EXPLANATORY NOTE

CLAUSE 32: TEMPORARY NON-RESIDENTS

SUMMARY

1. Clause 32 amends provisions in the Taxation of Chargeable Gains Act 1992 (TCGA) which apply in certain circumstances where individuals realise capital gains or losses on disposals of assets during a period of temporary absence from the United Kingdom. The purpose of those provisions is to secure that individuals who are resident or ordinarily resident in the United Kingdom are not able to avoid a charge to capital gains tax by arranging their affairs so that they realise gains while resident for tax purposes in a territory outside the United Kingdom and, after a short period, become once more resident or ordinarily resident in the United Kingdom for such purposes. The amendments made by the clause take effect from 16 March 2005: they counter tax avoidance schemes which are designed to exploit the terms of double taxation agreements (DTAs) to secure that little or no tax is charged in respect of such gains.

DETAILS OF THE CLAUSE

2. Subsection (1) provides for section 10A of the TCGA to be amended as provided for by the remaining subsections of the clause. A brief description of the main provisions of section 10A which are relevant to the clause is given in paragraphs 12 to 18 below.

3. Subsection (2) amends paragraphs (a) and (d) of subsection (3) of section 10A.

   - Paragraph (a) of subsection (3) is the provision described in paragraph 15 below. The amendment made to paragraph (a) modifies the requirement that the "taxpayer" (see paragraph 14 below) acquired the asset in question at a time in the year of departure, or any intervening year, when he or she was neither resident nor ordinarily resident in the United Kingdom. (The meanings of the expressions "the year of departure" and "intervening year" are explained in paragraph 12 below.) The revised paragraph (a) imposes the alternative requirement that the asset was acquired at a time when the taxpayer was resident

or ordinarily resident in the United Kingdom but "Treaty non-resident" (see paragraph 7 below).

- Paragraph (d) of subsection (3) contains references to the rollover relief provisions mentioned in paragraph 17 below. The amendment made to paragraph (d) has the effect of inserting a reference to section 153(1)(b) TCGA, which is a rollover relief provision that applies in relation to the replacement of business assets.

4. Subsection (3) amends the definition of "relevant disposal" in subsection (8) of section 10A. The current definition is set out in paragraph 18 below. The revised definition provides that a disposal of an asset is a "relevant disposal" for the purposes of section 10A if the person who makes the disposal acquired the asset in question while resident or ordinarily resident in the United Kingdom but not Treaty non-resident.

5. Subsection (4) replaces the existing subsection (9) of section 10A with three subsections: a new subsection (9), and subsections (9A) and (9B). The existing subsection (9) explains what it means for an individual to satisfy the "residence requirements" for a tax year (see paragraph 13 below) for the purposes of section 10A.

6. The effect of the new subsection (9) of section 10A is to provide that an individual satisfies the residence requirements for a tax year if either of two conditions is met. The first of these conditions is that there is a part of the year during which the individual is resident in the United Kingdom but not Treaty non-resident. The alternative condition is that the year is one during which the individual is ordinarily resident in the United Kingdom and not Treaty non-resident.

7. Subsection (9A) of section 10A provides that, for the purposes of section 10A, an individual is "Treaty non-resident" at any time at which there exist any "double taxation relief arrangements" (as defined in section 288(1) TCGA) for the purposes of which he or she falls to be regarded as resident in a territory outside the United Kingdom.

8. Subsection (9B) of section 10A secures that subsection (2) of section 10A does not have effect to postpone a charge to capital gains tax in respect of any chargeable gains which arise to an individual by virtue of any of sections 13, 86, 87 and 89(2) TCGA in a tax year which becomes an intervening year solely on account

of the changes made by this clause to the residence requirements. Section 13 has effect to attribute chargeable gains arising to offshore companies to its UK-based participators in certain cases. Sections 86, 87 and 89(2) have effect to attribute gains arising to the trustees of offshore settlements to UK-based settlors or beneficiaries in certain circumstances.

9. Subsection (5) of the clause inserts a new subsection, subsection (9C), after subsection (9B) of section 10A. The effect of subsection (9C) is to secure that nothing in the terms of any DTA which the United Kingdom has with any other territory can prevent the taxpayer from being chargeable to tax, as described in paragraph 14 below, in respect of the whole or part of any chargeable gain as is mentioned there.

10. Subsection (6) provides for subsection (10) of section 10A to be omitted. That subsection states that section 10A is without prejudice to any right to claim relief in accordance with any double taxation relief arrangements. The reason it is being removed is that it is considered to be unnecessary: its continuing presence in section 10A might cause doubt to be cast on the effects of other tax provisions which do not contain a corresponding statement. The application of section 10A in relation to an individual does not prevent the individual obtaining relief for foreign tax paid in respect of chargeable gains which are treated as arising to him or her in the year of return (see paragraph 12 below).

