The Offshore Taxation Review

TREATY OVERRIDE: *BRICOM HOLDINGS LTD v IRC* IN THE COURT OF APPEAL

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1 Importance of the Decision

1.1 The Result

The Court of Appeal of England on 25th July 1997 dismissed the appeal of Bricom from the decision of the Special Commissioners, discussed by me in' Double Taxation Treaties: the Antidote to Anti-Avoidance Provisions? *Bricom Holdings Ltd v IRC*' in Volume 6 Issue 3 of this *Review*, at page 151.[2] The Court of Appeal refused Bricom leave to appeal to the House of Lords. It is still possible for the House of Lords themselves to grant such leave.

1.2 No Treaty Override by other Anti-Avoidance Provisions

One result of the decision is that a double taxation arrangement cannot provide any protection against the liability of a United Kingdom resident company under the United Kingdom Controlled Foreign Companies legislation. At least as important, however, is the apparent acceptance by the Revenue and the Court that if a treaty is suitably worded then it can exempt from taxation a person to whom the exempted income and gains do not actually belong. Thus a treaty, it seems, can provide a defence against the application of other United Kingdom anti-avoidance provisions, couched in different language. In income tax, the Settlement provisions, contained in Taxes Act 1988 Part XV, and the tax avoidance by transfers of assets abroad provisions, contained in Taxes Act 1988 Part XVII Chapter III, immediately spring to mind; in capital gains tax, prime candidates are

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2 The reader should refer to that article for a fuller account of the facts and issues.

the Offshore Settlor Provisions, contained in Taxation of Chargeable Gains Act 1992 section 86 and Schedule 5, and the attribution of gains of non-UK resident close companies to participators, under Taxation of Chargeable Gains Act 1992 section 13.

1.3 Treaty Override by the Controlled Foreign Companies Provisions

1.3.1 The Author's Argument

In my article, I put forward an argument in favour of the taxpayer to the effect that, on the statutory hypothesis posited by the Controlled Foreign Companies provisions, income of the Netherlands company (Spinney) which was in fact relieved under the UK-Netherlands double taxation treaty from liability to UK tax never entered into the computation of "chargeable profits" which could be visited, directly or indirectly, on Bricom. The argument was put forward by Bricom as its first argument before the Court of Appeal. The Court of Appeal rejected it on the basis that in addition to the express statutory hypothesis that the Netherlands company was resident in the United Kingdom there was a further implied statutory hypothesis that it was not resident elsewhere. While I would respectfully suggest that this decision is completely contrary to the authorities, in particular to the decision of the Court of Appeal in *Marshall v Kerr*,[3] approved by the House of Lords on this point,[4] and to the recent Court of Appeal decision in *Walton v IRC*,[5] applying the earlier Court of Appeal decision in *Trocette Property Co Ltd v Greater London Council*,[6] the difficulty is that the relevant authorities do not appear to have been cited to the Court.[7]

1.3.2 The Four Issues before the Special Commissioners

Of the four issues before the Special Commissioners, the Court of Appeal decided against Bricom on the first one, namely that what was apportioned to it was not the income of the Netherlands company. The Court did not decide any of the other three issues, it not being necessary to do so. They did hint, however, that

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3 [1993] STC 360.

4 [1994] STC 368.

5 [1996] STC 68.

6 (1974) 28 P&CR 408.

7 The report mentions only the authorities cited in the skeleton arguments, so that it is possible that the relevant authorities were cited as an after-thought.

they might well have disagreed with the Special Commissioners on the second issue, where they had found that the tax to which a company is charged under the Provisions is not corporation tax. They expressed no opinion at all on the third and fourth issues.

2 The Argument on the Statutory Hypothesis

2.1 The Author's Argument

The argument, as I put it in my earlier article at section 10, was as follows:

> "What is apportioned is a controlled foreign company's chargeable profits, namely the amount of the total profits of the company on which, on the assumptions in schedule 24, after allowing for any deductions available against those profits, corporation tax would be chargeable. Schedule 24, paragraph 1(1) provides that the foreign company shall be assumed to be resident in the United Kingdom. Paragraph 1(2) makes it clear that nothing in sub-paragraph (1) requires it to be assumed that there is any change in the place or places at which the company carries on its activities. Paragraph 4(1) provides that, subject to two immaterial exceptions, where any relief under the Corporation Tax Acts is dependent upon the making of a claim or election, the company shall be assumed to have made that claim or election which would give the maximum amount of relief and to have made the claim or election within any time limit applicable to it.
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> "These assumptions are deeming provisions. The Court of Appeal in *Marshall v Kerr* laid down the proper approach to such deeming provisions. Peter Gibson J, with whom Simon Brown LJ and Balcombe LJ agreed, said, at page 366c:
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> > "For my part I take the correct approach in construing a deeming provision to be to give the words used their ordinary and natural meaning, consistent so far as possible with the policy of the Act and the purposes of the provisions so far as such policy and purposes can be ascertained; but if such construction would lead to injustice or absurdity, the application of the statutory fiction should be limited to the extent needed to avoid such injustice or absurdity, unless such application would clearly be within the purposes of the fiction. I further bear in mind that because one must treat as real that which is only deemed to be so, one must

> treat as real the consequences and incidents *inevitably*[8] flowing from or accompanying that deemed state of affairs, unless prohibited from doing so."

