TC02178

Appeal number: TC/2010/3902

Income tax – individual resident of Israel - claim for exemption under Art XI, UK/Israel double tax treaty – whether UK pension income exempted from tax under special Israel tax provision was entitled to treaty exemption from UK tax under Art XI – meaning of "subject to Israel tax in respect thereof"

FIRST-TIER TRIBUNAL
TAX CHAMBER

PAUL WEISER **Appellant**

- and -

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE & CUSTOMS **Respondents**

TRIBUNAL: JUDGE ROGER BERNER

Sitting in public at 45 Bedford Square, London WC1 on 3 August 2012

The Appellant in person, assisted by Murray St Albans, Burford and Partners LLP

Hui Ling McCarthy, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Respondents

DECISION

1. The Appellant, Mr Weiser, is an Israeli citizen and resident for tax purposes in Israel. Relying on Article XI of the UK/Israel double tax treaty ("the Treaty"), Mr Weiser claimed to be exempt from UK tax on his UK pension income. HMRC have refused that claim.

2. Article XI(2) of the Treaty provides that:

> "Any pension ... derived from sources within the United Kingdom by an individual who is a resident of Israel and subject to Israel tax in respect thereof, shall be exempt from United Kingdom tax."

3. Under Israel tax law, Mr Weiser is expressly exempt from Israel tax on his UK pension income for the first 10 years of his residence there. He has made no election to be taxed in Israel on that income.

4. Mr Weiser says that he falls within Art XI, because he is chargeable to tax in Israel by virtue of being resident there, even though Israel does not, because of the exemption, levy a tax charge on his UK pension income.

5. HMRC's position is that the expression "subject to Israel tax in respect thereof" means that the individual must be within the charge to Israel tax in respect of his UK pension income, that is to say that the income in question must be included in the computation of the individual's taxable income with the result that tax will ordinarily be payable in respect of that income, subject to any deductions for allowances and reliefs etc. As Mr Weiser's UK pensions are exempt from Israel tax, they are not "subject to Israel tax" during the exempt period with the result that double taxation relief under Art XI is not available.

The material facts

6. The material facts are as stated above. There is no dispute in that respect. The issue is purely one of construction of Art XI(2). Although both parties referred me to the background of the case, including Mr Weiser's emigration to Israel in 2010, and the procedure, including the issue of a certificate of residence by the Israel tax authority, whereby Mr Weiser made his claim and HMRC refused it, none of that is material to the determination of the appeal. The question whether Mr Weiser can rely on Art XI depends solely on the meaning to be given to "subject to Israel tax in respect thereof" in the light of the Israel tax exemption.

The law

7. I need refer only briefly to certain material elements of the applicable law.

8. The UK/Israel Treaty is an old one. It entered into force on 13 February 1963. The form of double tax treaties has developed since then, and not surprisingly the

Treaty does not conform to the current OECD Model Convention. That is the case for Art XI.

9. The preamble to the Treaty states that the UK and Israel governments agreed the articles thereunder:

> "... for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income"

10. Art II contains a number of definitions, including definitions of the terms "resident of the United Kingdom" and "resident of Israel":

> "(h)(i) The terms "resident of the United Kingdom" and "resident of Israel" mean respectively any person who is resident in the United Kingdom for the purposes of United Kingdom tax and any person who is resident in Israel for the purposes of Israel tax ..."

11. There is no dispute on any aspect of the Treaty apart from in relation to Art XI. Nor is there any dispute as to the incorporation of the Treaty into UK law under s 2 of the Taxation (International and Other Provisions) Act 2010, by virtue of the Double Taxation Relief (Taxes on Income) (Israel) Order 1963.

