IN THE COURT OF APPEAL

BRICOM HOLDINGS LIMITED

- v -

THE COMMISSIONERS OF INLAND REVENUE

LORD JUSTICE MILLETT:

This is an appeal by Bricom Holdings Limited ("the taxpayer") from a decision of the Special Commissioners given on 3rd April 1996 dismissing the taxpayer's appeal against assessments to tax made in accordance with Section 747(4)(a) of the Income and Corporation Taxes Act 1988 ("the Act"). The appeal is brought directly to this Court by special leave granted pursuant to RSC Order 59 Rule 25.

The case raises fundamental questions concerning the relationship between (i) the provisions of a Double Taxation Agreement and (ii) the statutory provisions relating to controlled foreign companies. The Agreement in question is the Double Taxation Convention entered into between the United Kingdom and the Netherlands on 7th November 1980 and scheduled to the Double Taxation Relief (Taxes on Income) (Netherlands) Order 1980 SI 1980 No. 1961. The statutory provisions relating to controlled foreign companies are contained in Chapter IV of Part XVII of the Act. Part XVII of the Act is the Part which deals with tax avoidance. Chapter IV contains provisions originally introduced by the Finance Act 1984.

Given the fundamental nature of the issues and the fact that the relevant provisions have been in force for more than 12 years, it is perhaps surprising that they have not been the subject of dispute before now. The taxpayer says that this is because the Double Taxation Agreement with the Netherlands is in an unusual form, and that most Agreements would not allow the taxpayer's arguments in the present case to succeed. The Revenue says that it is because its understanding of the effect of the controlled foreign company provisions is so obviously correct that no one has considered it worthwhile to challenge it before.

The facts.

The facts are extremely simple. The taxpayer is incorporated and resident in the United Kingdom and is an indirect wholly owned subsidiary of the The Bricom Group Limited ("BGL"). It has a wholly owned direct subsidiary Spinneys International BV ("Spinneys") which is incorporated and resident in the

Netherlands. Spinneys is an investment holding company which formerly carried on business through a branch in Singapore. After selling that branch it had surplus funds which it lent at interest to BGL. BGL duly paid interest to Spinneys, which was taxable on such interest in the Netherlands. The Revenue alleges that Spinneys is a controlled foreign company within the meaning of Chapter IV of Part XVII of the Act, which allows income of such a company to be attributed to its United Kingdom resident shareholders, and has raised assessments on the taxpayer by reference to the United Kingdom source interest received by Spinneys from BGL.

The taxpayer does not dispute that Spinneys is a controlled foreign company and that but for the provisions of the Double Taxation Agreement with the Netherlands it would be unable to challenge the assessments. But it claims that the terms of the Agreement exempt it from liability. For its part the Revenue accepts that the effect of the Agreement is to exempt the interest itself from United Kingdom corporation tax and not merely the resident of the Netherlands who receives it. The benefit of the exemption, therefore, is capable of enuring to the taxpayer. But the Revenue claims that the assessments are not precluded by the terms of the Agreement because they are not assessments to corporation tax on the exempted interest.

The Double Taxation Agreement with the Netherlands.

The dispute thus turns on the effect of the controlled foreign company provisions rather than the scope of the Double Taxation Agreement. This can be shortly summarised as follows.

The Agreement applies to persons who are residents of the United Kingdom or the Netherlands or both (Article 1). The taxes which are the subject of the Agreement include United Kingdom income tax and corporation tax (Article 2(1)); but the Agreement also applies to any

> "identical or substantially similar taxes which are imposed by either State after the date of signature of this Convention in addition to, or in place of, the existing taxes".

Article 11 deals specifically with interest. Article 11(1) provides that

> "interest arising in one of the States which is derived and beneficially owned by a resident of the other State shall be taxable only in that other State".

It is common ground that this prevents the interest paid by BGL to Spinneys from being chargeable to corporation tax in the United Kingdom.

