The Offshore Tax Planning Review

INCOME FROM LAND OVERSEAS: 1995 CHANGES

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The advent of self-assessment has stimulated a desire on the part of the Inland Revenue to simplify the law. Manifestations of this are found in the changes to the manner of calculating and assessing income derived from land in the United Kingdom brought in by the Finance Act 1995. These are to be welcomed. The major criticism levelled at them is that they apply only for the purposes of income tax. United Kingdom companies (or companies offshore with UK land held in a branch or agency) will continue to apply the old pre-6th April 1995 rules in computing income derived from United Kingdom land for the purposes of corporation tax. Such criticism should not detract from otherwise welcome reforms.

The Inland Revenue have not passed up the opportunity presented by the change to Schedule A to introduce measures which (broadly) are intended to ensure that the manner of calculating income from land overseas (where that income is taxable) proceeds on the same basis as that applying in computing income from land in the United Kingdom. This is achieved mainly by amendments to section 65 Income and Corporation Taxes Act 1988 ("Taxes Act 1988") introduced by section 41 Finance Act 1995.

The changes to the tax treatment of income from United Kingdom land are in part no more than the statutory recognition of practices long accepted by Inspectors of Taxes which departed in varying degrees from the strict wording of the law. The changes to the treatment of income from overseas land are also partly a statutory recognition of practice. The changes do not necessarily work to the advantage of the taxpayer.

Income in the form of profits derived from the carrying on of a trade of dealing in or of developing overseas land is unaffected.

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In considering the impact of the changes it is useful to give a short résumé of the law as it applied to income and other receipts from overseas land prior to 6th April 1995 — not least because the old rules still apply for the purposes of corporation tax.

Pre-6th April 1995 Rules

What then were the salient features of the old regime which distinguished it from that governing the taxation of rents etc from United Kingdom Land?

First, and most obviously, each parcel of land held overseas from which income was derived was to be treated as a single source of income. In such cases, separate "sources" of income for the purposes of Case V Schedule D would be acquired — or would cease — when an individual parcel of land or a building producing rents was purchased or sold. With the impending introduction (for new sources it has already arrived) of the current year basis of assessing income under Case V Schedule D from 1996-97 the difference between the basis of assessing income from a source which has commenced or ceased — as against that applied in assessing income from a continuing source — will soon lose significance. But for United Kingdom residents who were not domiciled in the United Kingdom a sale of land followed by a remittal of sums representing past income from land overseas in the year of assessment following the sale still presents a readily available means of avoiding United Kingdom income tax on income from a source which has "ceased".

Secondly, sections 34 to 36 of the Taxes Act 1988 provide for a means of assessing as income part of the premium payable on the grant of a lease of United Kingdom land for a term of less than 50 years (and kindred payment received on, for example, a conveyance with the right of re-conveyance or a payment received on the assignment of a lease granted at an undervalue). Premiums received on the grant of leases (for terms of less than 50 years) or other rights out of land overseas which are of a capital nature have hitherto been subject only to capital gains tax. Sections 34 to 36 of the Taxes Act 1988 did not apply. What was "income" from land overseas was determined according to the law of the country where it was situate.

Thirdly, there was no provision allowing the deduction from rents or other gross receipts arising from land overseas of any part of the expenses incurred in earning those receipts. As a matter of Inland Revenue practice (see *Ockendon v Mackley,* (1982) 56 TC 2 at 6) rates, insurance premiums, agent's fees and commissions were allowed as deductions "as expenses incurred in procuring and maintaining the rents" from overseas property. Interest on loans raised for the purchase of the property was not allowed (*Ockendon v Mackley*). Presumably, although it has not been decided, the same principle would apply to disallow head rents paid to a superior landlord and like deductions.

The disallowance of interest in computing rental income from overseas land assessable under Case V Schedule D only assumed significance where the income was assessable to income tax. Where the recipient of that income was a United Kingdom company within the charge to corporation tax the interest paid on loans raised to purchase overseas land was (and is) in most cases deductible as a "charge on income" under section 338 of the Taxes Act 1988. For these purposes it matters not that the lender is not resident in the United Kingdom so long as the interest is paid out of the overseas rental income (section 338(4)(d)).

The 1995 Changes - The "Schedule A Business"

The sub-heading is misleading. Income from overseas land will continue to be assessed under Case V Schedule D — if it is to be assessed at all. The sub-heading otherwise illustrates an important principle. It underlines the fundamental change introduced by section 41 of the Finance Act 1995, which is to align the computation of income from land overseas with the computation of income from land in the United Kingdom.[2] Under the new regime applying to United Kingdom land all activities involving the exploitation of land for rent or other receipts are to be regarded as a "Schedule A business". But the actual Schedule A business consisting of the exploitation for rent of land in the United Kingdom is not to be treated as the same business as that which results in the receipt of rents and like payments from land overseas. Each of the two "businesses" will be treated separately and will involve separate computations (see the new s.65A(1) of the Taxes Act 1988). Otherwise, income-producing land overseas will hereafter be treated as comprised in a "business" in precisely the same way as if the land was in the United Kingdom.

To the above there is one important qualification which takes effect during the transitional period. For the current year of assessment and for 1996/97 each property overseas is regarded as a single deemed "Schedule A business" for the purpose of computing the income arising therefrom and for the purpose also, it follows, of determining whether the source represented by that business has commenced or ceased (section 41(6) Finance Act 1995). So, for these two years, a United Kingdom tax payer who receives or is entitled to receive income from more than one parcel of land overseas will continue to apply the "source" doctrine in relation to each parcel. Each of the parcels will be treated as a separate "business" until 6th April 1997. This applies to land acquired in the transitional period as to land already owned.