11. Subsections (7) to (9) determine the commencement provisions for the amendments made by subsections (2) to (6).

BACKGROUND NOTES

The current rules in section 10A TCGA

12. Section 10A applies in certain circumstances where individuals realise chargeable gains or losses during a period of temporary absence from the United Kingdom. A period of absence is regarded as being temporary for this purpose if there are fewer than five complete tax years between the tax year of departure and the tax year of return. The individual must satisfy certain "residence requirements" (see paragraph 13 below) for the year of departure, the year of return, and at least four of the seven tax years immediately preceding the year of departure. Those requirements must not be met by the individual for any of the tax

years falling between the year of departure and the year of return. Section 10A refers to such tax years as "intervening years".

13. The residence requirements for a tax year are satisfied by an individual if he or she is resident in the United Kingdom during any part of the year or ordinarily resident in the United Kingdom during the year.

14. The effect of section 10A, in any case where it applies in the case of an individual (referred to, for convenience, in the legislation and this note as the "taxpayer"), is, broadly, that the individual is chargeable to capital gains tax as if any chargeable gains or losses which arose to him or her in any intervening year had instead arisen in the year of return.

15. An exclusion is made for gains or losses arising on the disposal of any asset (other than an interest created by or arising under a settlement) which the taxpayer acquired at a time in the year of departure, or any intervening year, when he or she was neither resident nor ordinarily resident in the United Kingdom. This exclusion is, however, subject to certain conditions.

16. One of those conditions is that the asset was not acquired by the taxpayer on a "relevant disposal" (see paragraph 18 below) which is treated for capital gains tax purposes as having been a disposal on which neither a gain nor a loss arose. (An example of such a disposal is the transfer of an asset from a man to his wife, or vice versa, in a tax year at some time in which they are living together as husband and wife.) The purpose of this condition is to prevent the exclusion from applying in relation, for example, to assets which were acquired by a man when he was resident or ordinarily resident in the United Kingdom, and then transferred to his wife (at a time when she was temporarily absent from the United Kingdom) for onward sale to a third party.

17. Another of the relevant conditions is that the amount or value of the consideration which the taxpayer gave (or is treated for TCGA purposes as having given) for his or her acquisition of the asset is not treated as reduced in accordance with any one of certain TCGA provisions that allow a gain resulting from an earlier relevant disposal to be "rolled over" against the acquisition cost of another asset and, thereby, become, in effect, chargeable to tax when there is a disposal of that other asset. The purpose of this condition is to prevent the rolled-over gain benefiting from the provision in subsection (3).

18. A disposal of an asset is a "relevant disposal" for the purposes of section 10A if the person who makes the disposal acquired the asset in question while resident or ordinarily resident in the United Kingdom.

Tax avoidance schemes addressed by this clause

19. Section 10A was introduced in the Finance Act 1998 to counter widespread use of tax avoidance schemes which relied for their success on the fact that the rules for capital gains tax do not impose a charge in respect of capital gains which are realised by an individual in a tax year during no part of which he or she is resident or ordinarily resident in the United Kingdom, except in circumstances where he or she is carrying on a trade in the United Kingdom through a branch or agency and the gains are referable to the trade.

20. The purpose of the measure is to ensure that a charge to capital gains tax is imposed in circumstances where the individual's absence from the United Kingdom is of a temporary nature and the gains in question were realised on assets acquired before the departure.

21. The amendments to section 10A which are made by this clause are designed to prevent UK-based individuals exploiting the terms of certain DTAs to avoid any liability to capital gains tax on chargeable gains which are realised while they are:

- temporarily neither resident nor ordinarily resident in the United Kingdom, or
- resident or ordinarily resident in the United Kingdom but temporarily Treaty non-resident.

22. The effect of section 10A, in any case where it applies, is to secure that an appropriate amount of UK tax is charged in respect of such gains. In any case where foreign tax has been paid, double taxation relief will be available in accordance with the normal rules, either in the UK or in the state of temporary residence.

EXPLANATORY NOTE

CLAUSE 33: TRUSTEES BOTH RESIDENT AND NON-RESIDENT IN A YEAR OF ASSESSMENT

SUMMARY

1. Clause 33 amends the rules which determine the circumstances in which trustees of settlements may be chargeable to capital gains tax on chargeable gains which arise to them when they dispose of assets comprising settled property. The purpose of the measure is to prevent trustees or settlors of settlements avoiding a charge to United Kingdom tax by means of changing the UK-residence status of the trustees for the purposes of the Taxation of Chargeable Gains Act 1992 (TCGA) during the tax year in which the disposal is made. The measure takes effect in relation to disposals made on or after 16 March 2005.

