CHAPTER 35

FOREIGN ASPECTS: SPECIAL RULES

35.1 Trading through a branch or agency

In this chapter we shall continue the theme of foreign aspects of capital gains tax by looking at one or two special rules.

We will start by looking at s.10 TCGA 1992. The normal rule in s.2 is that to be chargeable to UK capital gains tax a person must be resident or ordinarily resident in the UK. S.10 is an exception to this general rule, and one of the **very few instances when a non-resident person will be taxed on a capital gain.**

TCGA 1992, s.10

S.10 applies to a **non-resident person** who is trading in the UK through a **"branch" or "agency".** In general terms, a branch or agency simply means that the non-resident person has some sort of **trading outlet** in the UK, or a medium through which to receive UK trading income.

S.10 applies if the non-resident person sells a **UK asset which has been used for the purposes of his business.** Assets used in the business will typically be land and buildings or perhaps goodwill or plant and machinery. Gains made on sales of shares will never be caught under s.10, because shares can never be used for the purpose of a business.

If this is the case, the gain made by the non-resident person on the sale of the UK asset will be immediately chargeable. This is despite the fact that the person making the gain is not resident in the UK.

S.10 talks about a "person" making the gain, and in this context a "person" could mean a **non-resident individual or a non-resident trust.** S.10B is a similar provision relating to a **non-resident company with a permanent establishment** in the UK. "Permanent establishment" is defined as for corporation tax, but is basically the same as a branch or agency. Remember if a company makes a capital gain, that gain will be chargeable to UK corporation tax and not chargeable to UK capital gains tax.

There are a couple of **anti avoidance rules** to be aware of with regard to s.10. Without the anti avoidance rules, it would be possible for a person to avoid a s.10 charge by closing down the trade before selling the UK asset. Remember that s.10 only applies to assets used in the trade, so if there is no trade there is no s.10 charge. HMRC have countered this by saying that when a non-resident person **ceases his UK trade**, he is **deemed to have sold all of his assets** at their market value immediately before cessation. This will create a capital gain and those gains will be charged under s.10.

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Similarly it could be possible to avoid a charge by exporting the asset before selling it. Again there is some anti avoidance legislation which says that **if an asset is transferred abroad**, it is **deemed to have been sold** by the non-resident person at its market value at the date it is removed from the UK.

Finally here we should consider whether it is possible to defer a s.10 gain by using **rollover relief**. For example, if a non-resident person sells a UK asset used in his trade, and replaces it with another asset, can he claim rollover relief to defer the first capital gain? The answer to this question is "yes" but only if the new asset – i.e. the replacement asset – is also within the charge to tax under s.10. HMRC will therefore allow rollover relief **only if the replacement asset is also situated in the UK and is being used for the purposes of the trade**.

35.2 Apportioning gains to participators

TCGA 1992, s.13

Section 13 TCGA 1992 involves the situation where an individual who is resident or ordinarily resident in the UK owns shares in a foreign company.

This section applies if the company **would be a "close" company** if it were UK resident. A "close" company is any company which is controlled by five or fewer shareholders. Here if we assume that the UK taxpayer owns all of the shares, the company would be close.

The foreign company sells an asset and makes a capital gain. As this is a gain made by a non-resident person – i.e. a foreign company – the gain **cannot be charged in the hands of the company**. The only way the foreign company will have a UK corporation tax liability on this gain, is if the non-resident company is trading in the UK and is selling a UK asset being used in its trade.

Therefore, assuming this is not the case, the capital gain made by the foreign company is outside the scope of UK tax.

As there could be scope for a UK taxpayer avoiding capital gains tax by holding his personal assets within a foreign company, HMRC introduced s.13 which **takes the gains made by the company, and apportions them back to UK shareholders** in proportion to their shareholding in the foreign company. Therefore if the UK shareholder has 100% of the shares in the foreign company, he will have 100% of the capital gain apportioned back to him and charged on him in the UK. **No apportionment** is made if a shareholder has **10% or less** of the shares in the company.

Illustration 1

Charlie and Dennis are both resident in the UK. Between them they own the shares of a foreign company called Jersey Co Ltd – Charlie has 95% of the shares and Dennis has 5% of the shares.