[2] See the new subsection (2A) of s.65 Taxes Act 1988.

This change has two major effects.[3]

First, since all actions involving the exploitation of land as a source of rents or receipts overseas are to be treated as a single business, expenses (as to which see further below) incurred in connection with one parcel of land but which exceed the rents or other income arising from that one parcel will be allowed against the rents or other income produced by other land in the same ownership. That follows from the like treatment now accorded to land in the United Kingdom.[4]

Secondly, the changes have an important effect on individuals who are not domiciled in the United Kingdom who are reliant on what might loosely be called the "source" doctrine which enables them to escape the charge to income tax under Case V Schedule D by arranging for the sums of income from a source overseas to be remitted to them in the year of assessment after that source has ceased. From 6th April 1997 all land overseas will be treated as a single business and as one "source" in the hands of such individuals regardless of the number of properties concerned and of the fact that they may be held in different countries. From 6th April 1997 it will therefore no longer be possible for a non-domiciliary owning several properties overseas which form part of the single "business" for the purposes of the provisions to sell one of those properties and, in the following year of assessment, arrange for the remittal of income from that property to the United Kingdom claiming that it is income from a source which has "ceased". If such non-domiciliaries wish to enjoy income from such overseas properties tax free after they have sold or otherwise disposed of the same (that is, after the source has "ceased") they should arrange to sell the properties prior to 6th April 1997 and remit the income in the following year of assessment. Otherwise, those wishing to arrange such remittal to themselves in a tax free form will have to dispose of all land overseas the income from which is brought in as part of the profits of their deemed "Schedule A business", if the income when remitted is to escape the charge to tax.

The 1995 Changes — Receipts to be Included

The object of the changes to be found in the amendment to section 65 of the Taxes Act 1988 and the new section 65A is to align the computation of income derived from land overseas so far as possible with the computation of income derived from land in the United Kingdom. So a new subsection (2A) of section 65 provides

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3 Doubtless there are others, but this article will be concerned with the main effects of treating all Schedule A businesses as a single source.

4 Where, as would be usual, the rents or other income (not necessarily computed on the same basis) are subject to tax in the country where the land is situated, double tax relief may be available. That is considered further below under the heading "Double Taxation".

that, subject to section 65A and the transitional provisions taking effect in 1995/96 and 1996/97, income tax chargeable under Case V Schedule D on income which:

> "(a) arises from any business carried on for the exploitation, as a source of rents or other receipts, of any estate, interest or rights in or over any land outside the United Kingdom; and
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> (b) is not income immediately derived by any person from the carrying on by him of any trade, profession or vocation, either solely or in partnership,
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> shall be computed in accordance with the rules which are applicable under the Income Tax Acts to the computation of the profits or gains of a Schedule A business."

A new subsection (2B) provides:

> "The provisions of Schedule A shall apply for determining for the purposes of subsection (2A) above whether income falls within paragraph (a) of that subsection as they would apply if
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> (a) the land in question were in the United Kingdom, or
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> (b) a caravan or houseboat which is to be used at a location outside the United Kingdom were to be used at a location in the United Kingdom;
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> and any provision of the Income Tax Acts in pursuance of which there is deemed in certain cases to be a Schedule A business in relation to any land in the United Kingdom shall have effect, where the corresponding circumstances arise with respect to land outside the United Kingdom, as if, for the purposes of that subsection, there were deemed to be a business such as is mentioned in that paragraph."

The effect of these provisions is that there will be brought in as part of the deemed overseas "Schedule A business" all rents or other receipts from any estate or interest in overseas land, including annual payments derived from the land and payments for use of caravans or houseboats outside the United Kingdom. It will not be necessary for there to be an established "business" as such. The mere receipt of rents or other payments brought into charge without any action on behalf of the recipient or the receipt of "income" derived from a single and isolated transaction can constitute the carrying on of a "business" for the purposes of these provisions.[5] So, for example, a United Kingdom resident life tenant under a

[5] This follows from paragraph (2) of the new Schedule A — see below.

settlement the trustees of which are resident overseas and who hold land overseas will be treated as receiving the income from the carrying on of the overseas "Schedule A business", although as a beneficiary his participation in the business is confined to the passive receipt of the net income produced therefrom.

Do the receipts of a deemed overseas Schedule A business now include lease premiums or kindred sums which form part of the receipts of an actual Schedule A business if the land was situated in the United Kingdom (as a consequence of sections 34-36 of the Taxes Act 1988)? The charge under Case V of Schedule D is a charge to tax on income. Premiums received on the grant of leases out of land overseas are, in general, capital and until now have been subject to tax in the United Kingdom, if at all, under the capital gains tax regime. The new subsection (2A) of section 65 does not by itself provide an answer to the question of whether or not the premiums are intended to be brought within the charge. However, the new subsection (2B) provides the strongest indication that premiums are intended to be brought within the charge under Case V if, had the land been situate in the United Kingdom, such premiums would attract a charge to income tax. This follows from the closing words "any provision of the Income Tax Acts in pursuance of which there is deemed in certain cases to be a Schedule A business in relation to land in the United Kingdom shall have effect where the corresponding circumstances arise with respect to land outside the United Kingdom ...". These can only sensibly be taken as referring to the new paragraph 1(2) of Schedule A which contains the one "deeming" provision relevant for these purposes. This provides that

> "To the extent that any transaction entered into by any person is entered into for the exploitation, as a source of rents or other receipts, of any estate, interest or rights in or over any land in the United Kingdom that transaction shall be taken for the purposes of this Schedule to have been entered into in the course of such a business as is mentioned in sub-paragraph (1) above."

