DOUBLE TAXATION UNDER SECTION 13

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1. The Problem

Section 13 TCGA 1992 attributes a gain made by a non-resident close company to its UK resident participators in proportion to their interests[2]. If a participator is another such company, then its share of the gain is further apportioned amongst its participators, and so on through any number of companies[3]. The difficulty with this provision arises when a gain is realised in a non-resident subsidiary, and one wishes to pass the proceeds up to the shareholders in the non-resident parent company. In this article, I hope to explain why it is very difficult to do this without the shareholder risking a double charge to capital gains tax.

2. Preliminary

This article only considers the UK tax position. Of course, a non-resident company will often be taxed on its gains in the country where it is resident according to that country's domestic law. Normally, that tax can be applied to reduce the UK tax payable on the same gain. Alternatively, a Double Tax Treaty may give exclusive taxing rights to one country. If exclusive taxing rights are given to the other country, the Revenue accepts that this precludes a charge under section 13. Therefore, the problems discussed below may not arise if the country in which the company is resident is given exclusive taxing rights under the applicable Double Tax Treaty.

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2 Section 13(2) and (3).

3 Section 13(9).

3. The Assumed Facts

Assume the following facts. Mr A, who is resident and domiciled in the UK, owns 100% of the shares in B, a company not resident in the UK. In turn, B wholly owns another non-resident company, C. B has no assets other than its shares in C. There are no other participators in either B or C. Mr A initially subscribed £200,000 for his shares in B. B subscribed £200,000 for its shares in C. C bought an asset for £200,000, which is now worth £1 million. C has no other assets. Mr A now wishes to sell the asset and receive the proceeds. The companies will no longer be required, so the plan is to wind them up.

4. Why The Simple Route Doesn't Work

Let us consider what would happen if we were to adopt the straightforward route. C sells the asset to a third party for £1 million. C then goes into voluntary liquidation, making a distribution in its winding up to its sole shareholder, B, of £1 million. B then similarly goes into voluntarily liquidation, distributing its £1 million to Mr A.

There are three relevant events here. First, there is the sale of the asset by C. Section 13(2) treats the chargeable gain on this sale as accruing to Mr A. To keep the figures simple, I will ignore indexation throughout this article. Taper relief does not apply in any case[4]. Therefore, the chargeable gain attributed to Mr A will be £800,000. A capital gains tax liability of £360,000 will arise, assuming that Mr A's marginal rate is 40%.

The second relevant event is the distribution of £1 million by C to B in C's winding up. This is a capital distribution[5], and is treated as consideration received by B for a disposal of its shares in C[6]. B makes a gain of £800,000 on its shares in C, having initially subscribed £200,000 for them. This gain would be attributed to Mr A by section 13(2), creating a further liability of £360,000. However, on this occasion, Mr A can use the capital gains tax paid by him on the first event as a credit under subsection (5A). This should extinguish his liability, provided that the distribution by C takes place within 2 years of the initial gain accruing to C.

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4 Subsection (10A).

5 Section 122(5)(b) TCGA 1992.

6 Subsection (1).

The third relevant event is the winding up of B. This time, a gain will accrue to Mr A directly. However, in my view, it is not possible for him to use the tax paid on C's initial gain as a credit under subsection (5A) a second time. The subsection requires an amount to be distributed, *inter alia*, on the dissolution of "the company" within 2 years of the chargeable gain having accrued to "the company". The chargeable gain in question is the one on which the taxpayer actually paid the tax.

It appears that the company that made the chargeable gain on which the initial tax was paid must be the *same* company as is making the distribution which gives rise to the second liability. On the third event, this is not the case. The company making the distribution in its winding up is B. Although B made a gain that was in principle within section 13(2) – the gain on the disposal of its shares in C – no actual tax was paid because Mr A's liability on that gain was extinguished by subsection (5A). Therefore, on the distribution by B (the third event), no credit is available.