DETAILS OF THE CLAUSE

2. Subsection (1) inserts a new section, section 83A (Trustees both resident and non-resident in a year of assessment), into the TCGA, and subsection (2) provides for the amendment made by the clause to have effect in relation to disposals made on or after 16 March 2005.

3. Subsection (1) of section 83A provides for section 83A to apply in certain circumstances where a chargeable gain arises to the trustees of a settlement on the disposal of an asset. The circumstances are where the disposal is made by the trustees in a tax year in which they are "within the charge to capital gains tax" but are "non-UK resident" at the time of the disposal. The meanings of these expressions are explained in paragraphs 7 and 8 below.

4. Subsection (2) of section 83A has effect to provide that where section 83A applies, nothing in the terms of any Double Taxation Agreement (DTA) can be read as preventing the trustees being chargeable to capital gains tax, or of preventing a charge to tax arising (whether on the trustees or another person), by virtue of the accrual of the gain.

5. The reason for the reference to “another person” in paragraph 4 above is that, in certain circumstances where the trustees of a settlement are within the charge to capital gains tax in a tax year, the rules in section 77 TCGA provide that the trustees do not actually suffer a tax charge in respect of chargeable gains which arise to them on the disposal of settled property which originates from a UK resident or ordinarily resident settlor who has an interest in the settlement at any time in the year. Chargeable gains are instead treated as arising to the settlor, who is then chargeable to tax in respect of them.

6. The amount of the chargeable gains which are attributed to a settlor in this way is calculated by reference to the chargeable gains which actually arose to the trustees during the tax year. Such an attribution is made only if, disregarding the annual exempt amount, the trustees would (were it not for section 77) have been chargeable to capital gains tax for the tax year on an amount in respect of the chargeable gains which arose to them. It follows that the provision in subsection (2) of section 83A will secure that settlors are not able to escape a tax charge under section 77 in circumstances where the effect of a DTA would otherwise have been to prevent the trustees being so chargeable to capital gains tax.

7. Subsection (3) of section 83A explains what it means, for the purposes of section 83A, for the trustees of a settlement to be “within the charge to capital gains tax” in a tax year. This happens if the tax year is one in which either of two conditions is met by the trustees. The first of those conditions is that there is a part of the year during which the trustees are resident in the United Kingdom and not “Treaty non-resident” (see paragraph 9 below). The alternative condition is that, during the year, the trustees are ordinarily resident in the United Kingdom and not Treaty non-resident.

8. Subsection (4) of section 83A explains what it means, for the purposes of section 83A, for the trustees of a settlement to be non-UK resident at a particular time. This happens when they are neither resident nor ordinarily resident in the United Kingdom. It also happens when they are resident or ordinarily resident in the United Kingdom but are Treaty non-resident.

9. Subsection (5) of section 83A provides that, for the purposes of section 83A, the trustees of a settlement are Treaty non-resident at

any time at which there exist any "double taxation relief arrangements" (as defined in section 288(1) TCGA) for the purposes of which the trustees fall to be regarded as resident in a territory outside the United Kingdom.

BACKGROUND NOTES

10. The purpose of the measure introduced by this clause is to counter certain tax avoidance schemes commonly known as "sunset schemes". These schemes take various forms, but a feature common to many of them is that they exploit the terms of DTAs to secure that no UK tax liability is incurred in respect of chargeable gains arising on the disposal of assets held by the trustees of a settlement in which a UK-resident or ordinarily resident settlor has an interest. Sunset schemes can also be used to prevent a UK tax liability being incurred by the trustees of settlements in which no settlor has an interest.

11. The schemes all entail the disposal of the assets concerned being made at a time when the trustees are non-UK resident (within the meaning given in paragraph 8 above). The territory in which the trustees are resident for tax purposes when the disposal is made is selected so that little or no foreign tax is payable in respect of the gains concerned.

12. The effect of the new TCGA provision will be to secure that an appropriate amount of UK tax is charged on the settlor or, as the case may be, the trustees in circumstances where it applies. Relief will be given in the usual way for any foreign tax paid in respect of the gains in question.

EXPLANATORY NOTE

CLAUSE 34 AND SCHEDULE 4: LOCATION OF ASSETS ETC

SUMMARY

1. Clause 34 and Schedule 4 amend provisions in the Taxation of Chargeable Gains Act 1992 (TCGA) which determine, for the purposes of that Act, where assets are located or whether they are located in the United Kingdom. The location of assets is, in certain circumstances, of relevance in determining whether a UK tax charge arises in respect of capital gains realised on their disposal. In addition, the clause and Schedule provide for statutory cross-references to be updated in some provisions in the TCGA which apply in certain circumstances where a non-resident company is carrying on a trade in the UK through a permanent establishment. The amendments will have effect from 16 March 2005.