A Schedule A business means any business the profits or gains of which are chargeable to income tax under Schedule A (section 832 (1) of the 1988 Taxes Act) and includes any business in the course of which any transaction is by virtue of paragraph 1(2) to be treated as entered into.

This brings in as part of the receipts of the Schedule A business all sums charged to tax under the "lease premium provisions" of sections 34-36 of the Taxes Act 1988. It might be objected that there is an ambiguity in that the provisions of the new Schedule A deem certain transactions to be entered into "in the course of a Schedule A business", whilst the section 65(2B) simply refers to there being "deemed" to be a Schedule A business in certain cases. But there is no provision deeming there to be a Schedule A business other than that mentioned in "Schedule A" itself. It was clearly intended by these provisions to embrace lease premiums and kindred receipts from land outside the United Kingdom.

Rent from furnished lettings of land overseas is included. There will be excluded from the computation any profits derived from farming overseas or the exploitation of woodlands or mineral rights overseas, as also interest derived from loans secured on land overseas. That does not mean that these receipts are excluded from the Case V Schedule D charge. It simply means that they do not enter into the computation required of the profits from the overseas "Schedule A" business.

The one important departure from the treatment accorded to United Kingdom land is that the income derived from holiday lettings overseas will be treated simply as one of the receipts of the overseas "Schedule A business". The provisions of sections 503 and 504 of the Taxes Act 1988 under which income from holiday lettings in the United Kingdom can effectively be treated as trading income — with potentially favourable consequences for the purposes of capital gains tax in particular do not apply to lettings of land overseas. This is a distinction which may affect the owners of overseas flats and villas let for holiday purposes when they come to dispose of the same. "Roll-over relief" and "retirement relief"[6] cannot be claimed in respect of disposals of overseas furnished accommodation.

Where a United Kingdom resident is contemplating the grant of a lease of land overseas for less than 50 years (or an assignment of lease granted at undervalue or sale with a right of re-conveyance — being the other events which may result in a charge), consideration should be given to first conveying the land overseas to a United Kingdom company within the charge to corporation tax and leaving that company to grant the lease which would otherwise attract a charge to tax under Case V of Schedule D. The sale to the company would, of course, amount to a disposal for the purposes of capital gains tax. But the individual is only to be charged on the "gain" accruing — as distinct from the sum deemed to be rent under the lease premium provisions. Any chargeable gain may be reduced by indexation. As far as the company is concerned the new Schedule A provisions (and their extension for the purposes of Case V of Schedule D) have no application to profits within the charge to corporation tax (section 65A(4)). The company will be making a part disposal for capital gains tax purposes when it grants the lease for a premium of less than 50 years. But since it will only have recently acquired the property the part disposal is unlikely to result in a gain attracting corporation tax.

The 1995 Changes — Deductions

The effect of the changes to the rules governing the computation of income assessable under Schedule A is that income (actual income or deemed income) derived from land in the United Kingdom is to be computed on the same basis as if the receipts from that land were the receipts of a trade. The test now to be

6 That is, in ss 152 and 163 of the Taxation of Chargeable Gains Act 1992.

applied in the case of land in the United Kingdom is not whether an expense falls within some specific category allowable as a deduction but whether it was in fact incurred for the purposes of earning that income. The resolution of disputes in such cases is a matter rather of accountancy evidence as to whether such item was properly allowable in striking the balance of profit or loss rather than one of statutory interpretation of specific provisions. Once it has been determined that any expense is deductible in striking the balance of profit or loss it is only then necessary to determine whether it comes within one or other of specific classes of statutory prohibition which disallow (or in some cases allow) the deduction of expenses, which are now found in sections 74 to 99 of the Taxes Act 1988 — in particular section 74.

There is an exception from the provisions disallowing expenses in computing trading profits which is likely to be of particular significance to those deriving an income from land overseas. Section 82 of the Taxes Act 1988 prohibits the deduction of interest paid to non-residents in computing trading profits unless the person making the payments has deducted income tax from the payment in accordance with section 349(2) and accounts for the tax so deducted and the condition set out in subsection (2) is satisfied.[7] Section 82 is expressly disapplied for Schedule A purposes. There is therefore nothing to prohibit the deduction of interest charges which are otherwise deductible incurred in the course of the carrying on of the Schedule A business.

With one qualification these amendments to the computational rules for arriving at the income chargeable under Schedule A are to be applied for the purpose of computing income arising in the course of the deemed "Schedule A business" involving the exploitation of land overseas.

Sections 80 and 81 of the Taxes Act 1988 permit the deduction of travelling expenses incurred in carrying on foreign trades which are within the charge for tax under Case I of Schedule D, including the expenses of travel between different places in which those overseas trades are carried on. These are intended to provide a relaxation of the rule (as applied in numerous decisions) which prohibits the deduction of the expense of travelling to work in a trade, profession or vocation as being not "wholly or exclusively" for the purposes of that trade or profession or vocation. The relaxation is not extended to travelling in connection with the overseas "Schedule A business" (section 65A(2) of the Taxes Act 1988).

The application of the rules governing the computation of the profits of a trade for the purposes of Case I of Schedule D to the computation of the profits of a deemed "Schedule A business" coupled with the obligation (from 1996/97) to treat all

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[7] This provides that the liability to pay the interest was incurred exclusively for purposes of the trade and that the terms under which the interest is paid provide that it may be required to be paid outside the United Kingdom.

overseas land from which any form of income is derived by the United Kingdom resident as one "business" for computational purposes has several effects.

