DOUBLE TAX TREATIES AND SECTION 739 AND 740 ICTA 1988

by David Goy

Difficult questions arise as to whether the provisions of a double tax treaty can protect against charges to tax otherwise arising under anti-avoidance provisions. This note is concerned with the application of such treaties to charges otherwise arising under sections 739 and 740 ICTA 1988.

While there is no direct judicial authority (higher than the Special Commissioners) that has considered this issue, relevant authority is to be found in the case of *Bricom Holdings Ltd v IRC* 1997 STC 1179 ("*Bricom*"). This case was concerned with the question of whether the interest article in the Dutch Treaty prevented interest being taken into account in assessing chargeable profits for the purposes of the controlled foreign company ("CFC") legislation. The Court of Appeal concluded that the interest in question was not included in the sum apportioned under the CFC legislation. It was merely a measure by which an element in a notional sum was calculated and it was that notional sum which was apportioned and on which tax was charged. As the interest in question was not chargeable to tax the double tax treaty provided no relief.

Having reviewed a number of authorities Millett LJ (as he then was), said the following:-

> "…these cases show that the question turns on <u>the nature of the statutory process.</u> 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 v Bank of New Zealand* 1938 AC 366]). 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 *Lord Strathalmond v IRC* [1972] 1 WLR 1511]). But where tax is charged on a conventional or notional sum which exists only as a product of a calculation, the fact that one of the elements in the calculation is measured by reference to the amount of exempted income does not make the exempted income the subject of the tax (see [*IRC v Australian Mutual Provident Society* [1947] AC 605])."[1]

The Court of Appeal's conclusion that the interest in question was merely an element in a calculation led directly to its decision that the Dutch Treaty provided no protection from charge. While it may seem rather odd that a treaty can protect where the income in question is directly the subject of charge but not where what is chargeable are amounts measured by reference to such income, this, nevertheless, is the result of *Bricom*.[2]

For present purposes what is of particular relevance is what *Bricom* said about the *Strathalmond* case. In that case the taxpayer's wife was resident for tax purposes in the United States and under the treaty with the USA her American dividend income was exempt from tax in the UK. The taxpayer was assessed to tax on the income but the assessment was discharged on the basis that the treaty protected. Referring to this case in *Bricom*, Millett L J said:-

> "…the case shows that the relief from United Kingdom Tax accorded by a double taxation agreement can enure for the benefit of a third party. But the taxpayer in that case was directly assessable on his wife's income, which the relevant statutory provisions [… now repealed] deemed to be the income of her husband."[3]

Turning away from the CFC legislation to section 739, the principal point to be considered is "the nature of the statutory process". In this context the process appears to be very different from that applicable in the CFC legislation. Under section 739(2), where an individual has power to enjoy the income of a non-resident then…

> "…that income shall… be deemed to be income of that individual for all the purposes of the Income Tax Acts."

A like deeming provision operates under s.739(3) where capital sums have been received. The effect of the deeming provisions is therefore to make the individual directly assessable on the income in question. The income is not merely an element in a calculation as was the position in *Bricom*. On this basis there would appear no reason why, at least in theory, a double tax treaty cannot protect against a charge under section 739. Ultimately however, the protection of the treaty will not only depend upon the statutory process referred to above, but also upon whether upon a proper construction of the treaty itself, it can protect the particular taxpayer and the particular income from charge.

On the basis of what is said in *Bricom,* there appears to be no particular difficulty in concluding that a treaty can protect against charges arising under Section 739. The Revenue, however, are known to take a different view, invoking, in particular, the approach of the Special Commissioners in *IRC v Willoughby 1995 STC 143.* While this case is better known for what it says about tax avoidance, one issue raised before the Special Commissioners, but not the subject matter of appeal, was whether the Treaty with the Isle of Man prevented the profits of a Manx enterprise from being deemed to be income of the taxpayer under Section 739. The Special Commissioner said no. He said:-

> "In my opinion there is a distinction between actual income of an individual and actual income of another person which is deemed to be income of the individual. Such income is not industrial or commercial profits of the individual nor quoad the individual is it deemed to be industrial or commercial profits or deemed to be his income as if it were such profits".[4]

Such an approach appears to run counter to the approach adopted in *Strathalmond* and approved in *Bricom.* There is nothing to prevent the income of one person which is deemed to be that of another under Section 739, from being protected by a treaty. It is also worth noting that the absence of an appeal against the decision in *Willoughby* on this issue did not represent any acceptance on the taxpayer's part that the Special Commissioner's approach was correct.[5] As proved to be the case, the taxpayer had clearer arguments to put forward. As a factual matter, the income deemed to be the taxpayer's if Section 739 applied, only fell to be included in the Manx company's profits to a small extent. A large part of it was an expense for the Manx entity as it operated to enhance the value of the taxpayer's investment. Only the net surplus was taxable in the Isle of Man. The argument that the treaty protected could not be put forward in the most ideal context.

