Analysis

Macklin: World Bank pensions and treaty interpretation

SPEED READ Article 31 of the Vienna Convention on the Law of Treaties requires a treaty to be interpreted in accordance with the ordinary meaning of its terms in their context and in the light of the treaty's object and purpose. The Upper Tribunal applied these principles to conclude that the World Bank pension scheme is established in the United States. As a result, the US/UK tax treaty grants partial exemption on pensions paid to the World Bank's former employees who are UK resident. In light of the tribunal decision, employees and former employees of international organisations should re-evaluate their tax treatment, as error claims may result in the repayment of overpaid tax.

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World Bank Group employees who retire to the UK qualify for exemption from UK income tax on their pensions under the US/UK tax treaty. In *Macklin v HMRC* [2015] UKUT 39 (TCC) (reported in *Tax Journal*, 13 February 2015), the Upper Tribunal overruled the First-tier Tribunal [2013] UKFTT 554 (TC). It concluded that the exemption which non-US citizens resident in the US enjoy on their World Bank pensions must also be given to UK resident non-US citizens, by reason of art 17(1)(b) of the US/UK double tax treaty.

Article 17(1)(a) of the treaty grants exclusive taxing rights over pensions to the state of residence of the recipient of the pension payment. This right is not unfettered. Article 17(1)(b) requires the state of residence to exempt pension payments if:

- the pension scheme is established in a contracting state; and
- the pension would be exempt in that state if the beneficial owner were resident there.

Mr Macklin, a UK citizen, worked for the World Bank at its headquarters in Washington DC. He then returned home to the UK when he retired from the Bank. Expert evidence on US tax law confirmed that if he were US resident when he received his World Bank pension as a US resident alien, he would be exempt on his pension income there, to the extent of employer and employee contributions.

The issue thus turned on whether the World Bank Staff Retirement Plan (SRP) was 'established in' the US for purposes of the treaty. In this context, the term 'pension scheme' is defined in art 3(1)(o) of the treaty as:

i. 'any plan, scheme, fund, trust or other arrangement established in a contracting state which is:
ii. generally exempt from income taxation in that state; and
iii. operated principally to administer or provide pension or retirement benefits or to earn income for the benefit of one or more such arrangements.'

The SRP was set up and is fully managed and administered by the World Bank at its headquarters in Washington DC. The World Bank, with its principal office in the US, is the trustee of the SRP. A ruling from the IRS confirms that the SRP conforms with the relevant US domestic tax rules as a qualifying pension plan under s 401(a) of the US Internal Revenue Code (except that it is not 'created or organized in the US' because it is not a US domestic trust). Nonetheless, under s 402 pension payments qualify for equivalent treatment; accordingly, non-US citizens resident in the US are exempt from US income tax to the extent of contributions made both by the World Bank as employer and by the employee.

The Upper Tribunal ruled that the World Bank SRP is a pension scheme established in the US within the definition in art 3(1)(o) of the treaty.

In so deciding, the Upper Tribunal rejected HMRC's contention that only a pension plan 'established under and in conformity with the relevant contracting state's tax legislation relating to pension schemes', and that meets all US tax rules on pension plans, can be 'established in' the US. It also rejected HMRC's contention that the SRP was not 'generally exempt from income tax' in the US. (HMRC contended that the SRP was exempt under immunities from tax contained in the treaty establishing the World Bank as an international organisation, rather than under the US tax rules on pension plans.) The tribunal ruled that these terms in the US-UK tax treaty must be given their ordinary meaning in context, and in light of the object of the treaty, as required by the Vienna Convention on the Law of Treaties (VCLT).

Principles of treaty interpretation

The wider significance of the decision is in clarifying important issues in the proper interpretation of treaties. The expressions 'established in' and 'generally exempt from income tax' are not defined in the treaty. There was no authority on their meaning; therefore, the ordinary principles of treaty interpretation applied.

In the absence of a definition in the treaty, art 3(2) is normally the first port of call. It requires that any undefined term must have the meaning which it has for purposes of the domestic tax law of the state applying the treaty, unless the context requires otherwise. Since there was no relevant meaning of the phrase 'established in' in UK tax law (nor indeed in US law), the Upper Tribunal concluded that art 3(2) was of no assistance.

As a result, the task of the tribunal is to determine the 'autonomous meaning' of the relevant provision. In *R v Secretary of State for the Home Department, ex p Adnan* [2001] 2 AC 477, at [515], Lord Steyn said that principle is 'part of

the very alphabet of customary international law'. While the oft cited *Commerzbank* principles were recited, the Upper Tribunal adopted the modern approach of applying the rules of interpretation set out in arts 31 and 32 of the VCLT.