> "Although Spinney was to be assumed to be resident in the United Kingdom, that was not inconsistent with its being also resident in the Netherlands. We are expressly told by schedule 24, paragraph 1(2) that the mere assumption of residence in the United Kingdom does not require any further assumption that there is any change in the place or places at which the company carries on its activities. The company is thus assumed to be dual resident. Under the Convention, it is therefore deemed for the purpose of the treaty to be a resident of the Netherlands: see article 4(3) "where by reasons of the provisions of paragraph (1) a person other than an individual is a resident of both States, then it shall be deemed to be resident in the State in which its place of effective management is situated."

> "As a resident of the Netherlands for the purposes of the Convention, Spinney would, even if resident in the United Kingdom as a matter of United Kingdom municipal law, have been entitled to claim relief from corporation tax on interest derived and beneficially owned by it. Schedule 24, paragraph 4(1) requires one to assume that it would have made a timeous claim for such relief. In that case, the interest would have fallen out of account in calculating its chargeable profits. Hence, the interest could not be apportioned to Bricom."

2.2 The Court of Appeal's Reply

The Revenue apparently agreed with the argument, except that they claimed that Spinney should also be deemed not to be resident outside the United Kingdom. Their argument was successful. Millett LJ, giving the judgment of the Court, said at page 1193e:

> "It is crucial to the taxpayer company's argument that the assumption required by para 1(1) of Sch 24 is an assumption that the company, which is ex hypothesi resident outside the United Kingdom, is *also* resident in the United Kingdom. I do not accept that proposition. In my judgment, the relevant assumption is that the company is *instead* resident in the United Kingdom.

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8 Italics supplied.

"The taxpayer company contrasts the wording of para 1(1) of Sch 24 with other statutory provisions such as s 293(2) which deals with the requirements which qualify a company for inclusion in the business expansion scheme. This requires the company, throughout the relevant period, to be 'resident in the United Kingdom and not resident elsewhere'. I do not find such comparisons helpful, because the statutory context is different. ...

"The taxpayer company's answer to this question echoes a dictum of Sir Robert Megarry V-C in *Polydor Ltd and RSO Records Inc v Harlequin Record Shop Ltd and Simons Records Ltd* [1980] 1 CMLR 669 at 673 (although the case itself was not cited): 'The hypothetical must not be allowed to oust the real further than obedience to the statute compels'. But I do not read this as intending to lay down a special rule which requires a statutory hypothesis to be narrowly and literally construed. The scope of a deeming provision is a question of construction and is not subject to any special rule. As on any other question of statutory construction, the court must attempt to ascertain the intention of Parliament from the words used in the light of the legislative purpose. A statutory hypothesis, no doubt, must not be carried further than the legislative purpose requires, but the extent to which it must be carried depends upon ascertaining what that purpose is.

"In the present case the purpose for which the assumptions are required is self-evident. A controlled foreign company is ex-hypothesi resident outside the United Kingdom. As a non-resident, it will not normally be subject to United Kingdom corporation tax and will have made no claim to relief from such tax. The computation of the profits on which corporation tax is chargeable, therefore, involves ascertaining a hypothetical amount, that is to say the amount which would have represented the amount of such profits if the controlled foreign company had been resident in the United Kingdom and had made all necessary claims for relief. The assumptions which Sch 24 requires are not *additional* assumptions to be made in combination with the actual facts. In relation to the matters which they cover they are *substituted* for the actual facts. Spinneys was resident outside the United Kingdom; this means that it had no profits actually chargeable to corporation tax; accordingly its chargeable profits are to be ascertained on the footing that it was resident in the United Kingdom instead. It is as simple as that. There is no question of dual residence."

2.3 Critique

2.3.1 Is the result Self-Evident?

Now it will be seen that the crucial passage contains much assertion and re-assertion and little argument. The purpose for which the assumptions are required is said to be "self-evident". While Millett LJ does not actually state in terms what this purpose is, it is clear that he regards it as the bringing into charge to UK tax *all* profits of controlled foreign companies which can be apportioned to a UK resident company. With the utmost respect to Millett LJ, who is a most able judge and one of the members of the judiciary most experienced in taxation matters, it is not at all self-evident. It involves the proposition that the United Kingdom, having bound itself by international treaty not to tax the interest of Spinney, no matter in whose hands, should then renege on its treaty obligations by enacting the Controlled Foreign Companies legislation. To my mind, even if there were any ambiguity about the matter, one should presume that the United Kingdom had acted honourably. Nor would a decision in favour of Bricom have opened any flood-gates for tax avoidance. It would simply have involved a finding that the UK had so drafted its Controlled Foreign Companies legislation as to comply with its international treaty obligations.