Article 1(5) prevents the interest from being treated as a distribution made by the company paying such interest or from being disallowed as a deduction in

computing the taxable profits of the company paying the interest.

Provisions to similar effect apply to business profits (Article 7) dividends and distributions (Article 10) and "other income" (Article 21), but it is not necessary to consider these further.

Incorporation of the Double Taxation Agreement into English law.

Double Taxation Agreements have no direct effect in English law. They are given effect by Part XVIII of the Act. After certain formalities have been observed, the arrangements contained in a Double Taxation Agreement are given effect by Section 788(3) of the Act. The necessary formalities have been observed in relation to the Agreement with the Netherlands.

Section 788(3) provides

> "(3) Subject to the provisions of this Part, the arrangements shall, notwithstanding anything in any enactment, have effect in relation to income tax and corporation tax in so far as they provide - (a) for relief from income tax, or from corporation tax in respect of income or chargeable gains ...".

Accordingly the provisions of a Double Taxation Agreement which afford relief from United Kingdom income tax or corporation tax prevail over "anything in any enactment", including the Act itself. Part XVIII of the Act, however, contains no reference to "identical or substantially similar taxes".

The controlled foreign company provisions.

Section 747(1) and (2) read as follows:

> "747 Imputation of chargeable profits and creditable tax of controlled foreign companies (1) If the Board have reason to believe that in any accounting period a company - (a) is resident outside the United Kingdom, and (b) is controlled by persons resident in the United Kingdom, and (c) is subject to a lower level of taxation in the territory in which it is resident, and the Board so direct, the provisions of this Chapter shall apply in relation to that accounting period. (2) A company which falls within paragraphs (a) to (c) of subsection (1) above is in this Chapter referred to as a "controlled foreign company".

The Board have made a direction in the present case and it is not disputed that the three conditions were satisfied. Spinneys is therefore a controlled foreign company.

Section 747(3) directs that where the provisions of the Chapter apply in relation to an accounting period of a controlled foreign company, "the chargeable profits" of the controlled foreign company together with the creditable tax of the

company for that period are to be

> "apportioned in accordance with Section 752 among the persons .. who had an interest in the company at any time during that period."

There is no dispute that the taxpayer, as the sole shareholder of Spinneys, is potentially liable to have apportioned to it the whole of the chargeable profits and creditable tax of Spinneys.

Section 747(a) is the charging section. So far as material it reads as follows:

> "(4) Where, on such an apportionment of a controlled foreign company's chargeable profits for an accounting period as is referred to in subsection (3) above, an amount of those profits is apportioned to a company resident in the United Kingdom then, subject to subsection (5) below - (a) a sum equal to corporation tax at the appropriate rate on that apportioned amount of profits, less the portion of the controlled foreign company's creditable tax for that period (if any) which is apportioned to the resident company, shall be assessed on and recoverable from the resident company as if it were an amount of corporation tax chargeable on that company; ..."

Since a controlled foreign company is by definition resident outside the United Kingdom it would normally not be subject to corporation tax. Accordingly the expression "chargeable profits" is given an artificial definition. This is contained in Section 747(6)(a), which reads as follows:

> "(6) In relation to a company resident outside the United Kingdom - (a) any reference in this Chapter to its chargeable profits for an accounting period is a reference to the amount which, on the assumptions in Schedule 24, would be the amount of the total profits of the company for that period on which, after allowing for any deductions available against those profits, corporation tax would be chargeable; ..."

Schedule 24 contains a number of assumptions which must be made in order to enable the chargeable profits of a controlled foreign company to be ascertained. For present purposes the relevant assumption is that contained in paragraph 1(1):

> "The company shall be assumed to be resident in the United Kingdom."

The taxpayer accepts that if there were no Double Taxation Agreement it would be liable to tax under these provisions. As the Special Commissioners pointed out, they require a three-stage operation to be undertaken. The three stages are (1) ascertainment (2) apportionment and (3) assessment. In the present case they

are as follows:

Stage 1. Spinneys' chargeable profits are ascertained under Section 747(6)(a) and Schedule 24.

