits in order to qualify for DTR. If an alteration to article 23 was intended, it is surprising that it was dealt with in this oblique way.

93. In all the circumstances I would refuse permission to appeal on this further point.

Disposal of this appeal

94. For the reasons given above, I would dismiss this appeal. I would, however, like to express my gratitude to counsel for the clarity and economy of their submissions, and to pay tribute also to the helpful and skilful analysis in the Upper Tribunal's decision.

Lord Justice Lloyd:

95. I agree, for the reasons given by Arden LJ, that the application for permission to appeal on an additional ground should be refused, and that the appeal should be dismissed.

Lord Justice Laws:

96. I also agree.

Annex to the judgment of Arden LJ

Article 23 of the US/UK Double Tax Convention of 31 December 1975

> (2) Subject to the provision of the law of the United Kingdom regarding the allowance as a credit against United Kingdom of tax payable in a territory outside the United Kingdom (as it may be amended from time to time without changing the general principle hereof) –
>
> > (a) United States tax payable under the laws of the United States and in accordance with the present Convention, whether directly or by deduction, on profits or income from sources within the United States (excluding in the case of a dividend, tax payable in respect of the profits out of which the dividend is paid) shall be allowed as a credit against *any United Kingdom tax computed by reference to the same profits or income by reference to which the United States tax is computed;*
> >
> > (b) In the case of a dividend paid by a United States corporation to a corporation which is resident in the United Kingdom and which controls directly or indirectly at least ten per cent of the voting powers of the United States corporation, the credit shall take into account (in addition to any United States tax creditable under (a) the United States tax payable by the corporation in respect of the profits out of which such dividend is paid. (Emphasis added)