First, the ability to deduct various expenses: insurance premiums, commissions, expenditure on repairs and the like, deduction of which was previously a matter of Inland Revenue practice, will now depend on whether the expenses are properly deductible in striking a balance of profit or loss as an expense incurred in earning the profits which it was sought to tax and whether, if they do, they fall within any of the express prohibitions found in sections 74 to 99 of the Taxes Act (other than section 82).

Secondly, as an extension of this first point, the decision in *Ockendon v Mackley* (disallowing interest incurred on loans to purchase the overseas land) has effectively been set aside. Provided the interest would have been deductible in arriving at the profits of the Schedule A business had the land been in the United Kingdom it will be deductible in arriving at the profits of the deemed "Schedule A business" taxable under Case V of Schedule D.

Thirdly, the assimilation of the taxable element in lease premiums and kindred payments (brought into charge by ss 34-36 of the Taxes Act 1988) into the receipts of the Schedule A business will itself allow a more favourable system of deduction in arriving at the "income" derived from these receipts than hitherto. As an illustration, interest will be deducted in arriving at the income derived from lease premiums. Since these changes apply in computing the income derived from overseas land there is here some compensation at least for charging as income the taxable portion of "premiums" taken on the grant of leases of overseas land for terms of less than 50 years.

It has already been observed that the obligation (taking effect from 1997/98) to treat all parcels of land overseas from which income is derived as effectively being part of a single business will have results which are unfavourable in the case of non-domiciliaries wishing to remit income to the United Kingdom in the year of assessment after the land out of which it arose has been sold. Conversely, however, the treatment of all parcels of overseas land from 1997/98 as a single business has its advantages. For example, interest incurred in connection with a loan raised to purchase one overseas property will simply form part of a pool of expenses of the deemed "Schedule A business" overseas. It will matter not that the income from the overseas property purchased with the assistance of a loan is insufficient to cover the interest on the loan in the same year of assessment so long as income from other properties held by the same tax payer suffices for these purposes.

Losses

If, prior to 6th April 1995, rents or other income arising from a parcel of land in the United Kingdom were less than the expenses allowed in computing that income for Schedule A purposes the resulting loss was exceptionally allowed as a deduction in computing other income taxable under Schedule A in the year of the loss. Only in the case of interest was there any provision allowing for a very limited carry-forward of a loss generated where an outgoing exceeded the income available to meet it. Since interest was not allowed in arriving at taxable income from land overseas, and a deduction of other expenses was a matter of practice and concession, there would be no question until now of any losses arising from rented land overseas.

This is now to change. A new section 379A (paragraph 19 Schedule 6 Finance Act 1995) of the Taxes Act 1988 is to afford a measure of relief for losses sustained in carrying on a Schedule A business. Relief is given in two ways. First, relief is allowed generally in respect of all losses sustained in carrying on a Schedule A business by carrying the loss forward to the following year of assessment and (so far as the income is not then sufficient) to subsequent years of assessment. Relief here is allowed only against the Schedule A income. Secondly, and in this case subject to a claim being made, relief from income tax may be given for the year to which the claim relates on an amount of the claimant's income for that year equal to the amount of the loss (corresponding adjustments being made to any loss carried forward if a claim is made). This allowance can thus reduce taxable income from sources other than land. But it is of very limited use. The loss allowable under this provision in computing other income is confined to losses generated by claims to capital allowances or to "allowable agricultural expenses". This last expression is confined (as was the case with the old section 33 of the Taxes Act 1988) as meaning simply disbursements or expenses attributable to an agricultural estate which are deductible in respect of maintenance, repairs, insurance or management and otherwise and in respect of interest payable on any loans. These provisions will apply in relation to losses incurred in the overseas deemed "Schedule A business" but only with effect from the year of assessment 1998/99.[8] The earliest year in which a loss accruing in the carrying on of an overseas Schedule A business will be available for carry-forward under the new section 379A will be the year 1997/98 the loss being allowed in computing income for 1998/99. Losses incurred in carrying on of the overseas business generated by, for example, claims to capital allowances, relate to allowances and expenditure in 1998/99 and subsequent years.

Those minded to avail themselves of the provisions as to "losses" for these purposes should, accordingly, postpone expenditure giving rise to the losses until 1997/98 at the very earliest.

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[8] Section 41(8) Finance Act 1995.

Capital Allowances

Extensive adaptation of the capital allowances rules was required as a consequence of the 1995 Finance Act changes for two main reasons:

(a) there were fundamental differences between the treatment of capital allowances given in computing Schedule A income and those given in computing the profits of a trade, and

(b) the Finance Act changes in 1994 treat allowances as deductions in computing the profits of a trade taxable under Case I of Schedule D and charges as receipts of the trade.

The Finance Act 1995 changes apply the new rules for the purpose of giving allowances or creating charges in computing the profits of a trade taxable under Case I of Schedule D to the new Schedule A. These rules will in turn apply for the purposes of computing income from land overseas taxable under Case V of Schedule D.

The rules applying in determining whether or not capital allowances are deducted in computing the profits of a United Kingdom trade will apply in determining whether such allowances should be deducted in computing income from land overseas. Likewise, the limitations on those deductions (in particular the leasing of plant and machinery generally, and leases of plant and machinery in connection with dwellinghouses in particular) apply in computing income from overseas land as they apply in computing income from land in the United Kingdom.