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Jersey Co Ltd sells some shares in March 2011 making a capital gain of £100,000. This gain will not be charged to UK corporation tax as Jersey Co Ltd is a non-resident person. However, s.13 will apply as we have gains accruing to a non-resident company, controlled by five or fewer shareholders who are resident in the UK. The gain of £100,000 will therefore be apportioned back to Charlie and Dennis in accordance with their interest in the company.

Charlie will have 95% of this gain treated as accruing to him, and this will be included in his tax return for 2010/11. However as Dennis does not have more than 10% of the shares of Jersey Co Ltd, none of the gains are treated as accruing to him under s.13.

This assumes that Charlie and Dennis are not "associated" with each other. In order to determine whether a shareholder has a 10% holding, we **aggregate his shares with those of his "associates**". Here the term associates will include **spouses, ancestors and siblings.**

Having apportioned the gains to UK shareholders, these gains will be chargeable to UK capital gains tax and not UK corporation tax. However, because the gain was originally made by a company, to calculate the capital gain we use the **company rules** which means we can deduct **indexation allowance, calculated for the period from the date of acquisition to the date of disposal.**

If the individual who has a gain attributed to them is not domiciled in the UK and the gain is in respect of a non-UK asset, then the remittance basis can apply to the attributed gain.

35.3 Further points on s.13

There are one or two other points to pick up on with regard to s.13. If the foreign company **distributes the capital profit** – either by way of a dividend or a capital distribution – **within three years** of the accounting period in which the gain arises, any **tax paid by the shareholders under s.13 can be credited against any tax due on the dividend**.

A dividend paid by a foreign company to a UK shareholder is taxed as foreign income, so without this rule the shareholder could effectively pay both income tax and capital gains tax on the same capital profit.

If the CGT paid under s.13 exceeds the income tax due on the dividend, there is no tax repayment. Remember that this only applies if the company distributes the profits within 3-years. If the distribution is outside the 3-year period, any dividends are taxable in the normal way without credit for tax paid under s.13.

If the foreign company makes capital losses, these **losses can be apportioned back** to the UK shareholders in the same way that gains are apportioned.

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However such losses can **only be used against s.13 gains arising in the same tax year**. There is no provision for any carry forward of unused s.13 losses.

When the UK shareholders eventually sell their shares in the foreign company, they will make a UK capital gain. Any capital gains **tax paid by UK shareholders under s.13** and not credited against any other liability can be treated as an **allowable cost when calculating the gain on the sale of the shares** in the foreign company. Note that such s.13 tax is allowed as a deduction in calculating the gain, and is not a tax credit in itself.

35.4 Foreign currency gains

If a taxpayer holds money in a bank, he technically has a **chargeable asset** for CGT purposes. It is not possible for a taxpayer to make a chargeable gain if his cash is held purely in sterling. However if a taxpayer makes foreign currency gains – i.e. fluctuations in exchange rates are such that a capital profit arises – such a profit may be chargeable to UK capital gains tax.

Foreign currency is only treated as an **exempt** asset **if it was acquired for personal expenditure** outside the UK. Individuals who hold foreign currency for investment purposes and who make profits on exchange rate movements, will be liable to capital gains tax on those profits.

TCGA 1992, s. 269

When a taxpayer withdraws foreign currency from his account, a capital gain or loss will arise. In essence, the taxpayer is selling his foreign currency in exchange for UK sterling.

Prior to 2010/11, it was common practice to use the share pooling rules in order to calculate foreign currency gains. However, HMRC have confirmed that the correct treatment is to treat the disposal of foreign currency from a bank account as if it were the disposal of any normal asset.

So, when currency is added to an existing account, this is treated as enhancement expenditure. **If only part of the currency is withdrawn from an account, this should be treated as a part disposal.** The normal 'A/A+B ' part disposal calculation should be carried out to determine the allowable cost.

Illustration 2

Mr O'Neill is UK resident. On 1 January 2010 he opened a UK bank account. The cash in the account was held in Euros. Mr O'Neill started with a sterling deposit of £100,000. This was converted into Euros on the same day.

He added a further €50,000 on 1 March 2010. Interest was credited to the account on the 31 December 2010, and the interest totalled €8,000. On 1 June 2011, Mr O'Neill withdrew €66,000 from the account, and converted them back into sterling.

