The Offshore & International Taxation Review

DOUBLE TAXATION CONVENTIONS AND IMPUTED GAINS OF COMPANIES POST FINANCE ACT 2000

Robert Venables QC[1]

1 Scope of the Article

The United Kingdom Taxation of Chargeable Gains Act 1992 sections 13 and 14 ("the Provisions") attribute capital gains of non-UK resident quasi-close companies to their "participators", direct and indirect. The Provisions can apply to individuals, but also to companies, trusts and personal representatives resident in the United Kingdom. They can also apply to settlors and beneficiaries of non-UK resident trusts.

The Inland Revenue Commissioners have in the past accepted that a person to whom a gain of a company is attributed under the Provisions can in some circumstances take advantage of a suitably worded double taxation convention which exempts the gain of the company from United Kingdom tax, notwithstanding that that person is not himself a resident of the other Contracting State. Finance Act 2000 has added a new section 79B to the Taxation of Chargeable Gains Act 1992 which removes the immunity in certain circumstances where trustees are involved. The scope of section 79B is quite arbitrary.

In this article, I discuss the present position. I also discuss what trustees who now find they are in an undesirable position can do to extricate themselves. In addition, I query whether such structures are often necessary or even desirable.

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1 Robert Venables QC, Barrister of the Middle Temple and of Lincoln's Inn, Bencher of the Middle Temple, Council Member of the Chartered Institute of Taxation, Chartered Tax Adviser, TEP, Consulting Editor. Chambers: 24, Old Buildings, Lincoln's Inn, London WC2A 3UP. Tel+ 44 (0)20 7242 2744; Fax + 44 (0) 20 7831 8095.
e-mail taxchambers@compuserve.com.

The Provisions are very complex. The reader can find an account of them, with the emphasis on their application to trusts and their settlors and beneficiaries, in my *Non-Resident Trusts* 8th edition Chapter 15A.[2]

2 The General Pre-Finance Act 2000 Position

The Revenue appear to be of the view that if the gain of the company is relieved from capital gains tax/corporation tax by a double taxation convention, then section 13 cannot apply to it. Indeed, were this not their view, they need not have procured the enactment of section 79B. CCAB TR 500, of 10th March 1983 (Guidance note on taxation: points of practical interest) includes a statement, at paragraph 14, of the then Revenue view:

> "14. [TCGA 1992 s.13] can impose a charge on a UK parent company on capital gains arising from disposals by its overseas subsidiary if the latter would be a close company if it were resident in the UK. The Inland Revenue have confirmed that, where the overseas subsidiary is resident in a territory with which the UK has a double taxation agreement and there is an article exempting residents of that territory from a charge to UK capital gains, then such an article *may* prevent the imposition of a charge under s. 13."

The word "may", which I have italicised, is crucial. The Inland Revenue Capital Gains Tax Manual at 57380, (Double taxation agreements), as revised to July 1996 states:

> "You should always check whether there is a double taxation agreement between the UK and the country in which the company making the gain is resident. ... But, if the agreement provides that gains of the type realised by the non-resident company are only taxable in that company's country of residence Section 13 TCGA 1992 cannot apply. For example, Article 15(4) of the Kenya/UK Double Taxation Agreement would prevent Section 13 TCGA 1992 applying to the disposal of stocks and shares by a company resident in Kenya. Agreements will often treat gains on the disposal of particular types of asset differently."

Why did the Revenue say "may" in 1983, whereas in 1996 it stated categorically that section 13 Taxation of Chargeable Gains Act 1992 cannot apply? There is in my view no inconsistency. Double taxation conventions exempt either a person or a

2 My article *Attribution of Capital Gains of Non-UK Resident Companies* in *The Offshore and International Taxation Review* Volume 9 Issue 1 does not take into account the Finance Act 2000 changes.

profit from UK tax. If they exempt only the person, then *prima facie* no other person can claim the exemption. If they exempt the gain, there is no reason why the exemption should not apply to a gain of the relieved description which is attributed to a person who did not in fact realise it. In the 1983 statement, the Revenue referred to double taxation conventions in general. Hence, their statement was necessarily qualified. In the Manual, however, they refer specifically to a provision of a convention which exempts the gains. Article 15(4) of the Kenya/UK Double Taxation Agreement is in standard OECD Model form. It reads: "Capital gains from the alienation of any property other than those mentioned in paragraphs (1), (2) and (3) of this Article shall be taxable only in the Contracting State of which the alienator is a resident". It thus exempts from UK tax the gain itself rather than the resident of Kenya who realises the gain.