2.3.2 The Principles of Construction

On what principles should a court give effect to a deeming provision, or hypothetical or statutory fiction? The golden rule is that statutes are prima facie to be interpreted according to their plain and ordinary meaning. It is not for judges to second-guess what was or might have been in Parliament's mind. This is especially true of statutory deeming provisions. You *prima facie* deem to be true not only the deemed state of affairs but every necessary or inevitable consequence of that deemed state of affairs. Many of the authorities deal with the question when you are entitled *not* to deem all the inevitable consequences to follow. The answer is: Only when to do so would produce injustice or absurdity or defeat the *evident* purpose of the deeming provision. Where, as is often the case in a taxing statute, you cannot be sure precisely what the purpose is, then you must construe the deeming provision literally. The mistake which Harman J made in *Marshall v Kerr* at first instance was to jump to an *a priore* conclusion that the policy of the deeming provision did not require the deceased to be deemed to be the settlor of the trust created by the *post mortem* variation of the dispositions of his estate. The Court of Appeal, approved by the House of Lords, held this to be an illegitimate approach.

In *Bricom*, the Crown's argument was the opposite of what it had been in *Marshall v Kerr*,[9] namely that the Court should proceed on the basis of a further statutory fiction not mentioned in the statute and certainly not necessarily entailed by the statutory fiction which was mentioned. There was no authority justifying such a canon of construction and at least one House of Lords case and two Court of Appeal cases against. Moreover, *Marshall v Kerr* was expressly against it. It defies the golden rule.

Now I can quite appreciate the attraction of an argument that one would be justified in adopting such a further fiction where *not* to do so would produce injustice or absurdity or defeat the *evident* purpose of the deeming provision. But, with respect to the Court of Appeal, that is simply not the case here. The hypothesis that Spinney was resident in the United Kingdom is, *pace* Millett LJ, not in the least ambiguous. It does not for one moment entail that it was not resident elsewhere. It is by no means the *evident* purpose of the statute to tax in breach of international obligations. While Taxes Act 1988 Schedule 24 paragraph 1(1) provides that the foreign company shall be assumed to be resident in the United Kingdom, the very next sub-paragraph, 1(2), makes it clear that nothing in sub-paragraph (1) requires it to be assumed that there is any change in the place or places at which the company carries on its activities. The residence of a company not incorporated in the United Kingdom depends on the place at which the company carries on the activity consisting of the highest level of control and management of its business.[10]

2.3.3 Authority

So much follows from principle. Quite apart from the dictum of Megarry J which Millett LJ's researches discovered ,there were indeed authorities directly in point, one of them a Court of Appeal decision in a fairly recent tax case, reported at [1996] STC 68, namely *Walton (Executor of Walton deceased) v Inland Revenue Commissioners*.[11] The case concerned the "market value" of the interest of the deceased in a partnership which owned a tenancy. "Market value" was to be

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9 The argument did not succeed in *Marshall v Kerr*. The Revenue won their appeal to the House of Lords on the grounds, right or wrong, that one did apply all the consequences of the deeming provision but that still left scope for the real settlor to be regarded as the settlor of the trust. See my article 'What Did *Marshall v Kerr* Really Decide?' in Volume 7 Issue 1 of this *Review* at page 57.

10 Millett LJ did not mention paragraph 1(2) .

11 While the case involved capital transfer tax, the decision is also important for capital gains tax and corporation tax, as well as inheritance tax.

ascertained for capital transfer tax purposes by asking a hypothetical question: "What price might the property reasonably be expected to fetch if sold in the open market at the time of the charge?" It had been established as long ago as 1936 by the House of Lords in *IRC v Crossman*[12] that, in the case of the comparable estate duty provision, one must ignore reality in so far as it conflicts with the application of the statutory hypothesis. In that case, the House of Lords held that restrictions on the transfer of the shares in a company which prevented an actual sale in the open market fell to be ignored in so far as it was necessary to hypothesise such a sale on the deceased's death. More importantly, they rejected the Revenue argument that the shares should be deemed to be free from such restrictions in determining how much a purchaser would pay for them. That the purchaser should be deemed to be able freely to *buy* the shares was a necessary consequence of the statutory hypothesis, but it was not a necessary consequence that he should be deemed to be able freely to *sell* them in the open market, once he had acquired them.