The giving of capital allowances by way of deduction in computing the income otherwise taxable under Case V of Schedule D as an expense of that overseas "business" is a major concession to the taxpayer owning overseas land. It puts the taxpayer holding land overseas the income from which is assessable to income tax (rather than corporation tax) in a more favourable position than a company holding such land. Whilst that company may hitherto have been in a better position to be able to deduct interest on loans to purchase land overseas (as charges on income) it has not (and will not) be enabled to claim or deduct anything on account of its capital expenditure incurred in, for example, the construction of an industrial building for letting overseas.

Double Taxation

Rents and other income derived by a United Kingdom resident from land overseas will almost invariably be subject to tax in the country where the land is situate. Income from overseas land which may become the subject of a charge to tax in the country where it is situate will not necessarily equate with the sum potentially subject to tax as income in the United Kingdom. Lease premiums — to take one illustration — paid on the grant of a lease for less than 50 years may become the subject of a charge to United Kingdom income tax as an element in the profits of the overseas "Schedule A business" taxable under Case V of Schedule D. But the premium may not be taxed at all in the country where the land is situate. Or, if it becomes the subject of a charge to tax, it may be charged as capital or as a capital gain rather than income. Again, it may be found that the deductions and other sums allowed in computing the income from overseas land for the taxation purposes of the country where the land is are different from those allowed in computing that income for the purposes of United Kingdom law. The charge to tax may be on gross rents or a percentage of the same.

Where the income or other receipts derived from land overseas are subject to tax in the country where the land is situate relief from United Kingdom income tax chargeable under Case V of Schedule D will usually be available. In the absence of a specific provision in the relevant double tax treaty (if any) subsisting between the United Kingdom and the country where the land is situate, unilateral relief from United Kingdom income tax may be available under section 790 of the Taxes Act 1988. Where a treaty provides for reliefs in respect of taxes on income or other receipts from the land the invariable practice is to provide that the treaty country where the land is situate "may" charge the income derived from the land to tax.[9] This permissive power is presumably inserted to avoid doubts which might be inspired by other provisions in such treaties restricting the ability of the country where a source of income is situate to charge income from the source to tax where the recipient is resident in the other treaty country. In such cases the treaty will usually provide for relief to be given in the country of residence of the person entitled to the income from land by means of credit against the income taxes otherwise charged on such income in the country of situs.[10] The availability of credit in such cases is subject to the restrictions found in sections 795 and 796

[9] See, by way of illustration, Article 6 of the OECD Model Agreement and Article 5 of the Double Tax Treaty with France, SI 1968 No 1869, as amended by the protocol of 15th October 1987.

[10] See Article 23B of the OECD Model Agreement and Article 24 of the Treaty with France referred to in the previous footnote. The OECD treaty alternative found in Article 23A (which provides exemption for the income from immovable property in the country of residence of the recipient) is not commonly found in treaties to which the United Kingdom is party.

of the Taxes Act 1988.[11]

The credit regime in tax treaties will in most cases have a not dissimilar effect to section 790 conferring unilateral relief.

How then are the relieving provisions likely to operate in practice in respect of the profits of the deemed "Schedule A business" carried on by a UK resident taxpayer in respect of land overseas which have now to be computed in accordance with the rules prescribed for Schedule A purposes?

This must to a large extent depend on the proper interpretation of the relieving provisions (whether statutory or treaty). There are three potential problem areas. First, do provisions which allow as a credit against United Kingdom tax, tax charged on "income" in the country where the land was situate, apply where what is "income" in the United Kingdom is charged as capital in the other treaty country? Secondly, the method of computing income derived from land overseas for the purposes of the overseas tax may differ fundamentally or in detail (e.g., in the deductions allowed) from that applied in computing the like income for the purposes of Case V of Schedule D. Thirdly, it is uncertain how most (if not all) of the relieving provisions apply where the United Kingdom resident taxpayer owns land outside the United Kingdom in several different countries having differing systems of taxation. Until 1997/98 this does not present a problem. Until then, each parcel of land outside the United Kingdom will be regarded as a separate source of income.

Unilateral Relief

Section 790 of the Taxes Act 1988 gives relief by allowing the overseas tax as a credit against United Kingdom income tax. The provisions and restrictions applied to treaty relief by sections 795 and 796 are applied (subsection (3) of section 790) in giving unilateral relief. The credit is for tax paid under the law of the country where the land is situate computed by reference to the income arising in that country and the credit is allowed against United Kingdom income tax computed by

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11 Section 795(1), which applies to United Kingdom residents who have retained a foreign domicile, requires that the amount of the income which is being relieved under the Double Tax Treaty and which is received in the United Kingdom is to be treated as increased by the amount of the foreign tax for which relief is given in calculating the total income of the non-domiciliary for UK tax purposes. Subsection (2) prevents a deduction for the overseas tax being claimed in computing the overseas income. Section 796 operates to limit the credit given in respect of any overseas income tax to the amount of United Kingdom income tax chargeable in respect of the income in respect of which relief is given.

reference to "that" income.[12] Although relief is expressed to be given in respect of overseas tax computed by reference to chargeable gains accruing in the overseas territory, the context in which the reference to "chargeable gains" appears makes it clear that the credit for such tax on chargeable gains is given to companies within the charge to corporation tax rather than to persons who are subject to the charge to income tax. Subsection (12) makes this clear by providing amongst other things:

> "References to tax payable or paid under the law of territory outside the United Kingdom include only references
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> (a) to taxes which are charged on income and which correspond to United Kingdom income tax ..."