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The exchange rates at the date of the respective events are as follows:

1.1.10	£1: €1.40
1.3.10	£1: €1.30
31.12.10	£1: €1.25
1.6.11	£1: €1.15

Our requirement is to calculate Mr O'Neill's gain or loss on the sale of these €66,000.

To calculate Mr O'Neill's gain or loss, we start with the sterling proceeds and then deduct the relevant sterling costs.

On 1 June 2011, Mr O'Neill withdrew €66,000 from the account and he effectively "sold" them by converting them into pounds sterling. The exchange rate in June 2011 was €1.15 for every £1. Therefore €66,000 would have been sold for £57,391. These are Mr O'Neill's sale proceeds for CGT purposes.

Withdrawal 1.6.11 (€66,000 ÷ 1.15)	£57,391

To work out how much these Euros cost, we must first establish the total cost of the Euros in the account. Mr O'Neill acquired his Euros on three different dates – in January 2010, in March 2010 and in December 2010.

He bought some Euros when he opened the account on 1 January 2010. He opened the account with £100,000 sterling, which, at an exchange rate of €1.40 to £1 would have acquired him €140,000.

He purchased some more Euros on 1 March 2010. He acquired €50,000, which at an exchange rate of €1.30 to £1 would have cost him £38,462. At this point Mr O'Neill has €190,000 in his account.

The final acquisition of Euros was on 31 December 2010 when interest was credited. €8,000 Euros were credited to the account. When converted at an exchange rate of €1.25 to £1, the sterling equivalent is £6,400.

Date:		Euros	£
Purchase 1.1.10	£100,000 x 1.40	140,000	100,000
Purchase 1.3.10	€50,000 ÷ 1.30	50,000	38,462
Interest 31.12.10	€8,000 ÷ 1.25	8,000	6,400
		198,000	144,862

We now need to apply the part disposal formula to work out how much of the cost we can offset against the current disposal.

The 'A' in the formula is the value of the Euros sold, which we have already established is £57,391.

The 'B' in the formula is the value of the Euros retained. Mr O'Neill sold €66,000 of his €198,000 so €132,000 remain. Using the exchange rate of €1.15 for every £1, they are worth £114,783.

So, the cost available to offset in our gain calculation is:

$$£144,862 \times \frac{57,391}{57,391 + 114,783} = \underline{£48,287}$$

Our gain is therefore:

Gain:	£
Proceeds (1.6.11)	57,391
Less: cost	(48,287)
Gain	9,104

A quicker way to arrive at the calculation of cost is to work out the proportion of funds which have been withdrawn and deduct the same proportion of cost.

Here, Mr O'Neill sold €66,000 of his €198,000, being one-third. If we take the same proportion of total cost of £144,862, we arrive at our allowable cost figure of £48,287.

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Example 1

St Peters Ltd is a company resident in Guernsey and owned by 4 unconnected UK shareholders, each holding 25% of the voting rights.

St Peters Ltd sold an office building in Cardiff which it had used for distributing components manufactured in Guernsey.

The capital gain on the sale of the building will be charged on:

a) The UK shareholders as capital gains tax
b) St Peters Ltd as capital gains tax
c) St Peters Ltd as corporation tax
d) No one as the company is resident overseas.

Example 2

Nassau Ltd is a company resident in the Bahamas.

David owns 90% of the shares. His wife Victoria owns 7% of the shares. The rest of the shares are held by David's friend Gary. David, Victoria and Gary are resident in the UK.

Nassau Ltd sold an investment property in Bridgetown plc in June 2010 for £107,540.

The property had cost £20,000 in January 1987. Indexation allowance amounts to £24,820.

Calculate Victoria's chargeable gain in 2010/11.

Answer 1

The correct answer is ***C.***

In this situation there is a non-resident company which is trading in the UK through a permanent establishment and is selling a UK asset used in the trade.

Therefore s.10B TCGA 1992 applies and the gain is charged on the company which pays UK corporation tax on it.

Answer 2

	£
Proceeds	107,540
Less: cost	(20,000)
Less: indexation	(24,820)
Indexed gain	£62,720

7% of the gain is attributed to Victoria under s. 13 TCGA 1992 as she has a >10% holding together with her associate, David.

Attributable gain	
£62,720 x 7%	**£4,390**

Note: Companies receive indexation from date of purchase to date of disposal.

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