The Offshore Tax Planning Review

SOVEREIGN IMMUNITY AND REPAYMENT OF WITHHOLDING TAX

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1 What is the Nature of Immunity?

A foreign sovereign is, by the comity of nations, immune from direct taxation imposed by another state. Or is he? I must confess that until reading the decision[1] of the English Court of Appeal in *R v Commissioners of Inland Revenue ex parte Camacq Corporation*[2] and *Cambrian and General Securities PLC*[3] I had always supposed that sovereign immunity was an immunity from suit and not an absolute immunity. The theory is that a foreign sovereign cannot be forced against his will to be a party to proceedings in a municipal court; nor can judgment given against him be executed on his assets or his person against his will.

The distinction is crucial where in the first instance income tax has been withheld by the payer of the income and the foreign sovereign who is entitled to the income makes a claim for repayment from the taxing state. If the sovereign is indeed immune from taxation as such, i.e., is exempt, then the sum which has been withheld and paid over to the revenue authorities on account of his liability to taxation is paid in satisfaction of a non-existing liability. The sovereign is therefore entitled, on normal restitutionary principles, to recover that amount from the revenue. If, however, the sovereign merely has an immunity from suit, that will avail him nothing. The revenue authorities can simply sit tight and refuse repayment. After all, as a matter of general municipal law, repayment is not due. It is the foreign sovereign who then has to sue the revenue authorities. That he will not be able to do successfully.

True, if no tax had been withheld, either because withholding was not legally required or the payer had failed to comply with municipal law, then the foreign sovereign would be in a better position. The Revenue could not sue him for the

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1 Reported at 62 Tax Cases 651.

2 "Camacq".

3 "Cambrian".

tax, so that he would normally be immune. The practical result, in the vast majority of cases, is that he would be in as good a position as if he enjoyed an exemption from tax on the income.[4]

The result may appear to be somewhat capricious. Everything depends upon whether the foreign sovereign happens to be instituting or defending a suit. It may seem even more arbitrary and capricious in the sphere of taxation in that the withholding rules are, at least in the United Kingdom, regarded as mere machinery of collection, not affecting substantive tax liabilities. There is a parallel in the law of contract where the court will not enforce an "illegal contract", e.g., a contract of prostitution. Here, the Latin maxim is *in pari delicto, potior est conditio defendentis:*[5] i.e., as the court will not give a remedy to either party, the defendant is always in the better position.

There is, of course, no practical difficulty in the taxing state allowing a foreign sovereign to be sued in its courts and in executing judgment against him and his assets, insofar as they are within its jurisdiction. The self-denial on the part of a taxing state proceeds from considerations of international comity. It is therefore always open to the taxing state to withdraw the immunity if it considers it is being abused. In the twentieth century the principle of sovereign immunity has been severely curtailed, most notably where state agencies carry on functions which are commercial rather than governmental. It was therefore not surprisingly argued in the *Camacq* case that the immunity may not apply where a foreign sovereign was plainly abusing it.

2 The Facts of the *Camacq* Case

The facts of the *Camacq* case were quite extraordinary. Camacq made a public offer to buy all the issued shares of Cambrian. By this method, Camacq acquired only about 70% of Cambrian's shares. Some 20% of the shares had become vested in an escrow agent who held on trust for the United States Treasury. The shares had formerly belonged to a certain Mr Ivan Boesky and had been

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4 Even in this case, the practical position and the theoretical position do not always coincide. Suppose a dictator of some Hispanic republic were to amass a vast private fortune from bribes from drug smugglers which he were to invest in the United Kingdom, then, so long as he remained dictator, he would be immune from proceedings to recover tax due on that fortune. If, however, he were subsequently to be toppled from power, then his immunity would be removed. He could then be sued, subject to the normal rules as to limitation, for tax on income which had arisen during the period when he had been the foreign sovereign. This example illustrates vividly the difference between exemption from tax and mere immunity from suit.

