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UPSTREAM ATTRIBUTION OF INCOME AND GAINS AND DOUBLE TAX TREATY RELIEF: SOME IMPLICATIONS OF THE BRICOM DECISION

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A Introduction

In the recent case of *Bricom Holdings Limited v Inland Revenue Commissioners*[2], the English Court of Appeal[3] held that the tax charge imposed on UK-resident corporate shareholders under the UK Controlled Foreign Companies ("CFC") regime is not overridden by the reliefs available under UK double tax treaties.

The decision is important not only because of the conclusion on the CFC issue but also for various other reasons. These include the fact that it helps to clarify the principles to be applied in determining whether and to what extent double tax treaty relief can override other provisions of UK tax law whereby income or gains of a non-UK resident person are attributed to a UK resident person for UK tax purposes.

In this article, it is proposed to consider the practical implications of the *Bricom* decision in relation to a number of such attribution rules under UK tax law. Most particularly, reference will be made to s.13 of the Taxation of Chargeable Gains Act 1992 ("TCGA") which is the capital gains equivalent of the CFC regime[4] and s.739 of the Income and Corporation Taxes Act 1988 ("ICTA") which basically deals with income payable to a non-UK resident person in consequence of a

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2 [1997] STC 1179.

3 Upholding the decision of the Special Commissioners reported at [1996] STC (STD) 228.

4 The UK CFC regime only applies to revenue profits.

transfer of assets abroad by an individual ordinarily resident in the UK. It is hoped that non-UK readers may find interesting parallels under their own tax laws.

B An outline of the Bricom decision

For the purposes of this article, it is proposed to provide a brief outline of the key facts of the *Bricom* case and the decision reached by the courts on certain of the key issues. This is intended to serve as an introduction to the subsequent discussion of the wider implications of the case. More detailed commentary on the various issues which arose in the case itself can be found in other published articles.[5]

The facts of the case involved UK source interest income derived by a Netherlands resident company ("Spinneys") which was a wholly owned subsidiary of a UK resident company ("Bricom"). The interest was exempt from UK tax in the hands of Spinneys by virtue of the interest article contained in the UK/Netherlands double tax treaty.[6] The UK Revenue directed that the UK CFC regime[7] should apply in relation to Spinneys. Accordingly, it assessed Bricom to UK tax by reference to the underlying income of Spinneys.

Bricom argued that it was entitled to exemption from such UK tax liability on the basis that the tax charge arising under the UK CFC regime was overridden by the exemption contained in the interest article in the UK/Netherlands treaty.[8] The English Court of Appeal held that the nature of the tax charge arising under the CFC regime was such that it was not overridden by the treaty exemption.

The Court of Appeal decision was based on a detailed examination of the manner in which the tax charge under the UK CFC regime operates. The essential point on which the Court relied was that the CFC regime does not operate by making a direct attribution of profit from the foreign subsidiary to the UK parent, but rather it lays down a three stage process:

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5 On the Court of Appeal decision, see L Christie and M Sheiham, 'Bricom', *The Tax Journal* 11th August 1997 pp 13-14. On the Special Commissioners decision, see in particular D Shandler [1996] *British Tax Review*, Volume 5, 544-553 and R Venables, 'Double Taxation Treaties: the antidote to anti-avoidance provisions'? *Bricom Holdings v IRC*, *Offshore Tax Planning Review*, Volume 6, 1996, Issue 3, at 151-178.

6 Article 11.

7 See ss.747-756 and Schedules 24-28 ICTA.

8 Alternatively, it argued that the existence of the exception had the result that there were "no chargeable profits" with the consequence that the tax charge never arose in the first place

(1) first, the "chargeable profits" of the foreign company for the relevant accounting period are computed.[9] These are not the actual profits of the foreign company but rather a notional amount of profit on which the foreign company would be liable to UK tax if certain assumptions specified in the legislation were satisfied;

(2) secondly, the chargeable profits are "apportioned" to those persons who had an interest in the foreign company during the relevant accounting period according to their respective interests;[10]