DETAILS OF THE CLAUSE

2. The Clause gives effect to the Schedule.

DETAILS OF THE SCHEDULE

3. Part 1 of the Schedule makes provision in relation to the location of assets. Part 2 makes minor amendments in relation to non-resident companies carrying on a trade in the United Kingdom through a permanent establishment there. Part 3 contains the commencement provisions for the amendments to the TCGA which are made by Parts 1 and 2. Any reference in this note to a numbered section or Schedule is to that section of, or Schedule to, the TCGA.

Part 1

4. Paragraphs 1 and 2 make some minor amendments to the provisions in sections 715 and 723 of the Income and Corporation Taxes Act 1988 (ICTA) which specify that the location of securities for the purposes of those sections is to be determined in accordance with section 275 TCGA, which contains the main rules

relating to the situation of assets for TCGA purposes. Sections 715 and 723 ICTA form part of the rules for the Accrued Income Scheme, and the amendments made here are consequential on changes made to section 275 by paragraph 4 of this Schedule.

5. Paragraph 3 amends section 265, which provides for securities issued by certain international organisations to be situated outside the United Kingdom for capital gains tax purposes. The effect of the amendment is to secure that such securities are so situated for all purposes of the TCGA.

6. Paragraph 4 makes provision as described in paragraphs 7 to 13 below.

7. Sub-paragraph (1) of paragraph 4 provides for section 275 to be amended as set out in sub-paragraphs (2) to (8).

8. Sub-paragraph (2) of paragraph 4 provides for the existing section to become subsection (1) of the revised section.

9. Sub-paragraph (3) of paragraph 4 amends paragraph (d) of what will become subsection (1) of section 275. Paragraph (d) provides for shares or securities issued by municipal or governmental authorities, or bodies created by such authorities, to be situated, for TCGA purposes, in the country of the authority concerned, and the effect of the amendment is to replace the reference to "securities" with a reference to "debentures" (but see paragraph 13 below).

10. Sub-paragraph (4) of paragraph 4 inserts a new paragraph, paragraph (da), into that subsection – this provides for shares in, and debentures of, UK-incorporated companies to be treated as situated in the United Kingdom for the purposes of the TCGA. This is subject to the rule in paragraph (d) of subsection (1) described in paragraph 9 above.

11. Sub-paragraph (5) of paragraph 4 makes two amendments to paragraph (e) of that subsection – paragraph (e) determines the location for TCGA purposes of registered shares and securities. The effect of the first amendment is to make the rule in paragraph (e) subject to those in paragraphs (d) and (da) of subsection (1) (see paragraphs 9 and 10 above). The second amendment replaces the reference to "securities" with a reference to "debentures" (but see paragraph 13 below).

12. Sub-paragraphs (6) and (7) of paragraph 4 replace the existing paragraphs (h) and (j) of that subsection – these paragraphs make provision in relation to the location for TCGA purposes of certain types of intellectual property - with revised paragraphs (h) and (j). The main difference between the new paragraphs and those they replace is the inclusion in the new paragraphs of references to "corresponding rights" (see paragraph 13 below).

13. Sub-paragraph (8) of paragraph 4 inserts three new subsections, subsections (2), (3) and (4), into section 275. Subsection (2)(a) provides, in the case of a company without share capital, for the references in paragraphs (d), (da) and (e) of subsection (1) (see paragraphs 9 to 11 above) to "shares or debentures" to include any interests in the company which are possessed by its members. Subsection (2)(b) provides, in the case of a person other than a company, for the references in paragraphs (d) and (e) of subsection (1) to "debentures" to include "securities". Subsection (3) provides interpretation for the references to "corresponding rights" in the new paragraphs (h) and (j) of subsection (1), and subsection (4) provides for the provisions in subsection (1) to be subject to sections 265(3), 266 and 275C. Sections 265(3) and 266 make special provision in relation to securities issued by certain international organisations or the Inter-American Development Bank. An account of section 275C is provided in paragraphs 37 to 39 below.

14. Paragraph 5 inserts two new sections, sections 275A and 275B, immediately after section 275. Section 275A determines the question as to whether certain intangible assets are located in the United Kingdom, and section 275B supplements section 275A.

Section 275A TCGA Location of futures and options

15. Subsection (1) provides that section 275A applies for the purpose of determining whether certain "intangible assets" are situated in the United Kingdom if their situation "is not otherwise determined" (see paragraph 30 below). The meaning of "intangible asset" which applies for the purposes of section 275A is described in paragraph 16 below.

