The Offshore Tax Planning Review

ICTA 1988 SECTION 739 AND DOUBLE TAXATION RELIEF: AN OFFSHOOT FROM *WILLOUGHBY*

Stephen Brandon[1]

The tentacles of ICTA 1988, s.739, are, in my view, spread less widely than is often supposed and I hope to elaborate on this in the next edition of the *Review*. For the moment, I wish to deal with one small offshoot of *Willoughby* ([1995] STC 143) and present an argument for consideration.

In *Willoughby*, it will probably be remembered that W paid premiums to Royal Life in return for the issue of policies. As a result of these transfers, income became payable to Royal Life. The worth of the policies at redemption depended upon the income from and value of designated investments, and not simply a proportion of a pool of investments. W was assessed to tax under section 739 on amounts equal to that income.

"Direct" Relief[2]

Before the Special Commissioner, Counsel for W argued that the income and gains on those underlying investments which accrued to Royal Life were its "commercial profits" within Article 3(2) of the UK/Isle of Man Arrangement (SI 1955/1205). He went on to argue that not only was Royal Life entitled to claim this relief but, also, W was entitled to relief in respect of his liability under section 739. He drew an analogy with *Padmore* [1989] STC 493. There, the Court of Appeal held that, where a partnership itself obtained treaty relief, the individual partner (even if United Kingdom resident) also obtained relief.

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1 Stephen Brandon BA, LLM, Barrister, Tax Chambers at 24 Old Buildings, Lincoln's Inn, London WC2A 3UJ
Tel: (0171) 242 2744 Fax: (0171) 831 8095.

2 I use the term "Direct Relief" to cover the taxpayer who claims to benefit from treaty relief conferred on the foreign enterprise in respect of whose income he is taxable under section 739. I am not concerned with any argument that the treaty may somehow confer relief on that individual simply on the basis that he or she is taxable on the underlying income under section 739.

The Special Commissioner rejected the argument and his decision on this point was not appealed against. The Special Commissioner's decision must be correct. As regards the *Padmore* argument, the position was totally different there since, although the partnership was the "enterprise", UK tax law charges those profits to tax on the partner, in respect of his share of the profits of that enterprise. While section 739 taxes the individual by reference to the underlying income received by the enterprise, an assessment on him is not the mechanism by which the profits of the enterprise (here, Royal Life) are charged to tax. Indeed, since the income is deemed for all purposes to be the income of the individual (s.739(2), (3)) tax is not chargeable on the income of the Isle of Man enterprise in respect of an amount equal to that income.

To obtain such "direct" treaty relief, therefore, the taxpayer must argue that a person (the individual), other than the one on whom relief is conferred under the treaty (the enterprise) and who is not charged to tax as the mechanism by which the profits of the enterprise are taxed, can obtain treaty relief conferred on the enterprise in respect of income deemed to be his. Such an argument cannot be correct.

Quantum : "Indirect" Relief

It appears not to have been argued in *Willoughby* that, although "direct" treaty relief was not available, the *quantum* of charge might be affected by treaty relief, affording relief "indirectly". I put the following argument forward for consideration.

Section 739 levies tax on an amount equal to the "income" which becomes payable to the foreign entity. The meaning of "income" in this context was of course examined in *Lord Chetwode v IRC* [1977] STC 64. There, the House of Lords rejected the argument that, in computing the "income" which had become payable to a non-United Kingdom resident investment company, its management expenses could be deducted, as they would have been if it had been United Kingdom resident. It is crucial to appreciate that, in *Chetwode*, the taxpayer was not asking for available reliefs to be given in computing the "income", he was asking for unavailable reliefs to be given, on the hypothetical basis of what reliefs would have been available had the facts been different (had the company been United Kingdom resident).

This does not mean that it is always gross receipts which constitute "income" for section 739 purposes. At page 67, Lord Wilberforce approves of *dicta* in the earlier case of *IRC v Frere* 42 TC 125, at page 147, that "income" means:

> "... gross income as reduced for the purposes of assessment by such deductions only as are specified in the tax code ..."

Viscount Dilhorne also approved of this test (see page 71).

Lord Wilberforce also referred to the deductions to be made "under the schedule" (see page 68) but, in this passage, he was referring to the computation, under the rules of Schedule D Case I, of (net) trading profits, and rejecting by comparison the argument that, with receipts of investment income, a foreign company should be able to deduct expenses in a "notional profit and loss account". *Chetwode* can therefore be seen as providing that in ascertaining the "income", only deductions actually available to the foreign entity under the United Kingdom tax code are allowable deductions from gross receipts.

If that is correct, it is necessary, first, to isolate the gross income which becomes payable, and then apply the rules of the tax code to find the net income. These rules include ICTA 1988, s.788(3)(a), which provides for the giving of treaty relief. If the enterprise in question satisfies the terms of the treaty, it is entitled, under that section, to the relief there set out. Section 788 is, without doubt, part of the UK tax code.

Again, if that is correct, it follows that, in ascertaining the "income" upon which section 739 bites, relief pursuant to section 788 should first be deducted. Thus, the effect of applying treaty relief "indirectly" in this matter would be to reduce the income, perhaps to nil. It will of course be appreciated that the relief is still that of the foreign enterprise, and not the individual.

Would such an argument succeed? It could be argued that, as the effect of section 739 is to "transfer" the income from the "enterprise" to the individual, there is no "income" to which the treaty relief could apply. That, however, would be putting the cart before the horse: only when one has ascertained the "income" can it be so "transferred", and our argument is that the income which is to be transferred to the individual is (say) nil. A more tenable Revenue argument is that, as a matter of principle, treaty relief cannot be given by the back-door to the individual, since the object of granting treaty relief is to reduce the tax burden of a foreign enterprise, not a United Kingdom resident. *Padmore*, however, shows that a United Kingdom resident may benefit from treaty relief. I think the Revenue would have to mount a more fundamental attack, on the basis that the effect of *Chetwode* should be that the individual is simply to be taxed as if he were the recipient of the income, instead of the foreign enterprise, i.e., a notional substitution of him for the enterprise (see Lord Wilberforce at page 68). An obvious problem with that argument is clear if one considers trading income - it is difficult to see how one can ignore the enterprise which carries on the trade and incurs the deductions if one is to produce the computation of net income the House of Lords envisages. If one cannot, why should one ignore the foreign entity for the purpose of applying other allowances or reliefs in the tax code?

One final point: what if the enterprise does not itself need the relief? In *Willoughby*, the Special Commissioner accepted that Article 3(2) protected Royal Life. This will only be so if the foreign enterprise trades in the United Kingdom, or otherwise receives United Kingdom source income. A foreign enterprise

receiving purely foreign source income is not within the charge to tax and does not need treaty relief. (This does not prevent section 739 from applying, as we must ask, for the sake of comparison, if tax would be payable if the income were received by the individual.) We cannot, clearly, argue that there is no "income" under the tax code because of the foreign enterprise's resident status: *Chetwode* rules out any argument that we may assume that the foreign enterprise is United Kingdom resident. It may be, therefore, that the benefit of this argument is limited to circumstances where foreign enterprises require the treaty relief to shelter their tax liabilities. In such a case, at least, it may well be worthwhile maintaining that "indirect" relief is available.