The Revenue have adopted a liberal interpretation of section 790. They take the view (see Statement of Practice SP6/88, paragraph 4) that relief under section 790 may allow for a credit for overseas tax against United Kingdom capital gains tax on chargeable gains where, amongst other things, the overseas tax charges capital gains as income. But there is no suggestion that they also take the view that credit is available against United Kingdom income tax where the country of source charges what is deemed income in the United Kingdom to tax as a capital gain.

So overseas tax charged on lease premiums as capital or capital gains under the law of the country where the land is situate, part of which may be subject to a charge to tax as part of the profits of the overseas "Schedule A business", will not attract relief under section 790 as a credit against United Kingdom income tax.

What then of the second problem area referred to above? In *GCE International Limited v Yates* [1991] STC 157 the Revenue unsuccessfully contended that tax in Venezuela (ostensibly on trading profits) computed by reference to a percentage of gross receipts was not a tax which corresponded to United Kingdom income tax for the purposes of what is now section 790(12). *GCE International Limited v Yates* was concerned with relief to be given to tax on the profits of a trade. The principle is equally applicable where the income is income from land. It is possible to conclude that the view likely to be taken is that, provided the overseas tax imposed on or by reference to the rents or other overseas sources of income has some of the characteristics of income tax — in particular, that it is an annual tax — it will matter not that the income for the purposes of the overseas tax is expressed as a percentage of the gross receipts from the land or that some of the deductions which would be allowed in computing such income for the purposes of

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[12] Subsection (4).

United Kingdom law are not allowed in computing the income for the purposes of the overseas tax.[13]

There remains the third of the problem areas referred above. From the year of assessment 1997/98 the income which a United Kingdom resident derives from land overseas will, where that land is situate in different countries overseas, be computed and assessed as income from a single source. The computation of the income derived from the land in each of the countries concerned and the assessment of such income in each of those countries to tax will vary in each case. The problem which has to be addressed is the requirement in section 790(3) that credit for tax paid in the overseas territory is only to be allowed against United Kingdom income tax computed by reference to "that income". Section 796 also limits relief by allowing the overseas tax charged in respect of a particular source overseas to be given as a credit only against United Kingdom income tax charged on the like income. Sections 790(3) and (4) and 796 assume a system of taxing income from a "source" which is common both to the United Kingdom and the territory where the land is situate. But from 1997/98 the computation of United Kingdom income tax on income from land overseas will be by reference to the "profits" derived from the exploitation of land overseas regardless of the situation of the land. It will not be by reference to the income from a single parcel — or by reference to the land in one country. The relieving provisions seem ill-suited to cases where the overseas land is situate in different countries having different methods of computing and taxing the income from land. The Revenue may be persuaded to modify or extend their Statement of Practice SP7/91. Pending such modification the preferred view may be to treat all overseas taxes charged on income from land overseas as allowable as a credit against the tax charged on the profits of the deemed overseas "Schedule A business" without distinguishing the individual component elements in the profits from that business.

Treaty Relief

The OECD Model Agreement, Article 23B, as it applies to land, provides that the state where the recipient of income from land overseas is resident

> "shall allow:

[13] Paragraph 3 of the Revenue's Statement of Practice 7/91 would appear to confirm that the Revenue take this view. The question of whether a foreign tax is admissible for unilateral relief will be determined by examining the tax within its legislative content in the foreign territory in deciding whether it serves the same function as income tax serves in the United Kingdom in relation to the profits of a business. Turnover taxes "as such" are not affected by the revised interpretation and will continue to be inadmissible for relief.

(a) as a deduction from the tax on the income of that resident, an amount equal to the income tax paid in the state where the land is situate;

"(b) as a deduction from the tax on the capital of that resident, an amount equal to the capital tax paid in that other state ..."

It is further provided that such deduction in either case shall not exceed that part of the income tax or capital tax as computed before the deduction is given which is attributable as the case may be to the income or the capital which may be taxed in that other state.

The OECD method adopts the practice of merely allowing the tax charged on the overseas land, regardless of the country where it is situate, as a credit against the income tax charged on the United Kingdom resident. Where treaties following the OECD pattern exist, the second problem area referred to above no longer gives rise to difficulties. The limit placed on the credit does not assist in solving the problem arising where the profits from an overseas "Schedule A business" are derived from land in different countries (a single source from 1997/98). The Model Treaty does not improve on section 790 here. This leaves the first problem area (under which no credit is given for capital gains tax in the country of situs charged on lease premiums the subject of a charge to income tax in the United Kingdom). In the case of major treaty countries, such as France, Spain or the United States in which United Kingdom residents are likely to own land, the articles governing the elimination of double taxation allow the credit against United Kingdom tax computed[14] "by reference to the same profits, income or chargeable gains by reference to which" the foreign tax is paid. That echoes section 790(4). For present purposes the new regime does not address the three problem areas identified above in the context of the treaty relief most generally applicable.

The Basis of Assessment

United Kingdom domiciliaries

Income from overseas land remains assessable on an arising basis. Such income will be computed by reference to the profits derived from the carrying on of the overseas "Schedule A business" in respect of each separate source in 1995/96 and 1996/97 in the same way as it would be calculated for the purposes of a Schedule A business in the United Kingdom. From 1997/98 all sources of income comprising land overseas held by the same United Kingdom domiciliary liable to

[14] Article 24 of the French Treaty, Article 24 of the Treaty with Spain (SI 1976 No 1619) and Article 23 of the Treaty with the United States (SI 1980 No 568).

income tax will be treated as a single source (in the same way as land in the United Kingdom) and the receipts and expenses of such business will each be aggregated and the total deducted one from the other in arriving at the income. The transition from the "preceding year" basis to the "current year" basis of assessment is considered further below.