16. Subsection (2) provides the meaning of "intangible asset". This means any intangible or incorporeal property, and includes a thing in action, such as an option or a right to sue. It also means anything which under the law of a country or territory outside the

United Kingdom corresponds to, or is similar to, intangible or incorporeal property or a thing in action.

17. Subsection (3) provides that any intangible asset which is subject to UK law (see paragraph 31 below) at the time it is created is taken for TCGA purposes to be situated in the United Kingdom at all times.

18. Subsection (4) provides for subsections (5) to (9) to have effect in the case of any intangible asset which is a "future" or "option" ("contract X") which is not subject to UK law at the time it is created. The meanings of "future" and "option" which apply for the purposes of section 275A are described in paragraph 32 below.

19. Subsections (5) and (6) have the effects described in paragraphs 20 to 23 below.

20. If the "underlying subject matter" (see paragraph 33 below) of contract X is a future or option ("contract Y") then, if a certain condition is satisfied, subsection (6) provides that contract X is treated for the purposes of subsections (5) and (6) as being subject to UK law at the time it is created. Subsection (5) then provides that contract X is taken for TCGA purposes to be situated in the United Kingdom at all times.

21. The condition mentioned in paragraph 20 above is satisfied if two requirements are met in relation to contract Y. The first requirement is that contract Y is subject to UK law at the time it is created. The second requirement is that, on the assumption that there were no rights in or over contract Y, its situation would not otherwise be determined.

22. That condition is also satisfied if, as a result of the application of the rules described in paragraphs 20 and 21 above to contract Y and its underlying subject matter, the contract is treated by subsection (6) as being subject to UK law at the time of its creation for the purposes of subsections (5) and (6).

23. These rules apply recursively. In any case where there is a "nested sequence" of futures or options in which the underlying subject matter of each contract in the sequence consists of or includes the next contract in the sequence, subsection (5) has effect to provide that the first contract is taken for TCGA purposes to be situated in the United Kingdom at all times if the requirements described in

paragraph 21 above are met in relation to any of the contracts in the sequence.

24. Subsections (7) and (8) have effect in any case where contract X (see paragraph 18 above) is not taken to be situated in the United Kingdom for TCGA purposes by virtue of subsection (5). Subsections (7) and (8) have the effects described in paragraphs 25 to 28 below.

25. If the underlying subject matter of contract X consists of, or includes, an asset ("asset Z") in relation to which a certain condition is at some time satisfied, subsection (8) provides that contract X is treated for the purposes of subsections (7) and (8) as being situated in the United Kingdom at any time when the condition is satisfied. Subsection (7) then provides that contract X is taken for TCGA purposes to be situated in the United Kingdom at all such times.

26. The condition mentioned in paragraph 25 above is satisfied at any time when asset Z is situated in the United Kingdom for the purposes of subsection (8) by virtue either of subsection (9) (see paragraph 29 below) or of any provision of the TCGA apart from section 275A.

27. That condition is also satisfied at any time when, as a result of the application of the rules described in paragraphs 25 and 26 above in relation to asset Z in the case where it is itself a future or option, asset Z is treated by subsection (8) as being situated in the United Kingdom for the purposes of subsections (7) and (8).

28. The provisions in subsections (7) and (8) apply recursively. Suppose there is a "nested sequence" of futures or options contracts in which the underlying subject matter of each contract in the sequence consists of or includes the next contract in the sequence. Suppose further that the last contract in the sequence consists of or includes an asset which is at some time situated in the United Kingdom for the purposes of subsection (8) by virtue either of subsection (9) or of any provision of the TCGA apart from section 275A. The effect of the rules that the first contract in the sequence is taken for TCGA purposes to be situated in the United Kingdom at that time.

29. Subsection (9) applies where the underlying subject matter of a future or option consists of or includes shares or debentures issued by a company incorporated in any part of the United Kingdom, but

the shares or debentures have not been issued at the time the future or option was created. The effect of the subsection is that the underlying subject matter, or the relevant part of it, is taken, for the purposes of subsection (8), to consist of an asset which is situated in the United Kingdom at all times.

Section 275B TCGA Section 275A: supplementary provisions

30. Subsection (1) provides the meaning of references in section 275A to the situation of an asset not being otherwise determined. This is so if there is no provision of the TCGA outside section 275A which determines the question as to whether the asset is situated in the United Kingdom or the question as to where it is situated.

31. Subsection (2) provides that, for the purposes of section 275A, an intangible asset is subject to UK law at any time when any right or interest which comprises, or forms part of, it is governed by, or otherwise subject to, or enforceable under, the law of any part of the United Kingdom.