The Revenue certainly do not accept as a general proposition that a double taxation convention will necessarily afford relief to a UK resident who is charged to tax on an amount computed by reference to a profit or gain which, in the hands of the person to whom it arises, is exempted from UK tax by the terms of the convention.[3]

3 Trustee Participators Post Budget 2000

3.1 The Finance Act 2000 Change

The new Taxation of Chargeable Gains Act 1992 section 79B is intended to prevent the Provisions being nullified by relief under a double taxation convention in a case where trustees are, directly or indirectly, participators in the offshore close company. It removes treaty immunity from trustees, settlors and beneficiaries.

A second feature of section 79B is that convention-exempt gains are no longer apportioned to a (United Kingdom resident) close company if its participators include the trustees of a settlement, but are instead apportioned to its participators.

The enactment of section 79B involves the deliberate and flagrant violation of many treaties to which the United Kingdom is a party.[4] Under our constitution, there can be no challenge to its validity on that ground. Nor is there much prospect of it being successfully challenged under the Human Rights Act.

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3 See generally my articles "Double Taxation Treaties: the Antidote to Anti-Avoidance Provisions? *Bricom Holdings Ltd v IRC*" in *The Offshore Taxation Review*, Volume 6, Issue 3, p. 161 and "Treaty Override: *Bricom Holdings Ltd v IRC*" in the Court of Appeal in *The Offshore Taxation Review*, Volume 7, Issue 3, at p.151.

4 Those who seek to play down the perfidy involved prefer to speak of "treaty override".

3.2 Scope of Application of Section 79B

Section 79B (attribution to trustees of gains of non-resident companies) primarily applies

> "where trustees of a settlement are participators –
>
> (a) in a close company, or
>
> (b) in a company that is not resident in the United Kingdom but would be a close company if it were resident in the United Kingdom.
>
> For this purpose 'participator' has the same meaning as in section 13."[5]

3.3 Effect of Application of Section 79B

Where section 79B applies

> "nothing in any double taxation relief arrangements shall be read as preventing a charge to tax arising by virtue of the attribution to the trustees under section 13, by reason of their participation in the company mentioned in subsection (1) above, of any part of a chargeable gain accruing to a company that is not resident in the United Kingdom".

Hence, where trustees are direct participators in an offshore quasi-close company, the trustees cannot claim treaty relief as respects gains of that company which are apportioned to them. It does not matter whether the gains are actual gains of the company in which they are participators or of some other offshore quasi-close company, the gains of which are sub-apportioned to them by virtue of section 13(9).[6]

4 Gains Imputed to (UK Resident) Close Companies

The reference in section 79B(1)(a) to the trustees being participators in a close company is at first sight mystifying. A close company is necessarily United Kingdom resident. There was previously no provision in section 13 for the further apportioning to its own participators of gains apportioned to such a company. Instead, the company itself was (in the absence of treaty relief) liable to corporation

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5 Section 79B(1).

6 See my *Non-Resident Trusts* 8th edition 15A.11.

tax on the imputed gain. The draftsman was anticipating sections79B(3) and (4), which provide:

> "(3) Where this section applies and –
>
> (a) a chargeable gain accrues to a company that is not resident in the United Kingdom but would be a close company if it were resident in the United Kingdom, and
>
> (b) all or part of the chargeable gain is treated under section 13(2) as accruing to a close company which is not chargeable to corporation tax in respect of the gain by reason of double taxation arrangements, and
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> (c) had the company mentioned in paragraph (b)(and any other relevant company) not been resident in the United Kingdom, all or part of the chargeable gain would have been attributed to the trustees by reason of their participation in the company mentioned in subsection (1) above,
>
> section 13(9) shall apply as if the company mentioned in paragraph (b) above (and any other relevant company) were not resident in the United Kingdom.
>
> (4) The references in subsection (3) above to 'any other relevant company' are to any other company which if it were not resident in the United Kingdom would be a company in relation to which section 13(9) applied with the result that all or part of the chargeable gain was attributed to the trustees as mentioned in that subsection."