Plainly, Mr A cannot use subsection (7). That subsection is expressly disapplied where the tax paid has already been applied under subsection (5A) to reduce or extinguish a liability to tax. Therefore, on B's winding up, A incurs a liability to capital gains tax of £360,000, which he cannot reduce or extinguish. He will now have paid a total of £720,000 in capital gains tax - 80% of the actual gain.

5. Why Section 14 May Not Solve The Problem

5.1 The Basic Operation of Section 14

One apparent way around this problem is section 14 TCGA 1992. For the purposes of section 13, section 14 extends to non-resident groups the provisions that treat intra-group transfers as giving rise to neither a gain nor a loss. However, in my view, this does not remove the problem of double taxation.

In the above example, suppose this time that C sold the asset to B for £200,000, and B then sold it to the third party for its market value of £1 million. Under section 171(1), the sale by C to B is treated as giving rise to neither a gain nor a loss[7]. This involves assuming (as in fact is the case) a consideration of £200,000. The rule which deems a transfer between connected persons to be at market value is overridden. Therefore, no gain accrues to C.

7 Again, I am ignoring indexation.

However, when B sells the asset to the third party for £1 million, B makes a gain of £800,000, which is treated as accruing to Mr A under section 13(2), giving rise to a liability of £360,000. B can now wind C up without incurring a further gain: C will have £200,000 in cash to distribute in its winding up, equal to B's allowable expenditure on its shares in C[8]. Mr A then puts B into liquidation and receives a distribution of £1 million. This represents a chargeable gain in Mr A's hands of £800,000. The capital gains tax of £360,000 on this gain is extinguished under subsection (5A) or (7), on account of the tax which Mr A paid under section 13(2) in relation to B's gain on the asset.

5.2 Why the Amount of the Undervalue Is a Capital Distribution

So far, so good. Both companies have been wound up, and the proceeds of sale of the asset distributed to Mr A. Mr A has only paid capital gains tax once. However, I think that as a matter of law there was another deemed chargeable gain. When C sold the asset to B at an undervalue, C made a distribution. The meaning of "distribution" is given in section 209 ICTA 1988. The transfer of the asset by C to B appears to fall within either subsection (2)(b) or subsection (4). The amount of the distribution is £800,000 - i.e. the excess of the asset's market value over the consideration given. If the companies had been resident in the UK, subsection (5) would have prevented the transfer from being a distribution. However, subsection (5) does not apply to non-resident companies.

The next question is what, effect if any, such a distribution has. In general, distributions (other than those made in a winding up) are chargeable, if at all, to income tax. However, the reasons for this are specific to distributions made by resident companies. In my view, the distribution by C to B would be a capital distribution. A capital distribution is defined in section 122(5)(b) TCGA 1992:

> "capital distribution" means any distribution from a company, including a distribution in the course of dissolving or winding up the company, in money or money's worth except a distribution which in the hands of the recipient constitutes income for the purposes of income tax.

Given that the transfer is a "distribution" within section 209 ICTA 1988, and that it constitutes money's worth (£800,000, the amount of the undervalue), the only question is whether, in B's hands, the distribution is income for income tax purposes.

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8 Assuming that none of that expenditure has already been attributed to a part disposal of the shares. I will explain below why I think that there has been such a part disposal, and therefore why the allowable expenditure on the actual winding up of C is reduced so as to give rise to a gain.

My view is that it probably is *not* income for income tax purposes. The reasons for this are explained under the following heading. If correct, then they lead to the conclusion that there is a capital distribution and a deemed gain. The consequences of this are discussed in part 5.3 below. However, I accept that it is not totally clear whether such a distribution is income for income tax purposes. If I am wrong, and it *is* income, then there is still a possibility of double taxation, although to a lesser extent, if Mr A is within the charge under section 739 ICTA 1988.

5.2.1 Why the Distribution is Not Income For Income Tax Purposes

"Income" is not defined for tax purposes. If section 122 TCGA 1992 had merely excepted distributions which were "income", rather than excepting those which are "income for the purposes of income tax", we might have had to look at the general law to establish the meaning of "income". However, it is a rule of statutory construction that the legislature is deemed not to have included words for no purpose. Therefore, if the legislature adds the words "for income tax purposes" to the word "income", it means something by those words.