Stage 2. Spinneys' chargeable profits (less any creditable tax) are apportioned among its shareholders. Since Spinneys is a wholly owned subsidiary of the taxpayer, this means that its chargeable profits are attributed to the taxpayer.

Stage 3. The taxpayer is assessed on "a sum equal to corporation tax at the appropriate rate on that apportioned amount of profits" (less the apportioned amount of creditable tax) and the sum assessed is recoverable from the taxpayer "as if it were an amount of corporation tax chargeable on the taxpayer".

The decision of the Special Commissioner.

The question for the Special Commissioners was whether, at the end of the three stages process required by Section 747, Article 11 of the Double Taxation Agreement with the Netherlands exempts so much of the sum apportioned to the taxpayer as is attributable to Spinneys' United Kingdom source interest from the tax imposed by Section 747(4)(a). The Special Commissioners held that it does not because the interest loses its identity as United Kingdom source interest at stage 1 of the process.

This was sufficient to dispose of the appeal in favour of the Revenue. But the Special Commissioners also considered the alternative arguments which had been presented to them. They held that tax under Section 747(4)(a) is not corporation tax but a tax sui generis; that this tax is "substantially similar to corporation tax"; but that the exemption from such a tax granted by the Double Taxation Agreement is not given effect by Part XVIII of the Act. Had they not already disposed of the appeal on another ground, therefore, they would have reached the unattractive conclusion that the United Kingdom is in breach of its treaty obligations with the Netherlands.

The issues before us.

Four issues have been debated before us:

(1) Does Section 747(4)(a) charge tax on interest which is exempted from corporation tax by the Anglo-Netherlands Double Taxation Agreement?

(2) If so, is the tax in question corporation tax?

(3) If not, is it "substantially similar" to corporation tax?

(4) If so, is it exempted by Section 788 of the Act?

In relation to the first question the taxpayer has put forward a new argument which was not advanced before the Special Commissioners. This is that United

Kingdom source interest is excluded from the computation of Spinneys' chargeable profits at stage 1 and accordingly is not included in the amount apportioned to the taxpayer at stage 2. Logically this argument must be considered first.

Stage 1: the ascertainment of Spinney's chargeable profits.

Spinneys' chargeable profits are ascertained under Section 747(6)(a) on the assumptions contained in Schedule 24. They are the amount on which Spinneys would be chargeable to United Kingdom corporation tax on the assumptions directed by the Schedule. The relevant assumption in the present case is that, contrary to the facts, that Spinneys was resident in the United Kingdom.

The taxpayer points out that neither paragraph 1(1) of Schedule 24 nor any other provision of the Schedule requires the further assumption, also contrary to the facts, that Spinneys was not resident in the Netherlands. Accordingly, the taxpayer submits, in ascertaining its chargeable profits Spinneys must be treated as a company actually resident in the Netherlands but assumed to be also resident in the United Kingdom. There is, of course, nothing unusual or contradictory in the concept of dual residence. It is a commonplace that a company can be resident for tax purposes in more than one jurisdiction at the same time. Furthermore there is nothing in Schedule 24 to require the assumption, also contrary to the facts, that there was no Double Taxation Agreement between the United Kingdom and the Netherlands.

Accordingly, the argument proceeds, Spinneys' chargeable profits must be ascertained by treating Spinneys as having dual residence in the United Kingdom and the Netherlands and as entitled to the benefit of the Anglo-Netherlands Double Taxation Agreement. As I understand it, the Revenue accepts that, if this is the correct approach, the United Kingdom source interest, being exempt from United Kingdom corporation tax under the Double Taxation Agreement, falls out of the computation of Spinneys' chargeable profits at the first stage.