12. It is agreed that, but for the application of Art XI(2), Mr Weiser's UK pension income is subject to UK tax.

13. It is also agreed that Mr Weiser's UK pension income is exempt from Israel tax.

14. I was shown an English translation of the Israel Tax Ordinance 5721-1961 ("ITO"), which Mr Weiser accepted as authentic and accurate. Section 2 ITO provides for Israel income tax to be charged at the statutory rate on income from different sources (including, under subsection (5), pensions):

> "2. Subject to the provisions of this Ordinance, income tax shall be payable for each year, at the rates specified below, on the income of a person resident in Israel, which was produced or which accrued in Israel or abroad and on the income of a foreign resident which was produced or which accrued in Israel from the following sources:
>
> ...
>
> (5) pension, usufruct or annuity;"

15. Section 14(a) ITO exempts from that charge certain income (including pensions that are derived from sources within the UK) arising to certain individuals:

> "14(a) An individual who became an Israel resident for the first time and a veteran returning resident shall – during ten years after the date on which they became resident as aforesaid – be exempt of tax on their income from all sources enumerated in sections 2, 2A and 3 that were produced or accrued abroad or that are derived from assets abroad, unless they made a different request in respect of all or part of the income."

16. It is common ground that Mr Weiser made no such request, and that the exemption accordingly applies to his UK pension income.

Discussion

17. Mr Weiser's case is that the proper interpretation of Art XI(2) is that it exempts UK pension income from UK tax where, as in his case, as a resident of Israel the individual is chargeable to Israel tax under Israel law, but Israel as a sovereign state does not levy any charge on that income. He argues that the Treaty does not say in clear terms that the UK will charge tax on pension income. The law is not therefore transparent: if the UK wished to charge tax on such pension income, it ought to have included a further paragraph in Art XI expressly to that effect.

18. Mr Weiser's primary submission is that the meaning of Art XI is plain according to its terms, but he also argued that if Art XI permits of any other meaning then it is ambiguous, and ought to be interpreted in the manner he puts forward.

19. Although Mr Weiser put his argument in terms of transparency, and had consulted HMRC published information on the effect of the Treaty on his UK pensions before emigrating from the UK to Israel, I did not understand him to be arguing that he had been misled by any of those publications. The question is therefore solely one of treaty interpretation, although I will refer later to the HMRC published information.

20. Ms McCarthy referred me to two cases, *Bayfine UK v Revenue and Customs Commissioners* [2011] STC 717 and *Smallwood v Revenue and Customs Commissioners* [2010] STC 2045, both in the Court of Appeal. From those cases I can distil the following relevant principles to be applied in the construction of provisions of a double tax treaty:

(1) The fact that a treaty is an international instrument made by the two contracting states must be borne in mind in interpreting its provisions. In particular the treaty must be given a purposive interpretation.

(2) One should look first for a clear meaning of the words used in the relevant article, bearing in mind that consideration of the purpose is always a legitimate part of the process of interpretation. A strictly literal interpretation is not appropriate for an international treaty. A literal interpretation may be obviously inconsistent with the purposes of the particular article or of the treaty as a whole.

(3) 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 by reference to its language as set out in the relevant UK legislative instrument.

(4) Technical rules of English law, or English legal precedent should not be applied, but the treaty should be interpreted on "broad principles of general acceptation" (*James Buchanan & Co Ltd v Babco Forwarding & Shipping (UK) Limited* [1978] AC 141, per Lord Wilberforce at p 152).

(5) Among those principles is the general principle of international law, embodied in art 31(1) of the Vienna Convention on the Law of Treaties, that "a treaty should be interpreted in good faith and in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose".

(6) References to the primary necessity of giving effect to "the plain terms" of a treaty or construing words according to their "general and ordinary meaning" or their "natural signification" are a starting point or prima facie guide and cannot be allowed to obstruct the essential quest in the application of treaties, namely the search for the real intention of the contracting parties in using the language employed by them.