In my view, it means that we must look at the Income Tax Acts, rather than the general law, to determine what is "income for income tax purposes". This means that there must be some profit or gain which falls within one of the Schedules A to F of ICTA 1988, or which is brought within the scope of the Act by some other specific provision. A distribution by a non-resident company is not within any of the Schedules or any other charging provision. Section 18(1), which deals with the general scope of Schedule D, simply does not include profits or gains arising abroad to a person resident abroad. Case V is limited at the outset to profits and gains arising to a person who is resident in the UK.

Contrast this with section 20, discussed in *5.2.2* below, which deals with Schedule F. It expressly provides that, "for the purposes of income tax", distributions of UK resident companies are to be treated as "income", regardless of their treatment in the hands of the recipient. If the legislature intended all distributions of non-resident companies to be treated as income for income tax purposes, then presumably a similar provision would have been included for the purposes of Schedule D Case V.

5.2.2 Why Distributions Between Resident Companies Are Income For Income Tax Purposes and Therefore Not Capital Distributions

Arguments to the contrary may be based on comparing this case with (i) a transfer at an undervalue by a UK resident subsidiary to its UK resident parent;

or (ii) with a dividend paid by a UK resident company to another company. In neither of these cases is income tax payable by the recipient. Therefore, why are these not capital distributions?

In the first case, there is simply no distribution within section 209. Section 209(5) provides that neither section 209(2)(b) nor (4) apply where the transfer is by a UK resident company to its parent, if the former is a 51% subsidiary of the latter. Section 122 TCGA 1992 is inapplicable where there is not a distribution.

In the second case, there are two alternative explanations. First, section 20 ICTA 1988 treats all dividends and distributions of UK resident companies as income for income tax purposes (unless specifically excluded from income tax), however they fall to be dealt with in the hands of the recipient. Dividends and distributions to other companies are not specifically excluded from *income* tax (albeit that they are excluded from corporation tax). Therefore, despite their not being taxable in the hands of the recipient company, such dividends and distributions are nevertheless "income for income tax purposes", taking them outside the definition of a capital distribution in section 122(5)(b) TCGA 1992.

If I am wrong about the effect of section 20, then in the second case[9] perhaps dividends paid by UK resident companies to other companies within the charge to corporation tax *are* capital distributions. The result would be that, on a declaration of a dividend, each corporate shareholder would be deemed to have disposed of an interest in its shares. The amount distributed would often be small, compared to the value of the shares. If so, section 122(2) would permit the corporate shareholder to deduct the dividend from its allowable expenditure (provided that the dividend does not exceed the allowable expenditure), rather than realising a capital gain at that stage. Either way, it is thought that section 208 ICTA 1988 would not help. That section only exempts a company from corporation tax chargeable *on dividends and other distributions*. It does not exempt the company from a *chargeable gain* deemed to accrue as a result of a distribution

However, I consider that section 20 ICTA 1988 *does* prevent a dividend or distribution from one resident company to another from being a capital distribution. Section 20 does not apply to non-resident companies. For the reasons given earlier, I consider that there is no other basis for saying that distributions of non-resident companies, to other non-resident companies, are income for income tax purposes. This is reinforced by section 20 itself. Why would it need to provide that distributions of resident companies are to be regarded as income for income tax purposes *however they fall to be dealt with in*

9 I.e. inter-company dividends where both are resident and are not members of a group.

the hands of the recipient if, but for that provision, they would have been treated as income for income tax purposes anyway? The answer is that they would not have been, as distributions of non-resident companies are not.

5.3 The Consequence of a Capital Distribution

If C has made a capital distribution (of the amount of the undervalue) to B, then B is deemed to have disposed of an interest in his shares in C. The total allowable expenditure in relation to those shares is apportioned by reference to the amount of the distribution (£800,000), compared with the aggregate of that amount and the value of the remaining shares (£200,000). That proportion is 80%. Therefore, £160,000 of allowable expenditure is allocated to this distribution, giving rise to a gain of £640,000.