(3) finally, any UK resident company to which at least 10% of the chargeable profits are apportioned is assessed to "a sum equal to corporation tax at the appropriate rate" on the amount of chargeable profits apportioned to it less an adjustment in respect of "creditable tax".[11]

The Court of Appeal held that treaty protection was lost at the first stage because the "chargeable profits" were a "purely notional sum". Millett LJ said:[12]

> "They do not represent any profits of Spinneys on which UK corporation tax is chargeable, for there are no such profits. Nor do they represent any actual payments or receipts of Spinneys, whether of interest or anything else. They are merely the product of a mathematical calculation made on a hypothetical basis and making counter-factual assumptions. [They] exist only as a measure of imputation. What is apportioned to the taxpayer company and is subjected to tax is not Spinneys' actual profits but a notional sum which is a product of artificial calculation."

It may be argued that this distinction between a direct attribution of the foreign profits in question and an imputation of a nominal sum calculated by reference to those profits is a rather artificial one. In either case, UK tax is in effect being imposed by reference to the foreign profits in circumstances where those profits are supposed to be exempt from UK tax under a double tax treaty.

Nevertheless, the Court of Appeal decision in *Bricom* represents the current state of UK tax law and is likely to continue to do so unless and until a contrary decision is reached by the House of Lords. This does not mean to say that the

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9 In accordance with s.747(6) and Schedule 24 ICTA.

10 Pursuant to s.747(3) and s.753 ICTA.

11 Pursuant to s.747(4) ICTA.

12 [1997] STC 1179 at 1194.

same approach will necessarily apply in other countries which have CFC regimes. Readers from such countries are invited to consider whether their CFC regimes operate by means of a direct attribution of profits or by means of the imputation of a notional sum calculated by reference to profits and whether, under their tax law, the availability of treaty relief would turn on this distinction.

Accepting however that this distinction does currently apply under UK tax law, it is now proposed to turn to certain other provisions of UK tax law whereby income or gains of a non-UK resident person are attributed to a UK resident person for UK tax purposes.

C Attribution of capital gains pursuant to s.13 TCGA.

Probably the most important provision which may be indirectly affected by the decision in the *Bricom* case is s.13 TCGA. That is the provision whereby chargeable gains[13] accruing to a closely controlled non-UK resident company may be attributed for UK tax purposes to UK-resident shareholders or other "participators"[14] in the company in proportion to their interests as "participators".

As long ago as 1983, the UK Revenue confirmed that in the case of an overseas subsidiary of a UK parent company, "where the overseas subsidiary is resident in a territory with which the UK has a double taxation agreement and there is an article exempting residents of that territory from a charge to UK [tax on] capital gains,[15] then such an article may prevent the imposition of a charge under [s.13 TCGA]"[16]

At first sight, it seems anomalous that treaty relief can fail to override the CFC regime and yet can override the capital gains equivalent of the CFC regime. The reason lies in fine differences in the drafting of the relevant statutory provisions. As mentioned earlier, the CFC regime operates by way of an apportionment of a notional profit. In contrast, s.13(2) TCGA provides that a UK-resident participator in a non-UK resident company to which the section applies "shall be treated...as if a part of the chargeable gain had accrued to him". The gain accruing to the UK-resident participator is therefore the same gain that is exempted by the capital gains article in the relevant treaty.

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13 I.e. capital gains as adjusted for tax purposes.

14 As defined in s.13(12) TCGA by reference to the definition in s.417(1) ICTA.

15 E.g by article in the terms of Article 13.4 of the OECD Model Convention.

16 See CCAB Guidance Note (TR500) dated 10th March 1983.

This analysis is sufficient to deal with the most common type of situation in which s.13 TCGA might otherwise apply, namely, where the gain is realised by a first tier non-UK resident subsidiary. However, it is not entirely clear whether the UK Revenue's confirmation from 1983 is intended to apply where the capital gain in question is realised at the level of a second or lower tier non-UK resident subsidiary.