32. Subsection (3) provides the meanings of the expressions “future” and “option” which apply for the purposes of section 275A. These exclude futures and options, such as financial futures over the FTSE 100 index, which can be settled only in cash, rather than by delivery of any underlying subject matter.

33. Subsection (4) provides the meaning of the expression “underlying subject matter”, in relation to a future or option, which applies for the purposes of section 275A.

34. Subsection (5) provides that section 275A is subject to section 275C (see paragraphs 37 to 39 below).

35. Subsection (6) provides for section 275B to be construed as one with section 275A. This secures that expressions used in section 275B have the same meanings as they have for the purposes of section 275A.

36. Paragraph 6 of the Schedule inserts a new section, section 275C, into the TCGA immediately after section 275B.

Section 275C TCGA Location of assets: interests of co-owners

37. Subsection (1) provides that the section applies for determining, for TCGA purposes, the situation of any “interest” in an asset (see

paragraph 39 below), or whether the interest is situated in the United Kingdom.

38. Subsections (2) and (3) together provide that the situation of an interest in an asset is the same as the situation of the asset, determined on the assumption that the asset is owned wholly by the person who holds the interest.

39. Subsection (4) provides interpretation for references in section 275C to “interest”, in relation to an asset. The interests in question are the interests held by co-owners of assets. It is immaterial whether the asset is owned jointly or in common, and whether the interests of co-owners are equal.

Part 2

40. Paragraph 7 of the Schedule amends subsection (3) of section 16, which provides that capital losses arising in a tax year to a person who is neither resident nor ordinarily resident in the United Kingdom at any time in the year are not allowable losses except in certain circumstances where the person is carrying on a trade in the United Kingdom through a branch or agency and the losses are realised on disposals of assets situated in the United Kingdom which are referable to the trade. The significance of a loss being an allowable loss is that it can be set off against chargeable gains to reduce, or eliminate, the charge to tax on capital gains. The effect of the amendment is to secure that the exception applies in like circumstances in relation to losses arising to a company which, throughout the accounting period in question, is not resident in the United Kingdom but is carrying on a trade in the United Kingdom through a permanent establishment there.

41. Paragraphs 8 and 9 make minor amendments to section 179A(12) and paragraph 3(2)(c)(ii) of Schedule 7AC. They replace the references in those provisions to section 10(3) with references to section 10B. Section 10B superseded section 10(3) when provisions relating to non-resident companies carrying on trades in the United Kingdom through permanent establishments there were introduced by the Finance Act 2003. Section 179A makes provision in relation to groups of companies, and Schedule 7AC contains the rules providing exemption from corporation tax in respect of disposals by companies of substantial shareholdings.

Part 3

42. Paragraph 10 determines the commencement provisions for the amendments made by paragraphs 1 to 9 of the Schedule.

43. Sub-paragraph (1) of paragraph 10 provides that the amendments made by Part 1 of the Schedule have effect to determine, at any time on or after 16th March 2005, the question as to where, for the purposes of the TCGA, an asset is situated, or whether it is situated in the United Kingdom. This applies irrespective of when the asset was acquired by the person who holds it.

44. Sub-paragraph (2) of paragraph 10 provides that the amendment described in paragraph 40 above has effect in relation to losses accruing to companies in accounting periods ending on or after 16th March 2005.

45. Sub-paragraphs (3) and (4) of paragraph 10 determine the commencement provisions for the amendments described in paragraph 41 above.

BACKGROUND NOTES

46. In most circumstances, a person resident or ordinarily resident in the United Kingdom who realises a chargeable gain on disposing of an asset is liable to UK tax on the gain regardless of where the asset is situated. Special rules apply, however, in the circumstances described in paragraphs 47 and 48 below.

47. Where an individual is resident or ordinarily resident, but not domiciled, in the United Kingdom he or she does not incur any liability to UK tax in relation to chargeable gains arising on disposals of assets situated outside the United Kingdom unless amounts in respect of such gains are received in the United Kingdom.

48. Where a person is neither resident nor ordinarily resident in the United Kingdom, but carries on a trade, profession or vocation in the United Kingdom through a branch or agency or permanent establishment. A UK tax liability arises on, for example, any chargeable gains the person realises on disposals of assets situated in the United Kingdom which were used for the purposes of the trade before the time the gain arose.

49. Section 275 of the TCGA provides rules which determine the location of certain assets for the purposes of that Act. These determine, for example, that registered shares and securities are generally situated where the register is situated (or where the principal register is situated, if there is more than one). This is subject to the proviso that shares or securities issued by a municipal or governmental authority, or by a body created by any such authority, are situated in the country of the authority in question. But the rules in section 275 do not provide a comprehensive code for determining the location of all types of asset for TCGA purposes. Where section 275 has no effect, the location is determined by common law (except in the special cases addressed by sections 265(3) and 266 – see paragraph 13 above).