In *Walton* the Revenue contended that in applying the statutory hypothesis to a leasehold interest, you assumed that the landlord was a hypothetical person who might be prepared to pay for a surrender and you ignored the actual landlord (who, in *Walton*, had no interest in purchasing the lease). As this was contrary to all legal principle, they relied on alleged "practical common sense" and claimed that admitting the evidence of the actual landlord as to his desires and intentions would be "an unfair and undesirable course". This was a thinly-veiled invitation to the Court of Appeal to legislate, an invitation they unanimously and quite properly resisted, following earlier Court of Appeal authority. The judgment of the Court was given by Peter Gibson LJ:[13]

> "The insuperable difficulty in Mr Neuberger's[14] path is that there is nothing in the statute to support his contention. The open market hypothesis does not require as a **necessary** incident of it that the landlord should be hypothetical. In my judgment the statute requires one to assume a sale but it should be assumed to take place in the real world. As was said by Lawton LJ in *Trocette Property Co Ltd v Greater London Council* (1974) 28 P&CR 408 at 420:

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12 [1937] AC 26.

13 Emboldening supplied.

14 Leading Counsel for the Revenue.

> 'It is important that this statutory world of make-believe should be kept as near as possible to reality. No assumption of any kind should be made unless provided for by statute or decided cases.'

"The majority decision of this court in the *Trocette* case is in any event determinative of this question. In that case the claimants were the tenants of a property which they wanted to develop but they needed the concurrence of the respondent landlord. The landlord took the view that the property might be required for highway purposes and told the claimants that it was not prepared to grant a new lease. Nevertheless the claimants applied to the local planning authority for planning permission and when that was refused, served a purchase notice on that authority which accepted that it would purchase the claimants' interest as tenants of the property. By r.(2) of s.5 of the Land Compensation Act 1961 the compensation to be paid was... 'the amount which the land if sold in the open market by a willing seller might be expected to realise'. The Lands Tribunal to whom the question of compensation was referred held on this point that it was to be assumed that the landlord would grant a new long-term lease to enable the development to proceed. The question that arose was formulated by Megaw LJ (at 415) thus:

> 'Does the value of the claimants' interest, as a matter of law, fall to be assessed by reference to the actual intention of the actual landlord or by reference to the presumed reasonable intention of a hypothetical normal landlord, that is, a landlord who does not possess the special characteristics of the landlord in this case, namely, a local authority with a special planning interest relating to the use of the land in question?'

"He said (at 416):

> 'No buyer in the open market is going to offer to pay a price which takes into account the leaseholder's share of the potential "marriage value" if that buyer knows that in fact the freehold owner is either unable or unwilling to do that which it is necessary for him to do in order to create the "marriage value". **I see nothing in the legislation ... which compels or permits one to ignore, in assessing compensation for the leasehold interest, evidence of a fact which would be known to the buyers in the market and which would eliminate any question of "marriage value"** ... If the assessment of the value for the purpose of compensation is to be on the basis of ignoring a proven or admitted fact which would have affected the price of an actual sale

> on the open market, the use of such basis must, I think, be justified by reference to some specific provision of the legislation.'
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> "...
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> "Mr Neuberger submitted in the alternative that s 38 requires the assumption of a hypothetical landlord unless the actual landlord was a person with a policy known to the market. The freeholders in the *Trocette* case, he said, were such a person as also would be bodies like the National Trust. But to adopt a question posed by Henry LJ in the course of argument, does this mean that the well-advised family freeholders should put an advertisement in a newspaper as to the family's policy? This argument, to my mind, founders on the same rock as Mr Neuberger's primary argument, that is to say, **it is not justified by the language of s 38** nor by anything said by the majority in *Trocette*. **It is not necessary for the operation of the statutory hypothesis** of a sale in the open market of an interest in a tenancy that the landlord should be treated as a hypothetical person ..."

These authorities seem to be to be so compelling that I wonder whether the decision could have been the same had they been cited to the Court.

3 Other Anti-Avoidance Provisions

Millett LJ stated at page 1190c-e:

> "For their part the Revenue accept that the effect of the agreement is to exempt the interest itself from United Kingdom corporation tax and not merely the resident of the Netherlands who receives it. The benefit of the exemption, therefore, is capable of enuring to the benefit of the taxpayer company. But the Revenue claim that the assessments are not precluded by the terms of the agreement because they are not assessments to corporation tax on the exempted interest."

Tax advisers will wish to consider on a case by case basis which double taxation treaties can provide defences against the application of which anti-avoidance provisions. In my view, the acceptance by the Revenue before the Court of Appeal that a provision can, in a suitable case, enure for the benefit of a third party otherwise caught by an anti-avoidance provision is most important, as many of the United Kingdom provisions are worded very differently from the Controlled Foreign Companies legislation. Which double taxation arrangements will avail will be very much a matter of chance, depending on the drafting style employed.