It is critical to the taxpayer's argument that the assumption required by paragraph 1(1) of Schedule 24 is an assumption that the company, which is *ex hypothesi* resident outside the United Kingdom, is *also* resident in the United Kingdom. I do not accept that proposition. In my judgment, the relevant assumption is that the company is *instead* resident in the United Kingdom.

The taxpayer contrasts the wording of paragraph 1(1) of Schedule 24 with other statutory provisions such as Section 293(2) which deals with the requirements which qualify a company for inclusion in the business expansion scheme. This requires the company, throughout the relevant period, to be

> "resident in the United Kingdom and not resident elsewhere."

I do not find such comparisons helpful, because the statutory context is different. Section 293, for example, does not introduce a series of statutory hypotheses but

a series of qualifying conditions. Section 293(2) imposes two residential requirements. The company must be (i) resident in the United Kingdom and (ii) not resident elsewhere. The omission of the second qualification would change the conditions for relief, for a company does not cease to be resident in the United Kingdom by being also resident elsewhere. But paragraph 1(1) of Schedule 24 is a statutory assumption, and is ambiguous. The question is: what is the nature of the assumption?

The taxpayer's answer to this question echoes a *dictum* of Sir Robert Megarry V.-C. in *Polydor Limited and RSO Records Inc. v. Harlequin Record Shops and Simons Records Limited* [1980] 1 CMLR 669, 673 (although the case itself was not cited):

> "The hypothetical must not be allowed to oust the real further than obedience to the statute compels."

But I do not read this as intending to lay down a special rule which requires a statutory hypothesis to be narrowly and literally construed. The scope of a deeming provision is a question of construction and is not subject to any special rule. As on any other question of statutory construction, the Court must attempt to ascertain the intention of Parliament from the words used in the light of the legislative purpose. A statutory hypothesis, no doubt, must not be carried further than the legislative purpose requires, but the extent to which it must be carried depends upon ascertaining what that purpose is.

In the present case the purpose for which the assumptions are required is self-evident. A controlled foreign company is *ex hypothesi* resident outside the United Kingdom. As a non-resident, it will not normally be subject to United Kingdom corporation tax and will have made no claim to relief from such tax. The computation of the profits on which corporation tax is chargeable, therefore, involves ascertaining a hypothetical amount, that is to say the amount which would have represented the amount of such profits if the controlled foreign company had been resident in the United Kingdom and had made all necessary claims for relief. The assumptions which Schedule 24 requires are not *additional* assumptions to be made in combination with the actual facts. In relation to the matters which they cover they are *substituted* for the actual facts. Spinneys was resident outside the United Kingdom; this means that it had no profits actually chargeable to corporation tax; accordingly its chargeable profits are to be ascertained on the footing that it was resident in the United Kingdom instead. It is as simple as that. There is no question of real residence.

In my judgment the taxpayer's new argument fails. The chargeable profits referred to in Section 747(4)(a) must be ascertained without reference to the Double Taxation Agreement and must be measured by reference to the total income of Spinneys inclusive of United Kingdom source interest.

Stages 2 and 3: the apportionment and charge to tax.

The taxpayer's argument is straightforward. If, contrary to its new submission,

Spinneys' chargeable profits ascertained under Section 747(6)(a) include exempt United Kingdom source interest, then so do the sum which is apportioned to the taxpayer under Section 747(3) and the sum on which the tax is charged under Section 747(4)(a). The taxpayer lays stress on the fact that what is apportioned under Section 747(3) is not "a sum equal to the chargeable profits" but the chargeable profits themselves; and that the subject of the charge to tax in Section 747(4)(a) is not "a sum equal to the apportioned part of the chargeable profits" but the apportioned part of the chargeable profits itself.

The difficulty with this submission is that "the chargeable profits" as defined by Section 747(6)(a) are a purely notional sum. They do not represent any profits of Spinneys on which United Kingdom 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 counterfactual assumptions. The "chargeable profits" which are defined by Section 747(6)(a) exist only as a measure of imputation. What is apportioned to the taxpayer and subjected to tax is not Spinneys' actual profits but a notional sum which is the product of an artificial calculation.