We must now reanalyse the winding up of C. £40,000 of allowable expenditure remains; and the capital distribution in the winding up of C will be £200,000. Therefore, there will be a gain on this occasion of £160,000. The total gain on B's two part disposals of its shares in C is £800,000. This gain is attributed to Mr A, who is liable to another £360,000 of capital gains tax. Mr A has already paid the equivalent sum on B's disposal of the asset to the third party. Again, Mr A will have to pay a total of £740,000 in capital gains tax: an effective rate of 80%.

5.4 If the Transfer at an Undervalue is not a Capital Distribution, Sections 739 and 740

If I am wrong about the transfer not being income for income tax purposes, then there is no capital distribution. This would involve interpreting "income for income tax purposes" not in accordance with the Income Tax Acts, but in accordance with the general meaning of "income". The amount of the undervalue, by definition, represents distributable profits. Therefore, this argument would run, it is fruit rather than tree.

If this distribution *is* income for income tax purposes, then Mr A (at least, on the facts assumed in this article) is almost certainly chargeable to tax under section 739 ICTA 1988. He transferred assets abroad and (ex hypothesi) has power to enjoy the income from those assets. So, when income (the distribution) arises to a person resident abroad (B), Mr A is treated as if this income were his. The result of this would be that we return to the analysis in *5.1* above for section 13 TCGA 1992 purposes. The conclusion was that there was a net charge under section 13 of 40%. However, we add to Mr A's tax bill an income tax charge of 25% of the amount of the distribution, i.e. £200,000. In total, he has paid

£520,000, which represents a 65% tax charge. This is better than 80%, but hardly ideal!

One escape route would be if Mr A could show that the purpose of avoiding tax was not the purpose or one of the purposes of the transfer of assets abroad, or of any associated operations; or that the transfer and any associated operations were bona fide commercial transactions and not for the purpose of avoiding tax[10]. This is a fairly difficult test to satisfy, and is only relevant if the distribution in question is an income and not a capital distribution. As stated above, I consider that it is a capital distribution.

I hope that the problem I am trying to address is now clear. Parts 6 and 7 of this article attempt to suggest some ways of mitigating this double taxation.

6. C Makes a Distribution Directly to Mr A

This idea involves bypassing one layer of the corporate structure. Initially, C sells the asset to the third party for £1 million, realising a gain of £800,000. This is attributed to Mr A under section 13(2), giving rise to a capital gains tax of £360,000. Next, C pays a dividend of £800,000 to Mr A, on which Mr A is liable to income tax under Schedule D Case V[11].

However, section 13(5A) should prevent a charge to tax from arising on this distribution. Mr A paid capital gains tax in pursuance of section 13(2) when C disposed of the asset. The dividend paid to Mr A is an amount in respect of that chargeable gain. Therefore, Mr A may use the capital gains tax paid by him as a credit against his liability to income tax on the distribution, provided the distribution takes place within 2 years of the gain accruing to C.

As a matter of UK company law, it should be possible for C to make a distribution to Mr A if it obtains the consent of the necessary proportion of its shareholders. B owns 100% of the shares in C, and Mr A owns 100% of the shares in B. Therefore, it should be possible for B's consent to be procured.

10 Section 741 ICTA 1988.

11 Despite the fact that Mr A is not a shareholder in C, this is still a distribution as defined in section 209 ICTA 1988. Section 254 provides that a distribution is "in respect of shares" if it is in respect of shares of another member of a 90% group. The distribution to Mr A is clearly in respect of his shares in B, and B owns 100% of the shares in C.

However, one would need to ensure that the company law of the country where the companies were resident permitted this.

One possible concern is that the dividend could be treated as a dividend payable to B, which B has chosen to redirect to Mr A. This could be analysed as two distributions, leading to the result discussed in part 4 above. However, on a straightforward distribution by C to Mr A, I do not think that there would be adequate grounds for such a re-analysis.