Prior to *Bricom* it was thought that the 1983 confirmation did apply to gains realised by lower tier subsidiaries. This was confirmed when the UK Revenue's internal guidance manuals were finally made available to the public in 1994/95. The manual on the taxation of capital gains contains a commentary on s.13 TCGA which states[17] that, where there is a double taxation agreement between the UK and "the country in which the company making the gain is resident", then "if the agreement provides that gains of the type realised by the non-resident company are only taxable in that company's country of residence Section 13 cannot apply".

However, this commentary pre-dates the decision in the *Bricom* case.[18] Since *Bricom*, UK Revenue officials had been heard in public expressing the view that treaty relief from s.13 is no longer available in relation to gains realised by lower tier subsidiaries. The question to be addressed now is whether, in the light of the decision in *Bricom*, the UK Revenue has changed its view on this point and, if so, whether it is justified in so doing.

Where the capital gain in question is realised at the level of a second or third tier non-UK resident subsidiary, the position is governed by s.13(9) TCGA. That section basically provides that, where the shareholder or other participator in the non-UK resident company to which the capital gain accrues is itself a closely controlled non-UK resident company, then:

> "an amount equal to the amount apportioned under [s.13(3)] out of the chargeable gain to the participating company's interest as a participator in the company to which the gain accrues shall be further apportioned among the participators in the participating company according to the extent of their respective interests as participators and [s.13(2)] shall apply to them accordingly in relation to the amounts further apportioned, and so on through any number of companies".

Is treaty relief available in such a case? The argument against treaty relief being available is basically that the actual gain is only apportioned at the first stage of the apportionment process and what is apportioned at the second stage is simply "an amount equal" to the amount apportioned at the first stage and therefore no

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17 In paragraph CG 57275.

18 The commentary is dated March 1995.

longer has the character of the underlying capital gain. The argument in favour of treaty relief being available is basically that, under s.13, even in the case of a lower tier subsidiary, the process still starts with an actual capital gain and that is what is treated as being apportioned up the corporate chain.

How then does the gain preserve its character through the apportionment process? In the writer's view, this emerges from the interpretation of the inter-relationship between s.13(9) and s.13(2). The closing words of s.13(9) cited above provide that s.13(2) is to apply to the participators in relation to the amounts further apportioned to them, and s.13(2) in turn goes on to provide that each participator is to be treated "as if a part of the chargeable gain had accrued to him". Thus even though that which is apportioned at the second stage of apportionment is simply "an amount equal to" that which is apportioned at the first stage of apportionment, the amount so apportioned is nevertheless treated as if it were part of the original chargeable gain.

If the UK Revenue regards s.13 as ambiguous or unclear on this point and seeks to interpret the inter-relationship of s.13(9) and s.13(2) in a different way, the UK rules of statutory interpretation will need to be applied. It is now well established and was confirmed by Millett LJ in his judgment in *Bricom* that, in questions of statutory interpretation, "the Court must attempt to ascertain the intention of Parliament from the words used *in the light of the legislative purpose*" (emphasis added). This point was stated even more broadly by Lord Cooke in the House of Lords in the recent case of *IRC v McGuckian*[19], when he said that[20] "in determining the natural meaning of particular expressions in their context, weight is given to the *purpose and spirit* of the legislation" (emphasis added).

It is difficult to see that there can be any legislative purpose directed towards ensuring that double tax treaty relief is available in relation to s.13 TCGA where the gain in question accrues to a first tier subsidiary but not where it accrues to a second or lower tier subsidiary. On the contrary, any such distinction would be unnecessary and illogical. Consequently, on the basis that the express statutory words are sufficient to justify the interpretation which would support the availability of double tax treaty relief in both cases, it is considered that such an interpretation is to be preferred.

It is therefore hoped that the UK Revenue will adopt a pragmatic approach and provide confirmation that treaty relief will continue to be available even in relation to gains accruing to lower tier subsidiaries. If not, the UK courts may be called upon in due course to decide the point.

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19 [1997] STC 908.