The taxpayer relies on *Hughes v. Bank of New Zealand* [1938] AC 366 and *Strathalmond v. IRC* [1972] 1 WLR 1511. In my judgment neither case assists the taxpayer. In *Hughes v. Bank of New Zealand* the bank was resident outside the United Kingdom but had a branch in London on the profits of which it was assessable to tax in the United Kingdom. Part of the Bank's income represented interest which was exempt from United Kingdom tax in the hands of a non-resident. It was held that the exempt interest retained its exempt status in the hands of the London Branch. There, however, the interest was received by the bank and the Revenue sought to assess the actual interest which it received. The case is authority for the proposition that exempt interest retains its character as interest even when it is taxable as a component element of the recipient's trading profits. It would support the taxpayer's case if Section 747(4)(a) charged the taxpayer with corporation tax on Spinneys' trading profits; but it provides no assistance for the taxpayer's contention that that is what Section 747(4)(a) does.

In the *Strathalmond case* the taxpayer's wife was an American citizen resident for tax purposes in the United Kingdom. Because of her American citizenship, however, she was not resident in the United Kingdom for the purposes of the Double Taxation Agreement between the United Kingdom and the United States. Her husband was assessed to tax on her American dividends. The assessments were discharged on the ground that the dividends were exempted from United Kingdom tax by the Double Taxation Agreement. Thus 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 (most recently contained in Section 279 of the Act but now repealed) deemed to be the income of her husband. The decision would support the taxpayer's argument in the present case if Section 747 deemed Spinney's income to be the income of the taxpayer or apportioned Spinneys' income to the taxpayer; but it does not assist the taxpayer's contention that that is what the Section does.

In my judgment some assistance can be derived from a comparison of those cases with *IRC v. Australian Mutual Provident Society* [1947] AC 605 as explained by Lord Radcliffe in *Ostime v. Australian Mutual Society* [1960] AC 459 at p.479. The case was concerned with an assurance company which had its head office overseas but carried on life assurance business through a branch or agency in the United Kingdom. In such a case the relevant rule provided that an unidentifiable portion of the world-wide income of the company derived from the investment of its life assurance fund, calculated in accordance with a mathematical formula, should be charged to tax as income derived from business in the United Kingdom. It was held that the rule did not tax the company's investment income but a conventional sum calculated in accordance with the rule; and that accordingly the sum to be taxed was not affected by the fact that one of the elements in the calculation represented income from exempted investments.

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: *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: *Strathalmond*. But where tax is charged on a conventional or notional sum which exists only as the 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: *Australian Mutual Provident Society*.

Applying those principles to the present case, I am in no doubt that the Special Commissioners were correct to dismiss the taxpayer's appeal. They held that the interest lost its character as interest by the end of stage 1. I do not regard that as an accurate description of the statutory process. It is rather a reflection of the Revenue's unsuccessful argument in *Hughes*, viz: that interest from exempt securities loses its character as interest by being included in the computation of the recipient's trading profits. The correct analysis is that the interest received by Spinneys is not included in the sum apportioned to the taxpayer on which tax is chargeable. It merely provides a measure by which an element in a conventional or notional sum is calculated, and it is that conventional or notional sum which is apportioned to the taxpayer and on which tax is charged.

The remaining questions.

This makes it unnecessary to consider the other questions which have been argued, and I prefer to leave them for later decision. To my mind, however, there is force in the taxpayer's submission that the Special Commissioners' conclusion that the Section 747(4)(a) charge is not a charge to corporation tax may fail to give full effect to Section 754(2) of the Act which provides that

> "For the purposes of the Taxes Acts, any sum assessable and recoverable under Section 747(4)(a) shall be regarded as corporation tax ..."

Conclusion

In my opinion the taxpayer's appeal fails and must be dismissed.

LORD JUSTICE OTTON: I agree.

LORD JUSTICE BELDAM: I also agree.