Necessarily the question of whether what is chargeable under Section 739 is the same income as that protected by a treaty, is a matter of construction in each case. Even if an issue as to this arises in the context of 'industrial and commercial profits', it is unlikely to arise in the context of other categories of income such as dividends and interest where there is an obvious and direct equivalence between what is regularly protected by a treaty and what Section 739 brings into charge. Even in the context of 'industrial and commercial profits' the position is by no means clear. As mentioned by Millett L J in *Bricom,* the case of *Hughes v Bank of New Zealand* indicates that interest from exempt securities does not cease to be such by being included as a component in a person's profits. By analogy it can be argued that if a person's profits are protected from charge so is any component element in it.

In *Bricom* the Special Commissioners made reference to *Willoughby* and said of it:-

> "Income which was 'industrial and commercial profits' of one person was deemed by S.739 to be income of another person, but its character as industrial and commercial profits was not preserved as it was charged to tax in the hands of the deemed recipient under Case VI of Schedule D".[6]

It is not considered that there is anything in this point. The specific charging provisions under Section 739 do not change the character of the income charged to tax. If interest earned by a foreign company is deemed to be that of a UK resident under Section 739, it is the identical income that is taxed whatever the precise head of charge. In any event, it should be noted that the basis of the charge has been altered and Section 743 (1) now merely provides that " …. Income to which Section 739 applies shall be charged to income tax". If there ever was anything in the point it is no longer there.

In the circumstances, there is nothing in anything the Special Commissioners have said in either *Willoughby* or *Bricom* which demonstrates that as a general principle a treaty cannot protect against a Section 739 charge. Whether it does so in fact, will depend upon the precise provisions of the treaty being relied on.

Turning now to Section 740, the first issue to be considered is again the nature of the statutory process adopted. Here the position is different from Section 739. Section 740, when it applies, taxes the amount or value of benefits provided out of assets available for the purpose by reason of transfers of assets abroad. The charge on the benefits received is limited to the extent to which there is 'relevant income' arising in consequence of which benefits can be provided. What is charged to tax is not, however, the 'relevant income' itself but rather the amount or value of the benefits in question. In these circumstances, adopting the approach of the Court of Appeal in *Bricom,* it would not appear that any treaty relief applicable to the underlying income can protect against a charge to tax on the benefits in question. The income in question limits what may be chargeable but tax is not ultimately charged on the income itself.

In the circumstances, the writer's conclusion is that a treaty can protect in appropriate circumstances, against a charge under Section 739 but not under Section 740. There appears to be no good policy reason why this should be so but it appears to

follow from the different wording of the two provisions and the narrow approach adopted in *Bricom.*

As postscript, it is worth making reference to the compatibility of the provisions in Section 739 and 740 with the EU Treaty. A like issue has already arisen in the context of the CFC legislation in the cases of *Cadbury Schweppes*[7] and *Vodafone*[8] in which it has been argued that such legislation constitutes a breach of the freedom of establishment in Article 43 of the EC Treaty, a breach of the freedom to provide services under Article 49, and a breach of the freedom of movement of capital and payments under Article 56. These issues have now been referred to the European Court of Justice. Like arguments may be available in the context of Section 739 and 740. In some respects the arguments may be stronger in these cases. Where these provisions apply, income tax rates of up to 40 per cent can in effect be levied on the income of foreign companies. If such income arose to UK resident companies the maximum rate would be thirty per cent corporation tax. This may be contrasted with the CFC legislation, the effect of which in broad terms is to subject the parent company concerned to no more tax than if the foreign companies were resident in the UK.

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[1] 1997 STC 1179 at p1195
[2] A like approach did not appeal to the French Court in *Re Société Schneider Electric 2002 ITLR 1077*
[3] Supra @ p.1195
[4] 1995 STC 143 at p 169
[5] The writer of this note appeared with Philip Baker in *IRC v Willoughby* as counsel for the taxpayer.
[6] 1997 STC 1179 at p 1186
[7] [2004] STC (SCD) 342
[8] [2006] STC 483