

WHAT IS A DIVIDEND?

By **Barrie Akin**

This was one of the main questions for the Court in *Memec plc v Inland Revenue Commissioners* [1996] STC 1336 which is a useful reminder to practitioners that the approach adopted by the Court in interpreting tax treaties can differ markedly from the more familiar approach to the construction of domestic tax statutes. For Memec to succeed in its claim to double tax relief (“DTR”) it had to show that “dividend” had the same meaning for both treaty and domestic purposes, but the Court (Chancery Division, Robert Walker J) applied different principles of interpretation in holding that the word did not have precisely the same meaning for both purposes.

Before plunging in to the decision in *Memec*, it is useful to summarise the legal nature and effect of treaties and the principles surrounding their interpretation.

The Legal Nature And Effect of Treaties

All treaties (including tax treaties) are agreements between sovereign states and hence obligations of the states concerned under public international law. Treaties do not automatically give the private citizen any rights because they are not part of the domestic law of the United Kingdom. Frequently, parliament incorporates treaties into domestic law, giving the citizen the right to rely on them. Tax treaties become part of domestic law, following the procedure indicated in Section 788(1) ICTA 1988, by the issue of an Order in Council containing the text of the treaty and a declaration that arrangements have been made with the government concerned “with a view to affording relief from double taxation....”

Section 788(3) of ICTA goes on to provide that in these circumstances

“the arrangements shall, notwithstanding anything in any enactment, have effect in relation to income tax and corporation tax ...”

This wording incorporates the arrangements into domestic law. Where the arrangements conflict with domestic legislation, the wording is also sufficient to ensure that treaty provisions prevail: see *Ostime v Australian Mutual Provident Society* (1959) 38TC 492 at 514.

The Principles of Interpretation of Tax Treaties

The fact that tax treaties are part of domestic law by virtue of Section 788 ICTA does not mean that they are interpreted in the same manner as domestic legislation. The traditional rules of statutory interpretation have been shaped by domestic considerations. It does not follow that they are the right tools for interpreting agreements regulating the United Kingdom's dealings with foreign states.

In *Commissioners of Inland Revenue v Commerzbank AG* (1990) 63 TC 218 the Court (Chancery Division, Mummery J) adopted the approach used in the leading (non tax) case on treaties, *Fothergill v Monarch Airlines* [1981] AC 251. That approach can be summarised as follows:

1. Look first for a clear meaning of the words used in the relevant article of the treaty, bearing in mind that consideration of the purpose of an enactment is always a legitimate part of the process of interpretation.
2. If the provisions of a particular article are ambiguous, it may be possible to resolve that ambiguity by giving a purposive construction to the treaty, looking at it as a whole.
3. A strictly literal approach to interpretation is not appropriate.
4. The process of interpretation should take account of the fact that the language of treaties is not chosen by English parliamentary draftsmen, but is arrived at after negotiation between governments. It should be interpreted "unconstrained by technical rules of English law, or by English precedent, but on broad principles of general acceptance."
5. Regard should be had to Article 31(1) of the Vienna Convention on the Law of Treaties, which states that a treaty should be interpreted in good faith and in accordance with the ordinary meaning to be given to its terms in their context and in the light of its object and purpose.

6. If the adoption of this approach leaves the meaning of the relevant provision unclear or ambiguous or leads to a result which is manifestly absurd or unreasonable, recourse may be had to supplementary means of interpretation, including “*travaux préparatoires*” such as the OECD’s commentary on its model treaty. See: *Sun Life Assurance Co. of Canada v Pearson* 59 TC 250.

7. Subsequent commentaries on a treaty have persuasive value only, depending on the cogency of their reasoning.

8. Decisions of foreign courts depend for their authority on the reputation and status of the courts in question.

9. *Travaux Préparatoires*, such as the commentary on the OECD model treaty, international case law and the writings of jurists are not a substitute for study of the terms of the treaty and their use is discretionary, depending on their relevance and the weight to be attached to them.