50. In some circumstances, advantage has been taken of the absence of a specific rule in order to secure that the asset disposed of is not treated as being situated in the United Kingdom for TCGA purposes, even where the asset is related to the United Kingdom. For example, it may be possible for a UK-resident but non-UK domiciled individual to arrange for a disposal of bearer shares in a UK-incorporated company to take place outside the United Kingdom. Under common law the shares disposed of will be situated where the bearer instrument is present at the time of the disposal.

51. The amendments made by Part 1 of the Schedule are designed to counter tax avoidance schemes which aim to secure that persons who are within the charge to United Kingdom tax are able to avoid tax on capital gains arising on the disposal of assets which are related to the United Kingdom.

52. The amendments made by Part 2 of the Schedule update statutory cross-references in consequence of changes introduced by the Finance Act 2003.

EXPLANATORY NOTE

CLAUSE 35 AND SCHEDULE 5: EXERCISE OF OPTIONS ETC

SUMMARY

1. Clause 35 and Schedule 5 amend provisions in the Taxation of Chargeable Gains Act 1992 (TCGA) which relate to the computation of gains and losses in certain circumstances where assets are acquired or disposed of on the exercise of options. The main changes correct a defect in the current rules whose exploitation could enable people to avoid tax on chargeable gains, or to realise capital losses in circumstances where no commercial loss (or a commercial loss of a lesser amount) has been incurred. The Schedule also makes a number of minor amendments to the tax regime for options to rectify omissions or provide clarification. Most of the new provisions will apply in relation to options exercised on or after 2 December 2004.

DETAILS OF THE CLAUSE

2. The clause gives effect to the Schedule.

DETAILS OF THE SCHEDULE

3. Any reference in these notes to a numbered section is to that section of the TCGA. References to "ITEPA" are to the Income Tax (Earnings and Pensions) Act 2003.

Part 1

4. Paragraph (1) amends section 144ZA, with effect for options exercised on or after 2 December 2004, as follows;
   - sub-paragraph (2) amends subsection (1) to provide for the application of section 144ZA to be subject to section 144ZB (see paragraphs 6 to 12 below);
   - sub-paragraph (3) replaces an outdated cross-reference in subsection (4);

- sub-paragraph (4) introduces a new subsection, subsection (4A), which provides interpretation for the reference to "exercise price" in the amended subsection (4); and
- sub-paragraph (5) provides for the existing subsection (5) to be replaced: the new subsection provides interpretation for references to "option" in each of sections 144ZA to 144ZD, but, apart from that, the change in wording is made for clarificatory purposes.

5. Paragraph (2) inserts three new sections, sections 144ZB, 144ZC and 144ZD into the TCGA: they have effect in relation to options exercised on or after 2nd December 2004.

Section 144ZB *Exception to rule in section 144ZA*

6. Subsection (1) sets out the conditions for section 144ZB to apply. These are that, subject to subsection (2) preventing section 144ZB applying:
   - section 144ZA would apply in relation to an option if it were not displaced by section 144ZB, and
   - the exercise of the option in question is "non-commercial" (see paragraphs 13 to 18 below).

7. Subsection (2) provides that section 144ZB does not apply where:
   - the option is a securities option within the meaning of certain ITEPA provisions, or
   - section 144ZD applies (see paragraphs 19 to 22 below).

8. Subsection (3) provides that in any case where section 144ZB applies in relation to an option, the rules in subsection (4) or, as the case may be, subsection (5) apply in place of those in section 144ZA and paragraphs (a) and (b) of subsection (2) or, respectively, subsection (3) of section 144.

9. Subsection (4) applies in relation to options which bind the grantor of the option to purchase (these are known as "put options"). It provides that, for the purposes of tax in respect of chargeable gains:
   - the acquisition cost of what the grantor buys as a result of the option being exercised is the market value, at the time the option is exercised, of what is bought; and
   - the amount or value of the consideration for the disposal of what is bought by the grantor is the market value, at the time the option is exercised, of what is bought.

10. Subsection (5) applies in relation to options which bind the grantor of the option to sell (these are known as "call options"). It provides that, for the purposes of tax in respect of chargeable gains:
    - the amount or value of the consideration for the disposal of what is sold by the grantor as a result of the option being exercised is the market value, at the time the option is exercised, of what is sold; and
    - the cost to the person exercising the option of acquiring what is sold is the market value, at the time the option is exercised, of what is sold.

11. Subsection (6) adds a rider to the provisions in subsections (4) and (5). Its effect is that where the whole, or any part of, the underlying subject matter ("USM") of the option is subject to any right or restriction which can be enforced by the person selling it, or by a person "connected" with him (within the meaning in section 286), the existence of the right or restriction is disregarded in establishing the market value.