5 Where the parties are equally tainted with illegality, it is better to be in the position of the defendant.

transferred by him, under the direction of the United States District Court, in part satisfaction of a civil penalty levied against him. The Americans held out for a larger price. Camacq was in difficulty. It could not simply increase its offer, because that would have been contrary to the Takeover Code laid down by the Takeover Panel. An ingenious scheme was therefore devised which, somewhat surprisingly, was approved by the Takeover Panel. Possibly, they did not understand its full implications. In essence, the scheme involved declaring a dividend which would in fact be paid only on the shares held by the escrow agent. Thereafter the rights attached to the escrow agent's shares would be altered so that they would become virtually worthless, simply enjoying the right to repayment of capital on a winding-up. The actual amount of dividend to be paid would be such as would involve the escrow agent receiving directly from the company the same amount as any other shareholder. It was apprehended, however, that the escrow agent would, on behalf of the United States Treasury, be entitled to reclaim from the United Kingdom Inland Revenue a tax credit associated with the payment of the dividend.[6] Thus, while to the uninitiated it appeared that Camacq was paying the same amount, the United States Treasury was in fact receiving more, the difference being made up by the Inland Revenue.

Out of an abundance of caution, Messrs Linklaters & Paines wrote to the Revenue on 13th April 1989 asking for confirmation that the United States Treasury, as an organ of the United States Government, would be entitled to tax credits under section 232(3) of the Income and Corporation Taxes Act 1988 and would "consequently" be entitled to payment of those tax credits in full under section 231(3). In the first instance, the Revenue replied that the Treasury would be entitled to tax credits and that they could be reclaimed. When the scheme was amended, Linklaters & Paines wrote again to the Revenue and obtained a fresh confirmation on 8th June.

On 24th June, Linklaters & Paines advised the Inspector of Foreign Dividends that a Press Release would be issued by the Securities and Exchange Commission in the United States setting out the proposed transaction. At this point, apparently for the first time, the Inspector of Foreign Dividends notified a Mr Cook, who was concerned with questions of policy relating to sovereign immunity from taxation. Mr Cook appreciated that the difference between the price being paid by Camacq and the amount being received by the escrow agent was attributable wholly or mainly to the tax credit of approximately $8,000,000. In those circumstances, Mr Cook withdrew the earlier ruling, on the grounds that there was "considerable doubt" as to whether the escrow agent had the benefit of sovereign immunity, in all the circumstances.

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6 It was apparently common practice for the Inland Revenue to make repayment in such cases. This, perhaps the most extraordinary aspect of the whole affair, is commented on at 6, p 82 below.

Over the following days, the position of the Revenue hardened. They noted that Taxes Act 1988 section 235 is an anti-avoidance provision aimed at dividend stripping of this type. In brief, it applies where a person normally exempt from taxation acquires more than 10% of the share capital of a company and a dividend is paid to him out of pre-acquisition profits. Subject to the question of whether the United States Government was in fact "exempt",[7] that provision was exactly in point.

There is a not dissimilar provision in the UK/USA Double Taxation Convention of 31st December 1975, Article 10 paragraph 7. Article 10 paragraph 2 confers on a resident of the United States a (limited) right to a tax credit in respect of a dividend paid by a corporation resident in the United Kingdom. Article 10 paragraph 7 takes away that right in the case of a beneficial owner of 10% or more of the class of share capital in respect of which the dividend is paid, to the extent to which the dividend is paid out of profits earned or income received in a period ending more than twelve months before the date on which he became the owner of 10%. or more of the class of shares in question.

It was not claimed by the Applicants that Article 10(2) was point. This was no doubt because they would have had to overcome two formidable obstacles. Firstly, Article 10(7) expressly denies the tax credit where the recipient of the dividend is "exempt" from tax in the United States. Secondly, the United States government would have had to show that it was a "resident of the United States" within the meaning of Article 4(1)(b) of the Convention. In any case, the Article does not give the right to a full tax credit.

3 The Proceedings for Judicial Review

3.1 The Nature of the Relief Sought

Camacq and Cambrian then brought proceedings for judicial review against the Revenue for an order quashing the revocation and restoring the original direction. Judicial review is basically an administrative law remedy. Given that the proceedings were for judicial review, counsel for the companies faced a formidable challenge. It was neither necessary nor sufficient for him to show that the tax credit was in fact repayable. Indeed, that was something he was not allowed to do. For there existed an alternative procedure, namely for the United States Treasury to make a claim and, if this claim was then refused, to appeal to the Special Commissioners for Income Tax Purposes. Judicial review does not normally lie if there is a suitable alternative remedy.

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[7] As opposed to either immune or simply not capable of being sued.

