

## Long walk to tax freedom

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*Keith Gordon* looks at a case which considers how to interpret a Double Taxation Treaty in the light of a deeming provision in the domestic law

### What is the issue?

The case concerns the question as to whether the income from diving engagements undertaken by a South African resident in the waters of the UK continental shelf should be taxed in the UK or in South Africa.

### What does it mean to me?

Ultimately, the matter turns on the effect and scope of a deeming provision: does it denature the actual employment and turn it into a trade (as held by the majority) or does it merely treat certain employment income as trading income.

### What can I take away?

It is always worth considering precisely what the scope and effect are of the relevant provisions and check whether the consequences of any deeming are being taken too far or perhaps not far enough.

## Background

When I worked at the Tax Law Rewrite Project at the turn of the millennium, one of the targets for simplification was the removal or reduction of deeming provisions wherever possible. A deeming provision is one where the statute starts off with a particular situation and then pretends that it is another (i.e. X is treated as Y). The purpose of a deeming provision is to allow the consequences of Y to follow even though the reality of the situation is X (and not Y).

In many cases, deeming provisions were eradicated simply by ensuring that the particular tax consequences flowed from either X or Y (and so there was no need to enter the land of make believe). However, there can be no hard and fast rules and some deeming provisions are inevitable if the legislation is not to spiral (even further) out of control.

One such example is found in section 15 of the Income Tax (Trading and Other Income) Act 2015. Subsection (1)

makes it clear that the section applies if 'a person performs the duties of employment as a diver or diving supervisor' either in the UK or in the UK's Continental Waters. The deeming provision is found in subsection (2) which reads: 'The performance of the duties of employment is instead treated for income tax purposes as the carrying on of a trade in the United Kingdom.'

In most cases, the consequence of the deeming provision is clear: an employed diver is treated as self-employed. And, in such cases, the tax consequences (no PAYE, the less limited rules for deductible expenses etc.) are obvious.

The difficulties in this case arose because it was necessary to look beyond the domestic statutes and, in particular, to look at the interaction between the deeming provision and a Double Taxation Treaty.

## **Facts of the case**

The taxpayer, a Mr Fowler, is a qualified diver and a resident of South Africa. In the 2011 /12 and 2012 /13 tax years, Mr Fowler undertook a series of diving engagements in the waters of the UK continental shelf. The case ultimately concerns the question as to whether the income from those activities should be taxed in the UK or in South Africa.

The UK and South Africa have a Double Taxation Treaty whose pertinent provisions provide as follows:

- Income from self-employment (otherwise than through a permanent establishment) is taxable only in the country of residence (article 7). There is no question of a permanent establishment in the present case and, therefore, if self-employed, Mr Fowler would be taxed exclusively in South Africa.
- Income from employment, however, may be taxed where the employment is exercised (article 14). Accordingly, if Mr Fowler is an employee then his UK earnings would be taxable in the UK.

The issue in this case was to identify which of those two articles applies to the income of an employed diver in relation to the diver's UK income. In other words, does employment remain employment income and give UK taxing rights under article 14 (albeit by taxing the income as if it were trading income) or does the statutory deeming extend to the Treaty and engage the provisions of article 7?

The First-tier found for Mr Fowler. The Upper Tribunal allowed HMRC's appeal. Accordingly, the taxpayer appealed to the Court of Appeal.

## **The Court's decision**

The case came before Lord Justices Lewison, Henderson and Baker.

The facts were summarised in the judgment of Lewison LJ who also referred to a definitions provision in the Treaty. Article 3(2) provides that any term not specifically defined in the Treaty (such as 'employment') takes its meaning from the domestic law (and, where necessary, with domestic tax law taking priority over other domestic law).

However, the Judge considered that this article did not bring into the Treaty the result of the deeming in section 15. Essentially, section 15 does not modify any meaning of the word 'employment', but merely treats the performance of certain employment duties as if they were the carrying on a trade. Accordingly, the Judge concluded that article 3(2) was of no assistance to Mr Fowler.

Without anything to displace the ordinary meaning of 'employment' in the Treaty, the Judge concluded that (on the assumption that Mr Fowler was actually an employee in the UK) it must be article 14 that applies and therefore permits the UK to tax the income.

However, Henderson LJ (despite initially agreeing with the conclusion reached by Lewison LJ) took a different view. He noted that deeming provisions (except where it leads to an absurdity) should generally be given full effect. Therefore, if

a particular employment is deemed to be something else then 'you must [not] cause or permit your imagination to boggle when it comes to the inevitable corollaries of that state of affairs'. Accordingly, since section 15(2) has, for income tax purposes, determined that this particular employment is treated as a trade then it must fall outside the meaning of 'employment' for all such purposes, including the application of the Treaty.

As a result, Henderson LJ considered that article 7 applies, thereby providing that South Africa had exclusive taxing rights on the income.

Henderson LJ did not rely on the application of the definitions provision in article 3(2). Nevertheless, he considered that it was consistent with his conclusion.

With his two colleagues reaching conflicting views, the matter came to Baker LJ to determine the outcome of the case. He came down on the side of Henderson LJ (and, therefore, the taxpayer).

Mr Fowler's appeal was therefore allowed.

## **Commentary**

Despite the conflicting outcomes, the respective approaches of the different judges are broadly similar. Ultimately, the matter turns on the effect and scope of the deeming provision: does it denature the actual employment and turn it into a trade (as held by the majority) or does it merely treat certain employment income as trading income.

I can certainly see the merits of both approaches and hope that the parties (and the Courts) would allow this question to be determined by the Supreme Court, because it has potential ramifications far beyond this particular case.

The approach of the majority certainly has the advantage of relative simplicity and ensures that a statutory deeming is given full effect.

On the other hand, my instinctive feeling is that the judgment of Lewison LJ is to be preferred. Parliament, in my view, has not specified that the actual employment is denatured as such: merely that the duties of the employment are treated as something else. If Parliament had wanted a broader effect to the deeming provision, it would have stated so. However, I must confess (evidencing my own uncertainty on this matter) that any attempt to draft a deeming provision that actually modified the meaning of employment would be disproportionately cumbersome and perhaps this militates in favour of the outcome chosen by the majority.

Indeed, the broad-brush approach taken by the majority (as a by-product of the simplicity it promotes) would preclude Parliament from taking a more nuanced approach in different cases.

## **What to do next**

It is always worth remembering that a lot of what we do in tax is based upon deeming provisions (which, after a while, we take for granted). As a result, it is always worth considering precisely what the scope and effect are of the relevant provisions and check whether the consequences of the deeming are being taken too far or perhaps not far enough.

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