21. The principles I have derived are taken from the judgment of Arden LJ in *Bayfine* (at [13] to [18]). *Bayfine* was a case on the UK/US double tax treaty. Its preamble was similar in terms to the preamble of the UK/Israel Treaty to which I referred earlier. In that connection, Arden LJ said (at [16] and [17]):

> "[16] In this case, the preamble to the Treaty is very brief and states simply that the parties are:
>
> 'Desiring to conclude a new Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains;'
>
> [17] These words, however, make it clear that the primary purposes of the Treaty are, on the one hand, to eliminate double taxation and, on the other hand, to prevent the avoidance of taxation. In seeking a purposive interpretation, both these principles have to be borne in mind. Moreover, the latter principle, in my judgment, means that the Treaty should be interpreted to avoid the grant of double relief as well as to confer relief against double taxation."

22. Ms McCarthy submitted that Mr Weiser's case confuses the expressions "subject to tax" and "liable to tax" as employed in double tax treaties. There is, she submitted, an internationally recognised distinction between the two which gives the expression "liable to tax" a broader meaning that the expression "subject to tax". She argued that "liable to tax" is understood to require only an abstract liability to taxation on income in the sense that a contracting state may exercise its right to tax the income in question (whether or not the exercise of that right actually results in an amount of tax becoming payable). "Subject to tax", on the other hand, requires income actually to be within the charge to tax in the sense that a contracting state must include the income in question in the computation of the individual's taxable income with the result that tax will ordinarily be payable subject to deductions for allowances or reliefs, etc.

23. Ms McCarthy referred me to case law from other countries, and to academic writings which recognise the distinction. Mr Weiser argued that these were not relevant to the interpretation of a treaty between the UK and Israel. Whilst not determinative, such authorities are nevertheless relevant and it is appropriate to consider them in the search for those principles of general acceptation to which Lord Wilberforce referred in *Buchanan*.

24. An Australian case, *Emanuel v Federal Commissioner of Taxation* [1968] HCA 57, concerned the Australia/UK double tax treaty. At the relevant time, the rate of Australian withholding tax on domestic source dividends was 30%. Under the treaty, however, that rate was reduced to 15% in the case of such dividends to a UK resident "who is subject to United Kingdom tax in respect thereof". The UK resident recipient was not domiciled in the UK, and so, although generally within the scope of UK tax as a resident, was chargeable on income from non-UK sources only to the extent that the income was remitted to the UK. The dividends had not been so remitted.

25. In the High Court of Australia, Windeyer J held that the taxpayer was not entitled to the reduced rate of withholding tax. He said (at [15]):

> "The present case has, as I have said, proceeded on the basis that the taxpayer is not domiciled in the United Kingdom – and that he is treated as having satisfied the Commissioners of Inland Revenue of that fact. Therefore in respect of the dividends in question the 'remittance' basis would apply. Therefore, in my opinion, unless and until they be remitted and received by him in the United Kingdom he is not "subject to United Kingdom tax in respect thereof". These words I think describe a present liability of a person to tax, not the character of income in respect of which he will if it comes to him in the United Kingdom in the future incur then a liability to tax"

26. In *General Electric Pension Trust v Director of Income-tax (International Taxation) Mumbai* (2005) 8 ITLR 1053, the Indian Authority for Advance Rulings held that a pension fund which was exempt from tax in the US under US tax law was not "subject to tax" in the US and so could not fall within the meaning of "resident of a Contracting State" as that was defined for a trust under the US/India double tax treaty. After describing the relevant provision, under which in the case of income derived or paid by a trust the term 'resident of a Contracting State' applied only to the extent that the income derived by the trust (which would have to be liable to tax by reason of residence or another relevant criterion in the State in question) was in addition subject to tax in that State as the income of a resident either in its own hands or in the hands of the beneficiaries, Syed Shah Mohammed Quadri J said (at p 1061):

> "It is worth pointing out that the phrase 'liable to tax' in para (1) and the phrase 'subject to tax' in proviso (b) are not synonymous. If both were read to be synonymous, proviso (b) would become otiose. Whereas para (1) speaks of being in the tax net, proviso (b) speaks of actual taxation."