By treating close companies in which trustees are participators as non-UK resident for the purposes of apportionment of gains of genuinely non-UK resident companies, section 79B(3) ensures that gains bypass such companies and are apportioned to their participators.

5 Non-Trustee Participators in (UK Resident) Close Companies

The effect of section 79B(3) is not limited to trustees. It applies to anyone who is a participator in such a close company, simply because trustees are also participators. That, however, will be of no substantive consequence as participators who are not trustees will still be entitled to treaty relief. There will be a compliance cost in that relief will now need to be claimed by each non-trustee participator in the close company, rather than once by the close company itself.

The operation of section 79B(3) does not necessarily involve an immediate charge to United Kingdom tax. If non-UK resident trustees are participators in a (United Kingdom resident) close company, no gain will be imputed to the close company but a gain will be imputed to the trustees.

6 Settlor and Beneficiaries of Settlements

In my view, section 79B also removes the treaty immunity of settlors and beneficiaries of settlements as regards trust gains imputed to them, whether under section 86 or section 87 of the Taxation of Chargeable Gains Act 1992.

7 Forward Planning

Participation in an offshore quasi-close company by trustees, especially non-UK resident ones, can be highly disadvantageous in United Kingdom tax terms. As regards capital gains tax, the gains of the company can be imputed to the trustees and the trustees will normally realise a second level of capital gains if they dispose of their holding or the company is liquidated. Both sets of gains can in principle be taken into account for the purposes of the Offshore Settlor Provisions and the Offshore Beneficiary Provisions. While the holding of assets through a United Kingdom resident company can also result in a double charge to tax, at least in that case the company can distribute the gains by an income distribution so that there will in effect be no charge to lower rate tax on the recipient participator. If the participator is non-UK resident, the distribution will normally[7] give rise to no actual charge to United Kingdom tax at all.

An offshore company which has United Kingdom source income which is distributed to United Kingdom resident beneficiaries can also be disadvantageous in involving a loss of United Kingdom tax credits.

The main advantage of an offshore company is to convert United Kingdom situs property into "excluded property" for United Kingdom inheritance tax purposes. This is relevant only if the settlor of the settlement was not United Kingdom domiciled at a relevant time. Until 1988, such trusts would normally be outside the United Kingdom capital gains tax anti-avoidance provisions aimed at non-UK

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7 There may be a charge in the case of a non-resident trust. See my *Non-Resident Trusts* 8th edition 16.3B.3.5.

resident trusts. Now, one set of provisions, the Offshore Beneficiary Provisions, will apply irrespective of the domicile and residence of the settlor.

In my experience, too many assets are owned by trusts, especially non-UK resident trusts, through offshore companies. They sometimes serve little purpose or a purpose which can be achieved more cheaply and efficiently by another method. Trustees should ask themselves whether the companies they own are still worthwhile and, if not, how it is possible to disentangle from them without accelerating or increasing tax charges.

8 Unscrambling Arrangements

Suppose that offshore trustees already own an offshore company pregnant with gains to which section 13 will apply when they are realised. What can be done? The best solution will generally be for the trustees to emigrate to some jurisdiction which has a suitably worded double taxation convention with the United Kingdom and then to dispose of their interest in the company, before the company itself realises any gains. Naturally, the other jurisdiction must be one which will not impose any, or any substantial, charge to tax on the trustees' gains. While the Offshore Settlor Provisions may be a potential problem, and the Offshore Beneficiary Provisions will be a problem if the Offshore Settlor Provisions are not, it is in my view possible to circumvent the application of both in the year in which the gain is realised.