Non-domiciliaries

United Kingdom residents who are not domiciled in the United Kingdom will remain assessable only on sums received in the United Kingdom.[15] It is clear from section 65(5)(b) that it is only those sums of income representing the profits of the overseas "Schedule A business" which fall to be brought into account. The income of non-domiciliaries may thus be reduced by the somewhat more generous allowance given to the costs and expenses of the overseas "Schedule A business" than was hitherto the case. Conversely, sums representing lease premiums or their equivalent on the grant of leases of overseas land may, if remitted, now attract a charge to income tax under Case V of Schedule D as an element in the profits of the overseas "Schedule A business".[16] Reference has already been made to the effect of the changes (from 1997/98) on non-domiciliaries who are seeking to remit income from land disposed of in the years of assessment prior to the year of remittance. If such non-domiciliaries wish to secure the advantage of a remittance after the source of income has ceased, they will, from 1997/98, have to dispose of the whole of the business involving the exploitation of overseas land — wherever and in whatever country the land is situate.

There is nothing in the changes affecting the principle which allows a non-domiciliary to avoid remitting income by separating out the "income derived" from overseas land from capital or other non-taxable receipts and then remitting only the latter.

Change from preceding year to current year basis of assessment

For parcels of overseas land producing income prior to the 6th April 1994 the preceding year basis of assessment will continue to apply for years of assessment up to and including the year of assessment 1995/96. In the case of non-domiciliaries charged by reference to remittances in the preceding year of assessment the question to be asked is whether the source of income existed on 5th April 1994. If it did, the preceding year basis will apply to remittances in

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15 Section 65(5) of the Taxes Act 1988.

16 Insofar as they did not already attract a charge to capital gains tax.

assessing the income from the overseas "Schedule A business" in 1994/95 and 1995/96.

Land producing income which is acquired after 6th April 1994 will be assessed on the current year basis of assessment following the amendments to section 65 of the Taxes Act 1988 in section 207 of the Finance Act 1994.[17] It follows that the United Kingdom resident liable to income tax in respect of land overseas, who has owned land as a source of income prior to 6th April 1994 and who acquires other land in the transitional two years after that date, will have to contend with two different bases of assessment in respect of his income from land overseas.

From the year of assessment 1996/97 and thereafter all income from land overseas will be assessed on the basis (United Kingdom domiciliaries) of what arises in the year of assessment or (in the case of non-domiciliaries) is received in the United Kingdom in the year of assessment. In the case of non-domiciliaries, remittances of income which have arisen in previous years (from sources of income which continue to exist) will attract a charge to tax notwithstanding that they relate to earlier years.

For existing sources consisting of land overseas owned on 6th April 1994 which the United Kingdom resident retains on 5th April 1998, the transitional provisions of paragraph 6 of Schedule 20 will have effect in assessing such income in the year 1996/97. The assessable income from such overseas land will be 50% of the aggregate of the full amount of the income from the overseas land arising or received (depending on the domicile of the person entitled to the same) in the year of assessment 1996/97 and the year of assessment 1995/96.

Paragraph 10(5) of Schedule 20 to the Finance Act 1994 operates to reduce the credit for any overseas tax allowed in taxing such income to 50% of the overseas tax.

For United Kingdom domiciliaries (but not non-domiciliaries taxable only on a remittance basis) paragraph 10 of Schedule 22 to the Finance Act 1995[18] strikes at arrangements intended to take advantage of the transitional provisions of paragraph 6(2)(a) of Schedule 20 to the 1994 Act by inflating income in the transitional years of assessment 1995/96 and 1996/97 by the inclusion of amounts which would otherwise be taxed in earlier (or later) years of assessment. The provision strikes at

(1) "relevant arrangements" under which income arises at irregular intervals during the years 1994/95 to 1997/98 unless the arrangements are made

[17] Section 218 Finance Act 1994.

[18] See section 123 of the Finance Act 1995.

exclusively for *bona fide* commercial reasons or the obtaining of a tax advantage is not the main benefit which could reasonably be expected to arise from the making of the arrangements. A good illustration might be the grant of a lease at a premium in 1995/96 — the profits of which would be "averaged" over the two transitional years of assessment which would escape the higher charge to tax applying if the whole of the lease premium was brought into charge in one year in 1994/95 or 1997/98. In such cases *bona fide* commercial reasons would have to be demonstrated if the anti-avoidance provision is to be avoided;

(2) "relevant transactions" entered into with a connected person or which are self-cancelling subject to the same exceptions as are applicable to relevant arrangements.

In each case the counteraction prescribed by paragraph 10(2) is the addition of a sum equal to 62.5% of the amount of "profits" (in the case of overseas land) which has been diverted to 1995-96 and 1996-97 from the years preceding or following the same.

Given the exception for *bona fide* commercial reasons it is unlikely that these provisions will be of any relevance save in cases where artificial arrangements have been devised with a view to shifting income which, in the ordinary course of events, would have arisen in the years of assessment 1994/95 or 1997/98 to the intervening transitional period. Since they do not apply to non-domiciliaries it would appear possible for the latter to take advantage of the transitional provisions by substantial remittances[19] in the years 1995/96 and 1996/97 which might otherwise be made in other years.