27. The distinction between "liable to tax" and "subject to tax" has been the topic of some debate within the international tax community. This debate has been alluded to in a number of academic commentaries. Ms McCarthy referred me to one, from the Canadian Tax Journal (1996) Vol 44, No 2, 408 entitled "*A Resident of a Contracting State for Tax Treaty Purposes: A Case Comment on Crown Forest Industries*" by a number of contributors led by David A Ward of Canada, and including, from the UK, Dr John Avery Jones. The focus of the article is on the case in the Supreme Court of Canada of *The Queen v Crown Forest Industries Limited et al.*, 95 DTC 5389 (SCC) – a case on whether a Bahamian corporation carrying on business in the US and with a

place of management there was a resident of the US within the US/Canada double tax treaty. In that case, the Supreme court of Canada concluded that in interpreting the term "resident of a contracting state" in that treaty the expression "liable to tax" required the person in question to be subject to as comprehensive a liability to taxation as is imposed by a State. That analysis arguably brought the requirements of "liable to tax" closer to those considered appropriate for "subject to tax". But in their discussion, the authors draw the same distinction between "liable to tax" and "subject to tax" as was later described in *General Electric*.

28. The authors refer in particular to that distinction being drawn by participants at a seminar conducted in 1985 by the International Fiscal Association ("IFA"). The conclusion, for which it is demonstrated that there is widespread international support, is that if a person's connecting characteristics with a state are the same as those of persons who are fully liable and actually subject to tax, that person can be said to be liable to tax even though he is not subject to tax on part or all of his income by virtue of special provisions of the state of his residence: see p 419 and footnote 32.

29. This view has remained unaltered by the passage of time. According to an article published in 2011, "*Worrying Interpretation of 'Liable to Tax': OECD Clarification Would Be Welcome*" (Arnaud de Graaf and Frank Pötgens), Intertax, Vol 39, Issue 4, 169, which discusses a ruling of the Dutch Supreme Court (4 December 2009; V-N 2009/63.17) that adopted a similar approach to the residence article in the Netherlands/US treaty to that of *Crown Forest*, the broad international consensus was confirmed at the IFA Congress in 2004. As the authors describe the position (at p 172), that view encompasses a contrast between "liable to tax", which refers simply to an abstract liability to tax on a person's worldwide income, and the expression "subject to tax" which may require an effective liability to tax on a person's income.

30. The same analysis also appears from the Editor's Note to the *General Electric* ruling in the International Tax Law Reports, where he says (p1054):

> "It is generally recognised that 'subject to tax' has a different meaning from 'liable to tax' and requires that the person claiming benefit of the treaty is actually required to pay tax (or would, for example, be required to do so if it had any positive income)."

31. Although it was not cited to me, I should also refer to the commentary on the OECD Model Convention. Although, as I have mentioned earlier, the Treaty provision with which I am concerned does not follow the OECD Model, there are nonetheless some useful indicators to be obtained from the commentary.

32. In its reference to Article 18 of the Model on the taxation of pensions, the commentary refers to the possible mismatches that can arise where the contracting states may have different rules regarding pensions. It refers particularly to the position where one contracting state regards a deduction for pension contributions essentially as a deferral of tax on the part of the employment income that is saved towards retirement, and the other state, in which the individual becomes resident, does not tax pension benefits. In such cases the commentary refers to examples of

provisions which States are free to agree bilaterally. One such possible provision, which the commentary cites as an example of a provision allowing source taxation of pension payments only where the state of residence does not tax those payments is as follows:

> "However, such pensions and other similar remuneration may also be taxed in the Contracting State in which they arise if these payments are not subject to tax in the other Contracting State under the ordinary rules of its tax law."

This is therefore an example of the expression "subject to tax" being used to draw a distinction between cases where the state of residence taxes pension income, and cases where it does not.