7. Intra Group Transfer at Market Value Leaving the Purchase Price Outstanding

Another possibility involves a variation of the facts discussed in part 5 above. This time, C sells the asset to B for market value (£1 million). As with part 5, the combined effect of sections 14 and 171 TCGA 1992 is to treat this sale as giving rise to neither a gain nor a loss. Therefore, the consideration is deemed to be £200,000. The gain will accrue to B when B sells the asset to the third party for £1 million, and Mr A will incur a capital gains tax liability under section 13 of £360,000. As before, this tax can be used to extinguish Mr A's liability on the distribution by B of the proceeds of the sale.

The difficulty in part 5 was that the sale at an undervalue could be treated as capital distribution, creating a further liability under section 13. If the sale is for market value, then there is no such capital distribution. However, crucially, the market value must be left outstanding. Otherwise, we would end up with the proceeds of sale in C's hands, unable to be distributed to Mr A without C making a capital distribution.

However, there are a number of disadvantages with this method. First, it is messy. We are left with 2 companies, the sole asset of one being a debt owed to it by the other. Winding them up would be risky, because this would involve C writing off the debt. This could be a capital distribution, creating another section 13(2) liability for Mr A. Therefore, the companies would have to remain in existence until such time as the law changes, or Mr A decides to become non-resident for a period exceeding 5 years.

A second difficulty concerns the distributable profits of B. Whereas, for tax purposes, it was deemed to have acquired the asset for £200,000, and therefore made a gain of £800,000, this is not the case as a matter of company law. If B has really paid £1 million for the asset, in the sense of incurring a liability to C of that amount, then B has made no profit on the sale of the asset in accounting terms. This means that B has no distributable profits and was not in a position to make the distribution to Mr A. By doing so, it has in fact become insolvent.

8. Non Resident Trustees

This article has considered the effect of section 13 on a UK resident shareholder. One or more offshore companies, existing solely to hold an asset situated in the UK, are often owned by non-resident trustees. Section 13 expressly includes non-resident trustees amongst those to whom a gain may be apportioned[12]. Obviously, the trustees themselves are not within the charge to capital gains tax[13]. However, where the gains of such trustees are deemed to accrue to a settlor under section 86, the settlor is in much the same position as Mr A in the example. The Revenue appears to accept that the tax paid by a section 86 settlor, relating to gains of the trustees' underlying companies, is paid "in pursuance of" section 13. In principle, the credit under subsections (5A) or (7) is available. However, the limitations of those provisions, and the consequent problems of double taxation, are similar to those discussed in the example. Where there is no settlor within section 86, but the beneficiaries of the settlement are within section 87, care must be taken to ensure that such credit as is available under subsection (5A) or (7) is preserved. Detailed consideration of this scenario is outside the scope of this article, but briefly the tax must actually be paid by a beneficiary in relation to the first gain, and the same beneficiary must receive a capital payment giving rise to a prima facie charge in relation to the second gain. The Revenue will only treat tax paid by a beneficiary under section 87 as "in pursuance of subsection (2)" of section 13 if there were no other gains in the pool at the time with which the capital payment could have been matched.

9. Conclusion

As far as I am aware, the Revenue does not actually take the point that an intra-non-resident-group transfer at an undervalue is a distribution, either of capital or of income. However, if it were to, this could put the hypothetical Mr A in the position of paying tax at 80% or 65% as the case may be. This seems a fairly unsatisfactory state of affairs. If the Revenue does not propose to argue this point, then perhaps it should publish an appropriate Concession on it.

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12 Section 13(10).

13 Section 2(1).

Meanwhile, the best way of avoiding the risk of the Revenue taxing the section 14 transfer at an undervalue as a distribution would be to make a distribution of the proceeds of sale directly from C to Mr A. This is discussed in part 6 above. The most important qualification to this is to check that it is permitted by the company law of the country in question.