It was clear that Camacq could not have forced the Revenue to give a ruling in advance in the first place. It therefore had to argue that, because a ruling had been given, it should not then have been withdrawn, in other words that, as a matter of *administrative* law rather than *tax* law, the Revenue should be bound by their ruling, right or wrong. It could not point to any detriment which had been sustained as a result of acting on the ruling before it was withdrawn. In those circumstances, the prospect of success was a forlorn one and it was hardly surprising that Kennedy J dismissed the application and the Court of Appeal disallowed the appeal against such dismissal.

3.2 The Revenue Position

The United Kingdom Revenue had clearly proceeded on the basis that sovereign immunity required them to pay a tax credit to a foreign government. Their counsel in defending the proceedings succeeded in persuading them - no mean feat - to admit that their practice had been entirely wrong and that sovereign immunity was simply an immunity from suit and did not of itself entitle a foreign government to reclaim tax suffered by it, directly or indirectly, from the United Kingdom Revenue authorities.

The Revenue argued that there were perfectly good reasons for departing from their normal practice in this case, in effect the wholly artificial nature of the transaction which was something within the spirit, whether or not it was within the letter, of both United Kingdom municipal anti-avoidance legislation and the anti-avoidance provisions in the UK/USA Double Taxation Convention.

The Revenue are obliged by statute to administer the tax system according to law. In certain circumstances, they can be required, as a matter of administrative law, to treat a taxpayer more favourably than the law allows, but only where it would be unfair for them to act otherwise; see *R v Commissioners of Inland Revenue ex parte Unilever PLC* [1994] STC 841. What amounts to unfairness is still not settled. In particular, it is highly debatable in which circumstances the Revenue are precluded from resiling from a ruling or agreement as to the non-liability of a person to tax.[8] In the present case, there was clearly no such unfairness. The judges therefore did not have to decide the question of sovereign immunity. Nevertheless, they did express some views.

4 The Views of the Judges on Sovereign Immunity

Lloyd LJ, in the Court of Appeal, considered that there were "difficult questions of very great importance which may have to be determined hereafter" as to

[8] The leading case is the House of Lords decision in *R v Commissioners of Inland Revenue ex parte Preston* [1985] AC 282.

whether foreign governments are immune from taxation in general. Farquharson LJ expressly limited himself to the short ground that the Revenue were entitled, in the circumstances, to withdraw the "concession" - not, perhaps, the most apt word - that the tax credit could be paid directly to the escrow agent.

Only Dillon LJ considered the larger issue. He admitted that the question was one which it was unnecessary for the court to decide in the present case, it being sufficient to hold merely that the Revenue were entitled to revoke their prior authorisation. He did, however, express his personal view "without full development and argument" that the Crown's original position was correct and the new thoughts were misconceived. With respect, his argument is less than convincing.[9]

5 The True Position in Law

5.1 Summary

What, then is the true position in law? It my view, it is as follows:

1. sovereign immunity is merely immunity from suit and not immunity from liability to taxation

2. dividends paid by United Kingdom companies to foreign sovereigns are, on a true construction of the Taxes Act 1988, exempt from United Kingdom taxation so that in general foreign sovereigns are, as a matter of substantive United Kingdom law, entitled to repayment of the tax credit, but

3. such exemption, being given by statute, can also be removed by statute. In the present case, the exemption was removed as the transaction fell both within the spirit and the letter of section 235 Taxes Act 1988.

5.2 A Third Contention

Of course, this was a position for which neither side argued. It is hardly surprising that the companies did not claim that the dividend was exempt from tax by statute, as they would then, to a large extent, have fallen four-square within section 235. Why counsel for the Revenue did not raise it is less easy to fathom. Possibly, they were more concerned to get the law right than to save the Revenue's face. If so, one can but admire them. For if my view is correct, it follows that, at least as regards dividends paid from United Kingdom companies, the Revenue

[9] See pp 671C-672A.

were acting correctly both in their general practice of repaying the tax credit and in their specific refusal to commit themselves in the peculiar circumstances of the present case.

