THE IMPLICATIONS OF SECTION 174 FINANCE ACT 1996 FOR UK RESIDENTS AND DOMICILED INDIVIDUALS

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There has been much discussion about section 174 Finance Act 1996 ("FA 1996") which section amends s.13 TCGA 1992. Tax practitioners had for some time been aware that such a reform was imminent. What were not expected, however, were the serious consequences resulting from the proposed change.

The many flaws with s.174 were drawn to the relevant Minister's notice. However, apart from the removal of the £500 *de minimis* limit and the prevention of double taxation where a beneficiary under a trust and the trustees of the trust are both participators in a non-resident company, the otherwise unamended section was ordered to stand part of the Act.

In this article, the writer will discuss some of the implications of s.174 for a UK domiciled and resident individual that still remain despite the parliamentary debates and amendments.

The primary, and intended, effect of s.174 is to amend s.13 TCGA 1992 so that the gains of a non-resident company are attributed to a participator in the company, in proportion to the participator's interest in the company.

The term "participator" is given the s.417(1) ICTA 1988 meaning (s.174(9) FA 1996). Note that this meaning includes any person having a share or interest in the capital or income of the company and that the specific examples of participation given in s.417(1) ICTA 1988 are not exhaustive.

As a consequence of this change, the usual ruse of using a guarantee company will no longer be effective in avoiding an attribution of gains. Nor, for that matter,

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will the usual two-tier structure (a non-resident trust owning a non-resident company) be effective.

A Participator's Interest and Connected Persons

Section 174(3) amends the *de minimis* provision found at s.13(4) TCGA 1992. Consequently, the interests of persons connected with the participator are taken into account in determining the participator's interest in the company.

This means that if the participator in question and persons connected with him have less than a 5% interest in the non-resident company, then there will be no apportionment of the gain.

But where the participator in question only holds 1% but persons connected with him hold more than 4% (e.g. 20%), then the *de minimis* limit will be exceeded and apportionment will take place in the way prescribed.

A partner in a partnership which owns a non-resident company may also be similarly disadvantaged. Such a company will be a close company because all the partners are treated as connected with each other.

The s.286(4) TCGA 1992 relief which provides that partners are not connected for the purposes of the bona fide acquisitions and disposals of partnership assets, appears not to apply to assets of a non-resident company owned by a partnership. It is, therefore, likely that gains will be apportioned to a partner even though his personal stake in the company may be small.

Of even greater concern is that it is possible, on the wording, to attribute gains to participators who have no economic interest in the gains of the company. One example would be a loan creditor, who, because of s.417(1)(b) ICTA 1988, is a participator in the company for s.13 TCGA 1992 purposes.

"Just and Reasonable"

Section 174(9) introduces subsection (13)(b) to s.13 TCGA 1992. This subsection states that the extent of a participator's interest will be determined by calculating what proportion of the interests of all the participators in the company is, on a **just and reasonable** apportionment, represented by the participator's interest.

It is not entirely clear what subsection (13)(b) seeks to achieve. It may be that it seeks to separate those s.417(1) ICTA participators **with** an economic interest in the gains of the company, from those s.417(1) participators without an economic interest in the gains of the company. If this is so, it is suggested that a motive test (such as that found in s.741 ICTA 1988) may be more appropriate for two reasons. First, whether or not something is done for bona fide commercial reasons and without a view to avoidance of UK tax may, in general, be less difficult to determine than whether or not an apportionment is "just and reasonable".

Secondly, s.13 TCGA 1992 serves an anti-avoidance purpose and is, therefore, analogous to the income tax anti-avoidance provisions - ss.739, 740 ICTA 1988. It would, therefore, make more sense for the CGT and income tax provisions to mirror each other.

However, when such a motive test was discussed at the Sixteenth Sitting of Standing Committee E, the Minister stated that the introduction of a motive test would create even more uncertainty than the "just and reasonable" basis of apportionment. The Minister observed that without certainty, the taxpayer might have to make assumptions about how his actions might be viewed.

It is not entirely clear how the "just and reasonable" basis will achieve the certainty which the Minister seeks to provide. After all, the taxpayer will still need to make assumptions as to what the Revenue will consider to be a "just and reasonable" apportionment.

The Minister further stated that where there were doubts or disagreements about what was "just and reasonable", the Special Commissioners would be able to decide the issue.

It seems surprising that the Minister should extol the benefits of certainty in a tax system and yet, at the same time, advocate litigation as a means of determining an issue.

He apparently overlooks the fact that litigation is not only seen as a drastic, expensive and time consuming measure but also one the outcome of which is uncertain. This is especially true in cases in which the courts are required to apply such nebulous concepts as "just and reasonable" (see *Leedale v Lewis* [1982] STC 835; *Bayley v Garrod* [1983] STC 287).

Section 13(5A) TCGA: Two Year Limit

Other difficulties are thrown up by the wording of s.174 FA 1996. For instance, it is generally considered that the two year distribution rule is unnecessary and unfair. This rule, found at s.174(4) and which introduces a new s.13(5A) TCGA

1992, provides that where a participator pays CGT on his apportioned gains, and there is a distribution in respect of the gains within two years of the gains accruing to the company, then the CGT paid previously can be applied to reduce the liability to tax which will arise on the distribution.