Memec plc v Inland Revenue Commissioners

1. The Facts

Memec plc (“Memec”) and four of its wholly owned UK resident subsidiaries each owned 20% of a German holding company (“GmbH”). Until 1985 Memec and its UK subsidiaries received dividends from GmbH. The profits of GmbH were themselves derived from dividends from its German operating subsidiaries. Memec and its UK subsidiaries were chargeable to corporation tax on dividends from GmbH, but were also entitled to DTR under the provisions of article XVIII of the UK/German treaty (SI 1967/25) for German tax withheld by GmbH from the dividends and for German corporation tax chargeable on GmbH’s profits. These reliefs were apparently sufficient to eliminate all UK corporation tax on the dividends.

All five UK companies were also entitled, under the underlying tax relief provisions in Section 801(2) ICTA, to DTR for trade tax paid by the German operating subsidiaries on their profits. This was of no relevance at the time, given the sufficiency of the DTR available in respect of withholding tax on the dividends and corporation tax on GmbH’s income.

However, in 1985 Memec entered into an agreement designed to reduce German corporation tax: Memec and GmbH formed a silent partnership under German commercial law. In return for making a contribution to GmbH's capital, Memec acquired a silent partnership interest of 87.84% in the profits of GmbH's business. The effect of this was that 87.84% of the dividends that GmbH received from its German operating subsidiaries now found their way to Memec under its silent partnership interest, rather than, as previously, as dividends paid by GmbH to Memec and the UK subsidiaries. As this structure eliminated German corporation tax, but did not eliminate trade tax payable by the German operating subsidiaries, Memec's entitlement to DTR in respect of trade tax now became relevant.

2. The Issues

There were three main issues for the Court to decide. The first issue (dealt with only briefly in this article because it is not directly relevant to the interpretation issues) is whether the silent partnership was transparent. If that was the case the dividends would be treated as paid by the German operating subsidiaries of GmbH directly to Memec, so Memec would be entitled to DTR in respect of underlying tax (i.e. in respect of trade tax paid by the operating subsidiaries) for the purposes of Article XVIII (1)(b) of the treaty and Section 801(1) ICTA. The Court held that since, under German commercial law, Memec acquired no proprietary rights in the dividends themselves, but only a contractual right against GmbH, the silent partnership was not transparent: the source of the income received by Memec was not shares in the German operating subsidiaries but its rights under the partnership agreement. Memec therefore failed on this issue.

The second issue was whether "dividend" in Article XVIII(1)(b) of the treaty includes income arising from an interest in a silent partnership. If that was the case, Memec would potentially fall within the provisions of Section 801(2) ICTA 1988, which (subject to the outcome of the third issue below) would allow underlying relief for trade tax paid by the German operating subsidiaries.

The arguments of the parties on the second issue were:

1. The Revenue contended that, on a literal reading of the treaty, the definition of "dividends" in Article VI(4) (which includes silent partnership distributions) was confined to Article VI and did not apply for the purposes of Article XVIII. Memec disagreed.

2. Memec pointed to the use of “dividends” elsewhere in the treaty where the context probably required that the Article VI(4) definition was appropriate. This, it was said, indicated that the Article VI(4) definition should also apply to Article XVIII. The Revenue disagreed: just because the context of some Articles of the treaty suggested that the Article VI(4) definition might apply to them, it did not follow that the definition should also apply to Article XVIII, where the context did not require this.

3. The Revenue said that the meaning of “dividend” under UK tax law should apply because Article III(3) of the treaty provides that the domestic meaning applies to terms not otherwise defined in the treaty, unless the context otherwise requires. Memec said that this provision did not apply because the term was in fact defined, the context did “otherwise require” and in any event “dividend” has no clear meaning in UK tax law.

4. Memec relied on a decision of the German federal tax court which applied the definition of “dividends” in article 10(6) of the Swiss/German tax treaty (which, like article VI(4) of the UK/German treaty, specifically included silent partnership distributions) to another article of the Swiss/German treaty which had no definition of “dividends”. The Revenue disagreed: as with the second argument above, just because, in the context of the Swiss/German treaty, it was appropriate to extend the specific definition of “dividends” to some Articles of the treaty, it did not follow that the definition applied to all Articles of that Treaty.

5. Memec relied on the views of a German expert on Tax Treaties. The Revenue regarded his views as tentative and argued that reliance on them was not mandatory, but depended on their cogency.