5.3 United Kingdom Law on Taxation of Dividends

5.3.1 Prior to 1973/74

In order to understand the position fully, one must scrutinise more closely the relevant provisions of United Kingdom law. Before the introduction of the imputation system on 6th April 1973, when a company paid a dividend out of profits which had borne tax, the dividend was paid under deduction of standard rate tax. The company, however, was entitled to retain such tax. The recipient of the dividend received the dividend plus a credit for standard rate tax on the grossed-up amount. If he were liable to pay standard rate tax, no more, no less, then his liability had been fully settled. If he were liable to pay surtax, then he could be assessed separately. If he were not liable to pay standard rate tax, or not pay it in full, then he could require repayment from the Revenue.

5.3.2 From 1973/74 Onwards

5.3.2.1 United Kingdom Residents

With the introduction of the imputation system in 1973, the position is superficially the same and, indeed, in many cases, the practical result is identical. When a company pays a dividend, it must now account for advance corporation tax on the grossed-up amount of the dividend.[10] The rate of advance corporation tax was until 1993/94 equal to basic rate[11] tax. Since 1993/94, it has been equal to lower rate tax. That advance corporation tax can, however, be set against the company's liability to mainstream corporation tax. The result is that, as before, it does not, at the end of the day, pay any additional tax in respect of dividends paid out of taxable profits. So far as the recipient is concerned, if he is a person other than a company and is resident in the United Kingdom, then he is taxable on the grossed-up amount of the dividend and the advance corporation tax paid in respect of it, but receives a tax credit equal to the advance corporation tax. So far as such a person is concerned, therefore, the new system makes no difference.[12] The

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[10] Taxes Act 1988 s.14.

[11] For present purposes, the concept of basic rate tax, which was also introduced on 6th April 1973, can be regarded as identical to that of the standard rate tax which it replaced.

[12] See Taxes Act 1988 section 231.

position where the recipient is another United Kingdom resident company is broadly the same, albeit reached by a different route.[13]

5.3.2.2 Non-United Kingdom Residents

Where, however, the recipient of the dividend is not resident in the United Kingdom, the position is more complex. On the one hand, such a person is not entitled to a tax credit. On the other hand, he is liberated from liability to income tax at the basic[14] rate.[15]

In the case of a non-resident who enjoys no special status, the position is unchanged. After the introduction of the imputation system, he receives, just as before, a dividend liberated from the liability to pay tax thereon at the basic[16] rate, none of which he will be able to recover. Where, however, the non-resident enjoys some exemption from United Kingdom taxation, the position is revolutionised. Take, for example, the case of a resident of Italy for the purposes of the Convention of 4th July 1960.[17] Under Article VII of the Convention, it is provided that he shall be liable to tax on a dividend paid by a United Kingdom company at a rate no higher than 15%[18] of the gross amount of the dividend. Thus, when a dividend was paid to him before 6th April 1973 and he had suffered, say, 40% standard rate tax by deduction, he would be entitled to recover 25%. Where a dividend was paid to him after the 5th April 1973 he found that he could recover nothing. For the gross amount of his dividend was now the actual amount paid to him; and on that he is not taxed at all. The benefit of the treaty was therefore useless to him.[19] Slowly, our treaty partners have woken up to this

13 The recipient company is exempt from tax on the dividends: see Taxes Act 1988 section 208.

14 As from 6th April 1993, the recipient is liberated from liability to income tax at the lower rate. As, however, a person who would previously have been taxable only at the basic rate is now taxable only at the lower rate, the net result is, for present purposes, the same.

15 Taxes Act 1988 section 233(1).

16 Or, since 1993/94, lower.

17 This Convention has now been superseded by that of 21st October 1988.

18 5% in special cases.

19 Unless he was an individual whose income was so high that he was liable to United Kingdom tax at the higher rates.

slight of hand on the part of Perfidious Albion and have renegotiated their treaties.[20]

5.3.3 Special Rule for Sovereign Powers

Taxes Act 1988 section 232(3) lays down a special rule where the recipient of the dividend is, *inter alia*, a foreign sovereign:

> "Where a qualifying distribution is income of, or of the government of, any sovereign power or of any international organisation, that power, government or organisation shall be entitled to a tax credit in respect of the distribution to the same extent as to a recipient mentioned in section 231(1)[21]."