The Upper Tribunal reaffirmed, contrary to HMRC's submissions in the First-tier Tribunal, that the VCLT is applicable to interpret the US-UK treaty, even though the US is not a party, as the VCLT are rules of customary international law. They are therefore binding on all states, regardless of whether or not they are parties to that convention (*Ben Nevis (Holdings) Ltd v HMRC* [2013] EWCA Civ 578, [2013] STC 1579, at 17).

Ordinary meaning

Article 31 of the VCLT requires a treaty to be interpreted in accordance with the ordinary meaning of its terms, in their context and in the light of the treaty's object and purpose. The Upper Tribunal ultimately held that 'established in' refers to a pension scheme's physical location, consistent with the ordinary meaning of 'established in'. HMRC's construction would, in effect, involve importing into art 3(1)(o) the words 'under or in conformity with the relevant contracting state's tax legislation relating to pension schemes' and 'as a pension scheme', which Mr Justice Newey considered unjustified. The same reasoning resulted in the rejection of HMRC's argument that the SRP was not 'generally exempt from income tax', because the exemption from tax was not in the US tax legislative provisions relating to pensions but elsewhere.

HMRC's position was somewhat curious, since its published view is that: 'Normally, a scheme will be treated as established in the country where its registered office and main administration is, or, if there is no registered office, where its main administration is … where the scheme's decisions are made.' (HMRC's *Registered Pension Schemes Manual* RPSM14101030)

The Upper Tribunal rejected as irrelevant and inadmissible the evidence of the HMRC expert on the meaning of the treaty. That evidence was an opinion on the very point of interpretation that the tribunal had to decide. Questions of interpretation are for the tribunal (see *Ben Nevis (Holdings) Ltd v HMRC* at 34). It is surprising that HMRC pressed for the inclusion of evidence of the same kind as was successfully opposed in *Ben Nevis*.

The HMRC expert's conclusions were also based in part on a report prepared for the Senate Foreign Relations Committee in advance of the treaty's ratification. Under English law, however, such material cannot be taken into account (*IRC v Commerzbank AG* [1990] STC 285 at 302). Since there can be only one autonomous meaning, the views of the HMRC expert – that the SRP was 'as a matter of US law' not established in the US for the purposes of the treaty because it was not created or organised under or governed by US law and its administration is not generally subject to the jurisdiction of any US court – were erroneous.

Context

The text of a treaty forms part of the context within which terms must be understood (VCLT art 31(2)). Article 3(1)(k) of the US-UK treaty defines 'qualified governmental entity' to include 'a person that is wholly owned by a contracting state or a political subdivision or local authority of a contracting state', provided that, among other things 'it is organised under the laws of the contracting state'. For the taxpayer, it was argued that the parties to the treaty would have used comparable wording had they intended there to be a requirement for a 'pension scheme' to be 'established' 'under or in conformity with the relevant contracting state's tax legislation relating to pension schemes'.

For HMRC, it was argued that that it would be unsatisfactory if a scheme such as the SRP represented a 'pension scheme established in that state', within the meaning of art 18(2); and, hence, a benchmark for the purposes of deciding whether reliefs exceed those that would be allowed 'by the other state to residents of that state for contributions to, or benefits accrued under, a pension scheme established in that state'.

The context also includes any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty (VCLT art 31(a)). This includes the Exchange of Notes signed in connection with the conclusion of the treaty and exchanged on the same day that the US/UK treaty was concluded.

In particular, the Exchange of Notes clarifies that the definition of pension schemes includes certain specific statutory schemes under the pension laws of each state. HMRC contended that the inclusion of personal pensions under ICTA 1988 s 632, which do not need to be physically set up or administered in the UK (if the provider is in the EU and exercises a fundamental freedom) meant that a scheme can be 'established in' the UK without being physically set up or administered there. For Mr Macklin, it was argued that the list of schemes is not exhaustive and that the inclusion of specific schemes was to forestall any argument over whether certain schemes fell within the scope of the treaty.

The Upper Tribunal concluded that neither the terms nor the context sustained HMRC' construction and it was not inconsistent with the purpose of the treaty for the exemption to apply to World Bank pensions. The Upper Tribunal's analysis was thus squarely framed by the rules of treaty interpretation required by the VCLT.

Call to action

Employees and former employees of international organisations need to re-evaluate their tax treatment. In many cases, error claims may result in the repayment of overpaid tax. ■

The author acted for the appellant in this case.

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Cases: *Michael Macklin v HMRC* (11.2.15)