20 Ibid at page 920.

In the meantime, in circumstances where s.13 TCGA might apply to the gain accruing to a lower tier subsidiary unless the availability of double tax treaty relief is recognised, prudent tax planners may prefer to avoid having a chargeable gain accruing to the lower tier subsidiary in the first place. In some cases, a convenient way of avoiding any possible exposure in this regard may be to transfer the asset in question from the lower tier subsidiary to a first tier subsidiary by means of an inter-group transfer falling within s.14 TCGA before selling it on to a third party.

D Attribution of income pursuant to s.739 ICTA

The other key provision to be considered is s.739 ICTA. That provision basically applies where an individual ordinarily resident in the UK has transferred assets (e.g. cash or investments) to a non-UK resident person (e.g. a trustee) and, in consequence of that transfer, that individual has "power to enjoy"[21] income accruing to that non-UK resident person (e.g. income from those investments). In such a case, the income in question will be "deemed to be income of that individual for all purposes of the Income Tax Acts" and will be charged tax under a miscellaneous head of charge known as Case VI of Schedule D.[22]

What then if the non-UK resident person to whom the income in question actually accrues is resident in a country with which the UK has a double tax treaty and, under the terms of that treaty, the income in question is expressed to be taxable only in that other country? The treaty provisions which are likely to be particularly relevant in this regard are the business profits article and the "other income"[23] article. Dividend and interest articles could also be relevant but only in respect of UK source dividends and interest.

At least at first sight, it seems that in such a case the treaty exemption should prevail, at any rate provided that the treaty exemption attaches to the profits or income in question rather than to the recipient of the profits or income. This requirement would, for example, be satisfied in the case of the standard "business profits" article and the standard "other income" article. The position is therefore analogous to that considered above in relation to capital gains whereby a domestic UK tax liability arising under s.13 TCGA would be overridden by an exemption contained in a treaty capital gains article.

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21 The expression "power to enjoy" is broadly defined in s.762(2) ICTA.

22 Pursuant to s.739(2) and s.743(1) ICTA but subject to the exemption in respect of *bona fide* commercial transactions in s.741 and the relief in favour of non-UK domiciled individuals in s.743(3).

23 It is assumed that those articles will normally be in broadly the same terms as Articles 7 and 21 of the OECD Model Convention.

However, during the first instance hearing in *IRC v Willoughby*,[24] Counsel for the UK Revenue argued that the exemption in respect of industrial or commercial profits in the double taxation arrangement between the UK and the Isle of Man did not have the effect of overriding a tax charge arising under s.739 ICTA but rather that exemption was personal to the Isle of Man company to which the profits in question actually accrued. The Special Commissioner stated in his decision[25] that one could not "apply the provisions [of the industrial or commercial profits article] twice nor to two different people". He went on to express the view that income which had the character of "industrial or commercial profits" in the hands of the person by which it was actually derived would cease to have that character in the hands of an individual by whom it was deemed to be derived pursuant to s.739 ICTA. This latter aspect of the Special Commissioner's decision in *Willoughby* was cited with approval by the Special Commissioners in *Bricom*.[26]

If these propositions were to be correct, it would not be possible for a tax charge under s.739 ICTA to be overridden by a business profits article in a treaty and it is questionable whether it could be overridden by an "other income" article either. Fortunately, these propositions appear to have been overruled by Millett LJ in *Bricom*. After commenting on the implications of the decisions in *Hughes (Inspector of Taxes) v Bank of New Zealand*[27] and *Lord Strathalmond v IRC*,[28] he concluded:[29]

> "In my judgment, these cases show that the question turns on the nature of the statutory process. Interest from exempt securities does not cease to be such by being included as a component element of the recipient's taxable profits (see Hughes). Exempt income does not change its character or lose its exemption merely because it is deemed to be the income of another person or is imputed to him (see Strathalmond)."

It is particularly notable in the present context that Millett LJ states that exempt income does not change its character or lose its exemption either in the case where it is imputed to another person or in the case where it is deemed to be the income of another person. This seems to forestall any possible argument that there is a material distinction between the two situations and that, whilst treaty exemption

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24 [1995] STC 143.

25 Ibid, at p 168.

26 [1996] STC (SCD) 228 at page 235.

27 (1938) 21 TC 472.