6. Memec argued that the main purpose of the treaty was to eliminate double taxation, so there should so far as possible be symmetry between the Article of the treaty that allocates taxing rights between countries (Article VI) and the Article that grants credit (Article XVIII). The Revenue said that this did not follow because the wide differences between tax laws in different countries meant that taxing rights and credit arrangements cannot be expected to mesh together exactly.

The Court, following the principles set out in *Commerzbank* derived little help from the first three points. A literal approach to the treaty was inappropriate. The fourth and fifth points were held to be of some help, but not determinative. The Court was, however, clearly persuaded that they reflected the correct approach, as argued by

Memec in the sixth point, i.e. that the purposive argument for construing the treaty in as symmetrical a way as possible dictated that the definition of “dividend” in Article VI(4) should also apply to the relevant parts of Article XVIII.

Memec accordingly succeeded on the second issue.

Memec had also to win the third issue in order to succeed overall. The third issue was the meaning of “dividend” in Part XVIII ICTA 1988, specifically in Sections 790(6) and 801(1). If “dividend” included income arising from an interest in a silent partnership, underlying DTR would be available, either unilaterally under Section 790(6) or through the treaty under Section 801(2) ICTA, in respect of trade tax suffered by the German operating subsidiaries of GmbH. The route to relief depends on the outcome of the second issue. If the meaning of “dividend” did not extend to silent partnership distributions, no underlying relief would be available.

The decision of the Court on this third issue was based on the more familiar domestic approach to statutory interpretation. For Memec to succeed, it had to show that for the purposes of Part XVIII ICTA “dividend” did not simply mean “...a payment-out of part of the profits for a period in respect of a share in a company”, per Harman J in *Esso Petroleum Co Ltd v Ministry of Defence* [1990] 163 at 165.

The principal argument which found favour with the Court was that the definition of “distribution” in Section 209 ICTA 1988 began with “dividends paid by the company” (Section 209(2)(a)) and continued with... “any other distribution out of assets of the company...in respect of shares in the company...” (Section 209(2)(b)). This suggested strongly that “ordinary businessman’s understanding” of “dividend” as per the dicta in *Esso* should normally apply for the purposes of the Taxes Act. In addition, the language of Section 790(6) and Section 801(1) and (2) were expressly concerned with dividends payable by a company, whilst Section 832 ICTA 1988 defines “company” in a way which would normally exclude a partnership.

Accordingly Memec lost on the third issue and on the appeal as a whole.

It is, however, interesting to speculate as to what the position would have been if the businesses of the German operating subsidiaries had been carried on by GmbH itself, rather than by those subsidiaries. In that case, trade tax would presumably have been payable by GmbH, so the silent partnership distribution would have been a dividend eligible for underlying credit under Article XVIII (1)(b) of the treaty, but not, if the third issue was correctly decided, under Section 801 ICTA. Presumably underlying

relief would have been available to Memec because the treaty would have prevailed, given the wording of Section 788(3) and the decision in *Ostime* (see above).

3. Comment

This decision illustrates the Court's differing approaches to the interpretation of treaties and of domestic legislation. In arriving at the meaning of "dividend" in Article XVIII of the treaty, the crucial factor was the underlying purpose of the treaty. Arguments based on a close textual analysis of the treaty were barely taken into account. Conversely, when the Court attempted to find the meaning of the same word in domestic legislation, the decision resulted entirely from a textual analysis, apparently without any examination of the policy behind the legislation. We are therefore left with the apparently odd result that "dividend" has different meanings for rather similar purposes.

If the DTR legislation is principally designed to give effect to treaties, it seems unduly restrictive to interpret it more narrowly than in the treaties themselves. However, there are at least two points that can be made against this point of view. First, the United Kingdom has concluded very many tax treaties, so the meaning of "dividend" in one treaty should not necessarily govern its meaning under domestic law. Second, the reason for having to look at both the treaty and the domestic rules in *Memec* was that the UK/German treaty did not allow underlying relief for trade tax suffered by the German operating subsidiaries. By advancing its arguments under the second and third issues, which relied on a mixture of treaty relief and domestic relief, or alternatively on purely domestic unilateral relief, Memec was seeking a better result than it could obtain under the treaty alone. In the circumstances, the effect of the Court's decision does not seem so unreasonable.