This is an inadequate relief because s.174 provides no relief where either the original gain or the subsequent distribution is relieved in some other way - for instance, loss relief, double tax relief or reinvestment relief. An example of this would be that an asset held by an offshore company appreciates by £1m. The participator has losses of £1m elsewhere. As the amount of the capital gains can be offset by the capital losses, the participator has no tax liability on the apportionment. When, however, the gain of £1m is distributed, the participator will have a chargeable gain of £1m but no remaining reliefs or losses with which to offset the gain.

Another defect of the new s.13(5A) TCGA 1992 is its potential for double taxation where distribution occurs after the two year time limit. This is best illustrated using a numerical example. Assume that in a given year a company makes a gain of £1m which causes the share value of the company to increase by a corresponding amount. Where the £1m gain of the company is apportioned to the participator, in accordance with s.13 TCGA 1992, the participator will pay tax of £400,000 (i.e., tax at 40% of £1m gain). The £400,000 tax paid is added to the base cost of the participator's shares in order to reduce the tax liability on a subsequent distribution of the gain (s.13(7) TCGA 1992). There will still be a chargeable gain of £600,000 on a subsequent distribution. The participator, therefore, has a tax liability of £240,000 at the time of distribution (tax at 40% on a gain of £600,000). The participator's total tax liability on a gain in the company of £1m is £640,000 - an effective tax rate of 64%. This is more than if a taxpayer winds up a tier of companies in the UK.

Where the distribution occurs within the first two years, the £400,000 tax paid on the original gain is set against £400,000 tax on distribution, so that no extra tax is due.

Section 174 also creates difficulty in the following situation: a taxpayer invests £1m in a non-resident company which has an asset worth £1m; the company sells the asset and realises a gain; that gain is apportioned to the taxpayer as participator and the taxpayer pays tax of £400,000. When the company is wound up, there is no gain then arising against which the £400,000 tax paid can be offset.

While it is understood that s.13 needed to be changed in order to stop schemes involving intra-group transfers of assets and subsequent intra-group distributions, it is thought that this change does not provide an adequate remedy where the participator receives a gain on a later distribution. A change in the rules relating to distributions within the non-resident group, in conjunction with a better thought out definition of "participator", may well suffice.

Bearing in mind, however, that tax is charged on a participator at the time that the gain accrues, there seems no clear reason why tax should, once again, be charged on the participator when that gain is distributed to him. Even more puzzling is the use of an arbitrary two year time limit to determine eligibility for the s.13(5A) relief.

One suggestion for correcting the potential double tax charge imposed by s.13(5A) is to give credit for the whole gain on a subsequent distribution of that gain, rather than credit merely for the tax paid. It has also been suggested that the arbitrary two year time limit should be removed.

The defects described above were debated with the Minister at the Sixteenth Sitting of Standing Committee E. In response the Minister stated:

> "There is inevitably a rough and ready element in such measures. However, people become involved in these arrangements as an opportunity to invest overseas and avoid a liability to capital gains tax. We are dealing with sophisticated investors who know the anti-avoidance procedures and will also know the time scale within which the provisions of the section will operate."

It is clear that the Minister regards investors in non-resident companies as "sophisticated tax avoiders". It is also clear that, in his view, manifest unfairness to this type of taxpayer is perfectly acceptable.

In addition, the Minister stressed that investment in non-resident companies was not "an area into which innocent taxpayers stumble inadvertently". It is, however, probable that "innocent" people will be adversely affected: people such as individuals who invested in non-resident companies before they came to the UK; individuals trading abroad using a non-resident company or individuals who inherit holdings in non-resident companies.

Burden on the Taxpayer

Drawing an analogy with *IRC v Garvin* [1979] STC 98 at 120-124 (where the onus was on the Revenue to prove that a company was a close company for s.461 TA 1970 - now s.704 ICTA 1988 - purposes), it is thought that the onus will lie with the Revenue to show that a non-resident company is close.

Further support for this proposition can be found in *Untelrab v McGregor* [1996] STC (SCD) 1. This case concerned the residence of a company. It was held that the burden of proving residence lay with the Revenue because the question was whether the Revenue had jurisdiction to make an assessment.

Since s.13 TCGA 1992 will only apply to a non-resident "close" company, the Revenue will need to prove "closeness" before making a valid assessment. This being a jurisdictional issue, the Revenue will, therefore, also have the burden of proof in proceedings.

Note, however, that although the Revenue will have the onus of proof in any proceedings, a taxpayer wishing to invest in a non-resident company will nevertheless need to discover whether his chosen company would be close if it were UK resident. For this purpose the taxpayer will need to get a list of that company's shareholders as well as information regarding the relationships between the shareholders.

The taxpayer is, therefore, expected to obtain information which will, in most cases, be difficult to obtain. Where the taxpayer cannot get the requisite information, he will have to choose whether or not to invest in that company. If he takes the risk and invests and later discovers that the company is close, a gain may have already accrued.

It is unduly burdensome on the taxpayer for the legislator to presume, first, that the taxpayer **can** thoroughly investigate a non-resident company; and, second, that if he does choose to invest in what later turns out to be a close company, he takes that decision knowingly.

However, in the light of the Minister's views on those who invest in non-resident companies, there is little likelihood that this burden on the taxpayer will be lifted or reduced.

As is apparent from the above discussion, s.174 FA 1996 as it is presently drafted, creates several difficulties. Rather than tackle these difficulties, the Minister seems content to justify them by claiming that they only affect "sophisticated tax avoiders". This attitude is, perhaps, too simplistic and cavalier.