28 (1972) 48 TC 537.

29 [1997] STC (SCD) 228 at page 235.

may be preserved where the income of a non-resident person is simply imputed to a UK resident person for UK tax purposes, it is nevertheless lost if the income is deemed to be the income of the UK resident person for UK tax purposes on the basis that in that case it can then no longer be regarded for treaty purposes as the income of the non-UK resident person to whom it actually accrued.

It may therefore be concluded that there are strong grounds for the view that, in an appropriate case, treaty relief may override the tax charge under s.739 ICTA and that the Court of Appeal decision in *Bricom* strengthens the argument rather than weakens it. It is understood that the UK Revenue have in the past taken the view that treaty relief does not override s.739 ICTA and they were no doubt reinforced in that view by the statements of the Special Commissioners in *Willoughby* and *Bricom*. Following the Court of Appeal decision in *Bricom*, however, they may have to reconsider their view on this point and it is understood that they may already be doing so.

E Some other attribution rules

The same principles may be applied to other attribution rules under UK tax law. The following brief examples will suffice.

Under ss.86 and 87 TCGA, gains accruing to the non-UK resident trustees of a settlement may in certain cases be attributed to the settlor or to the beneficiaries. In the light of the decision in *Bricom*, it is suggested that no treaty relief is available in relation to any tax charge arising under either of these sections. This is because both sections operate by means of computing a notional amount on certain hypothetical assumptions and then treating the settlor or the beneficiaries (as the case may be) as receiving chargeable gains of an amount equal to or calculated by reference to that amount. The position is therefore analogous to that which arises in the case of the CFC regime as established by the *Bricom* decision.

Under s.660A ICTA, income arising under a settlement may be attributed to the settlor if he retains an "interest" in the settlement. It is suggested that treaty relief may (in an appropriate case) be available in relation to a tax charge arising under this section. This is because the attribution rule provides that the income is to be "treated for all purposes of the Income Tax Acts as the income of the settlor and not as the income of any other person". The position is therefore broadly the same as that discussed above in relation to s.739 ICTA, assuming that the trustees are non-UK resident persons and that the income would qualify for treaty relief in their hands.[30]

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30 It is arguable that the inclusion in the additional wording whereby the income is not to be treated as the income of any other person may affect the position, but it is thought that the better view is the principle laid down by Millet LJ in *Bricom* in the light of *Strathalmond* continues to apply notwithstanding that additional wording. See the penultimate paragraph of section D.

F Article 52 of the EC Treaty

In an earlier issue of this journal[31] it was reported that the Special Commissioners had noted in their decision in the *Bricom* case[32] that the taxpayer had reserved the right to argue on appeal that the manner in which the UK Revenue sought to apply the UK CFC regime was contrary to the freedom of establishment provisions in, what was Article 52, of the EC Treaty.

It is understood that in the event this argument was not pursued on appeal by virtue of the fact that insufficient factual evidence had been adduced at the first instance to support the argument. It therefore still remains to be seen whether, in an appropriate case, even though no treaty relief may be available, the UK CFC regime may instead be overridden by Article 52.

G Conclusions

It has for a long time been a matter of debate whether and in what circumstances treaty relief might be able to override the UK CFC regime and other attribution rules under UK tax law.

The *Bricom* case is the first leading case on the point and, whilst some points of uncertainty still remain, the decision of the English Court of Appeal in that case not only largely resolves the issue in the context of the UK CFC regime but also clarifies the principles to be applied in addressing the issue more generally.

It remains to be seen how the UK Revenue will deal with this issue in practice and whether further decisions of the UK courts will be required in order to clarify precisely which attribution rules may be overridden by treaty relief and in what circumstances.

It will also be interesting to see how this issue will be dealt with under continental European tax systems and by continental courts and whether the approach will be similar or perhaps more liberal. Readers with particular thoughts on this are invited to make their views known through the pages of this *Journal*.

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31 See Timothy Lyons, 'UK tax and controlled foreign companies', ECTJ, Volume 1, 1995/96, Issue 3, p 225.

32 [1996] STC (STD) 228 at 237.