33. The starting point is to look for a clear meaning of the words in Art XI(2) that is consistent with the purpose of the Treaty. That purpose I discern to be the allocation of taxing rights as between the UK and Israel to obviate double taxation, and to prevent the evasion of tax. Its purpose is not to enable double non-taxation of the relevant income.

34. In my view, consist with what I regard as the purpose of the treaty in this regard, the ordinary meaning of Art XI(2) is that pension income derived from UK sources is only exempt from UK tax if that income is chargeable to Israel tax such that Israel tax will ordinarily be payable in respect of that income, subject to deductions for allowances and reliefs, etc. This follows from the distinction that must in my view be drawn between the use, in double tax treaties, of the expressions "liable to tax" and "subject to tax", and also by the requirement, under Art XI(2), that the individual concerned should not only be a resident of Israel (that is, resident in Israel for the purposes of Israel tax), but should be subject to tax *in respect of* the relevant income. The reference to that income in this context clearly distinguishes this provision from one which requires that the individual fall within the scope of a State's taxation generally. This provision is not concerned with the status of the individual, but with the chargeability to tax of the specific income. Income which is exempted from taxation cannot during the currency of that exemption be income in respect of which an individual can be said to be subject to tax.

35. Although it is not necessary to place any reliance on the international cases and academic writings I have referred to, nor on the OECD commentary, this conclusion does accord with what appears to be a broad consensus as to the meaning of the expression "subject to tax". I have no doubt that the contracting states of Israel and the UK, when entering into the Treaty, intended that pension income exempt from Israel tax should be excluded from the exemption from UK tax. If it had been intended otherwise, so that merely being within the scope of Israel tax as a general matter would suffice for the treaty exemption to apply, there would have been no need to include any reference to the pension income being subject to tax; the position would have been covered by the mere reference to the individual being a resident of Israel.

36. It follows that I do not accept Mr Weiser's arguments on the proper meaning to be given to Art XI(2). Nor do I accept that the terms of Art XI are ambiguous or anything other than clear and, adopting Mr Weiser's phraseology, transparent.

37. Ms McCarthy referred me to certain references from HMRC's International Tax Manual to illustrate the long-standing published view of the phrase "subject to tax". Paragraph 332210 of that manual was first published on HMRC's website on 29 December 2006. It reads:

> "**INTM332210 – DT applications and claims – Subject to tax**
>
> **Background**
>
> The expression "subject to tax" usually means that the person must actually pay tax on the income in their country of residence.
>
> However, a person is still regarded as "subject to tax" if, for example, he or she does not pay tax because their income is sufficiently small that it is covered by personal allowances that are available to set against liability to tax in the other country.
>
> A person is not regarded as "subject to tax" if the income in question is exempted from tax because the law of the other country provides for a statutory exemption from tax. For example
>
> - the income is that of a charity
> - the income is that of an exempt approved superannuation scheme (pension fund)
>
> In such cases the "subject to tax" condition is not met and relief is not allowable."

38. I agree with this summary. It refers to particular exemptions by way of example, but it is not limited in any way, and is apt to apply also to the exemption from Israel tax enjoyed by Mr Weiser in respect of his UK pension income.

39. Mr Weiser referred to the different treatment that applies for residents of Israel who receive pensions from a number of countries, including the US. That difference in treatment is not the consequence of a different interpretation of the treaty provisions; it is because Israel and, by way of example, the US have negotiated a different treaty, and have agreed not to make the exemption from US tax conditional on the pension income being charged to tax in Israel. Article 20 of the US/Israel treaty applies only the test of residence, and not the "subject to tax" test.

Decision

40. For the reasons I have given, I conclude that Mr Weiser is not entitled to claim exemption from UK tax on his UK pensions under Art XI of the UK/Israel double tax treaty.

41. Accordingly, I dismiss this appeal.

Application for permission to appeal

42. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

ROGER BERNER
TRIBUNAL JUDGE

RELEASE DATE: 10 August 2012