Now, a sovereign power or the government of a sovereign power will, *ex hypothesi*, not be resident in the United Kingdom. If section 232(3) did not exist, therefore, section 233(1) would apply so that the sovereign power would not be liable to tax on the dividend. Now, if the only effect of section 232(3) is to confer a tax credit on such sovereign power, without affecting the question of whether it is in fact liable to tax on the dividend, then it is wholly redundant. For if the sovereign power is liable to tax, then the amount of its liability is exactly equal to the tax credit. Nor will there normally be any question of a sovereign power being entitled to payment of part of that credit under the terms of a double taxation convention. Such conventions apply only to a resident of one or other of the Contracting States. But that term is almost invariably defined to include only persons liable to tax in that state by virtue of some connecting factor, such as residence. As the sovereign power will be the authority levying the tax rather than a person liable to it, it cannot qualify.

5.4 Conclusion

Thus, in my view, in order to give section 232(3) any effect at all, one must imply that the sovereign power is not only to be entitled to a tax credit but is to be exempt from tax on the income and therefore is to be entitled to repayment of that tax credit.

Once the immunity is seen to depend upon section 232(3), however, there is nothing to prevent section 235 applying so as to disallow the exemption in respect of distributions by way of dividend of pre-acquisition profits. For it would only

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[20] *Steel v European Vinyls Corporation NV* [1995] STC 31 is an example of current litigation where the Revenue are relying on the failure of Italy to renegotiate the 1960 Convention until 1988.

[21] i.e., a person resident in the United Kingdom.

be "by reason of an exemption from tax" that the sovereign power would be "entitled to recover tax", all within the meaning of section 235(1).

What of other income, tax on which has been withheld? If my view is correct, then it follows that in the case of other United Kingdom source income which is liable to United Kingdom tax, a foreign sovereign would not be entitled to recover tax withheld. For example, if a foreign sovereign were to lease land in the United Kingdom to a tenant who was required to deduct basic rate tax from the rent and account for it to the Revenue.[22] We have for some time in the United Kingdom been moving nearer to a position where non-residents are, by and large, charged to tax only where tax is withheld.[23] It will thus be more important than ever to determine whether foreign sovereigns actually enjoy a general exemption from United Kingdom taxation on income[24] or simply an immunity from suit. If only the latter, then in practice they will rarely be better off than any other non-resident. Ironically, they will often be worse off as they will not enjoy the benefit of a double taxation treaty even though their own citizens do!

6 Comment

The position revealed by the case is unsatisfactory in the extreme. Perhaps the most extraordinary aspect of the whole affair was that it was apparently common practice for the Inland Revenue to allow repayment claims by foreign sovereigns in all cases. In the financial year 1987/88, apparently a sum of £190,000,000 was refunded to sovereign immune bodies and the five largest recipients accounted for 80% of the total repayment! Sovereign immunity from suit is one thing; exemption from taxation and entitlement to refund is quite another. Here, by administrative action, huge benefits were being conferred on foreign states. It is one thing when the United Kingdom enters into a treaty, ratified by Parliament, whereby taxpayers in the United Kingdom pay taxes to subsidise, say, inefficient Continental farmers. It may not be desirable, but at least it is done democratically. One wonders how long, but for this case, the Revenue would have continued their practice. Indeed, one wonders whether they have even as yet discontinued it.

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22 See Taxes Act 1988 section 43, in the course of being superseded by Finance Act 1995 sections 37-40.

23 See my article in this issue: *UK Taxation of Non-Residents: The New Substantive Rules*.

24 With regard to capital gains, the position is largely academic. For persons who are not residents of the United Kingdom are liable to the tax only when they carry on a trade through a branch or agency in the United Kingdom. In such a case, it is most doubtful whether sovereign immunity would be available anyway, given the commercial nature of the transaction.

There may or may not be very good reasons of policy for exempting, say, the Government of Kuwait from United Kingdom taxation on its United Kingdom income. One might reasonably take the view that what is good enough for Kuwait is too good for Libya or Bosnia. Yet this is a decision which ought to be taken by Parliament and not by Ministers behind closed doors or, worse still, by Revenue officials acting on a wholly misconceived view of the law. One cannot sufficiently endorse the suggestion of Dillon LJ, made a good five years ago, that legislation is required to clarify the position.[25] Even if the only legislation which is forthcoming is to the effect that Ministers have a general discretion to dispense foreign sovereigns from liability to United Kingdom taxation where, for reasons of policy, they think fit, that would be an improvement on the existing position.

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25 He recognised that the point is very important and it is very desirable that it should be clarified by legislation if the Crown intended to maintain the new position: see p 672A-B.