Non-Residents

There are two situations in which the charge to income tax on income from land overseas may affect persons not resident in the United Kingdom. First, income may accrue or be payable to the non-resident trustees of a settlement, the beneficiaries of which are or include United Kingdom residents. Typically these beneficiaries are non-domiciliaries (usually the settlors of such settlements) who consider that they may at some subsequent date become domiciled in the United Kingdom and who wish to ensure that the property overseas retains its status as "excluded property" for the purposes of inheritance tax.[20]

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19 Assuming remittances of income are needed!

20 Which it will do as a consequence of section 48 of the Inheritance Tax Act 1984.

Where the terms of the overseas settlement construed according to its proper law[21] confer on the United Kingdom resident beneficiary a right to the income accruing to the trustee as it arises, the better view is to treat the profits of this deemed overseas "Schedule A business" as the income of the life tenant beneficiary.[22] This is so notwithstanding that the beneficiary is not entitled to the gross income as it arises, but only to the net sum remaining after deducting expenses, such as ground rent, and interest, for which only the trustees are accountable. It will be for the beneficiary to claim double tax relief in respect of tax charged on such rents in the country of residence. It is the beneficiary who will be entitled to the benefit of the albeit limited loss relief available in respect of businesses which derive their income from land.

What then of United Kingdom resident beneficiaries who do not have an interest in possession, but who — typically — are only one of several objects of the trustees' discretion? The rental and other income from the overseas land will in all such cases be the trustees' income. Such income is not within the charge to United Kingdom income tax in the hands of the overseas trustees and cannot therefore be made the subject of the charge to tax at the rate applicable to trusts by section 686 of the Taxes Act 1988. United Kingdom beneficiaries who receive sums representing income from overseas land in the exercise of the trustees' discretion will be treated as if the "source" of that income was their right in the settlement, and not the property from which the income of the trustees was derived.[23] These beneficiaries will not therefore be concerned with the computation of the profits of the deemed overseas "Schedule A business" save to the extent that such computations determine the character (as capital or income) of any sums received by them from the overseas trustees in the exercise of the latter's discretion. The principal drawback for such beneficiaries is that unless the sums paid to them by the trustees attract some kind of withholding tax in the country of residence of the trustees which itself (a) qualifies as a credit in the hands of the trustees against the tax charged on them in the country where the land is situate, and (b) can itself be used as a credit against United Kingdom income tax, the income received by the beneficiaries will effectively suffer a double charge to tax — indirectly on the overseas income from land in the country where the land is situate, and directly in the hands of the beneficiary in the United Kingdom. One solution is to ensure either that there is no income from the land or that the land is held on interest in possession trusts for United Kingdom beneficiaries. Alternatively, reliance may be placed on the somewhat obscurely worded Extra-

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21 As to which see *Archer-Shee v Garland* [1931] AC 212.

22 Lease premiums will, however, not be part of the life tenant's income for these purposes. Quite how the rules requiring all receipts to be aggregated will work in such cases remains to be seen.

23 A principle established by a long line of authorities beginning with *Drummond v Collins* (1915) 6 TC 525.

Statutory Concession B.18 which may allow the United Kingdom beneficiary to claim treaty relief as if the income of the overseas trustees was his income.[24]

Where, exceptionally, a United Kingdom resident settlor has retained an interest in a settlement the trustees of which are overseas (attracting a charge to income tax on the settlor under the provisions of the new s.660A of the Taxes Act 1988) the "income" of the settlement to which the settlor is entitled will retain the character which it has as income in the hands of the trustees.[25] So where the trustees of the settlement hold overseas land the income from the land will in such cases be treated as the settlor's income and he will himself be entitled to the benefit of any double tax relief. In the case of a non-domiciled settlor the settlor will only be charged on remittances of such income.

The second situation where the income from overseas land accruing to a non-resident might affect the liability of a person to United Kingdom income tax arises in cases where sections 739 and 740 of the Taxes Act 1988 may operate in relation to a "transfer of assets". So far as the 1995 Finance Act changes are concerned the only matter worthy of comment is that the "income" which may be assessed on a transferor by virtue of his power to enjoy under section 739 will be the income from the overseas land. In these cases the transferor should accordingly be entitled to the benefit of losses or credit for any double tax relief which may be given. By contrast, sums which may be chargeable to income tax on a transferor receiving a "capital" sum, or a non-transferor receiving a "capital" sum out of relevant income assessable under section 740, will not attract any form of credit, although the sums so paid will reduce the amount of any income available for the purposes of these charging provisions.

Corporation Tax

The changes with which this article is concerned do not affect the computation and assessment of income from land overseas which is within the charge to corporation tax. Companies, in common with persons within the charge to income tax prior to the commencement of the year of assessment 1995/96, were unable to deduct interest in computing income from overseas land assessable under Case V of Schedule D. But, in practice, the right to deduct "charges on income" which includes annual interest would almost invariably allow United Kingdom companies a deduction for such interest as against the income from overseas land in arriving at their total profits for the purposes of corporation tax. In this respect companies enjoyed an advantage over individuals which the Finance Act 1995 has set at nought.

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24 Although not, apparently, unilateral relief.

25 Section 660G(3) of the Taxes Act 1988.

For the purposes of corporation tax the profits from overseas land, so far as the overseas tax thereon is not available as a credit against United Kingdom corporation tax, will be computed and assessed as hitherto. Since lease premiums payable on the grant of a lease of overseas land by a company within the charge to corporation tax will remain outside the provisions of ss.34 to 36 of the Taxes Act 1988 as now applied for the purposes of income tax, there may thus be some advantage in a United Kingdom individual who is contemplating the grant of such a lease in first selling the land to a company within the charge to corporation tax (under his control) and arranging for that company itself to grant the lease. This arrangement is considered at page 7 above.