12. Subsection (7) provides that the expression "underlying subject matter" means, for the purposes of section 144ZB, what falls to be sold on the exercise of a call option, and what falls to be bought on the exercise of a put option.

Section 144ZC *Section 144ZB: non-commercial exercise of option*

13. This section determines whether the exercise of an option is "non-commercial" for the purposes of section 144ZB (see paragraph 6 above).

14. Subsection (1) provides that the exercise of a put option is non-commercial if the exercise price is less than the open market price of the USM.

15. Subsection (2) provides that the exercise of a call option is non-commercial if the exercise price exceeds the open market price of the USM.

16. Subsection (3) defines "exercise price", in relation to an option, for the purposes of section 144ZC.

17. Subsection (4) provides that, for such purposes, the "open market price" of the USM of an option is the price which it might reasonably be expected to fetch if it were to be sold in the open

market at the time the option is exercised. Further interpretation is given by:

- subsection (5), which provides for any right or restriction which can be enforced by the seller, or by any person connected with him, to be disregarded in establishing the open market price; and
- subsections (6) and (7), which provide for sections 272(2) and 273(3), which apply in certain circumstances in relation to the determination of the market values of assets for TCGA purposes, to be applied in like fashion in relation to establishing the open market price:
  - in the case of section 272(2) or 273(3), of the USM of an option, or
  - in the case of section 273(3), of assets forming part of the USM of an option.

18. Subsection (8) provides for section 144ZC to be construed as one with section 144ZB: this has the effect that expressions used in both sections have the same meaning.

Section 144ZD *Section 144ZB: alteration of value to obtain tax advantage*

19. This section determines the circumstances in which section 144ZB does not prevent section 144ZA applying in cases where:
    - the exercise of the option is non-commercial, and
    - the option is not a securities option within the meaning of certain ITEPA provisions.

20. Subsection (1) provides that five conditions must be satisfied in relation to the option if section 144ZB is not to apply in such a case. The conditions, which are provided by subsections (2) to (4), (6) and (7), are that:
    - section 144ZB would apply in relation to the option if it were not prevented from doing so by virtue of subsection (2)(b) of that section;
    - the open market price of the USM of the option at the time it is exercised differs from its open market price at the time it was granted;
    - some or all of that change in price results to any extent, directly or indirectly, from arrangements to which a relevant person (see paragraph 21 below) is, or has been, a party, or which include a transaction to which such a person is, or has

been, a party (these arrangements are referred to as "the relevant arrangements" in what follows);

- the exercise of the option would not be "non-commercial", as determined by section 144ZC, if such of the change in open market price which results directly or indirectly to any extent from the relevant arrangements were to be disregarded; and
- if section 144ZD were not to apply, then, as a result directly or indirectly of the relevant arrangements, an advantage (see paragraph 21 below) in relation to capital gains tax, or corporation tax in respect of chargeable gains, resulting directly or indirectly from the exercise of the option would be, or might be expected to be, obtained by the person who granted the option or the person who exercised it.

21. The meanings of the references to "advantage", in relation to capital gains tax or corporation tax in respect of chargeable gains, "arrangements" and "relevant person" are provided by subsections (5), (8) and (9).

22. Subsection (10) provides for section 144ZD to construed as one with sections 144ZB and 144ZC.

Part 2

23. Paragraph (3) amends section 105A, which forms part of the rules for identifying which shares are disposed of on the part-disposal of a holding. The effect of the amendment is that references to certain income tax provisions are updated so as to take account of their migration to ITEPA. The change has effect for options exercised on or after 2 December 2004.

24. Paragraph (4) amends section 149A, which, in the cases where it applies, has effect to determine what is treated for TCGA purposes as the amount of consideration given when an employee or director of a company is granted an option to acquire shares. The amendment extends the scope of section 149A by replacing the existing reference to a right obtained by reason of an individual's office or employment with a reference to the relevant ITEPA provisions which relate to rights to acquire securities in certain circumstances. The changes have effect in relation to options granted on or after 2 December 2004.

25. Paragraph (5) replaces some words in section 288 (which provides general interpretation for the purposes of the TCGA). The new words, which have effect in relation to options granted on or after

2 December 2004, amend the meaning of the expression "employment-related securities option" which applies for the purposes of subsection (1A).

Part 3

26. Paragraph (6) contains the various commencement provisions.

BACKGROUND NOTES

27. In what follows, reference is made to put options and call options. These expressions are defined in paragraphs 9 and 10 above. "USM" means "underlying subject matter" (see paragraph 12 above).

The current treatment of options for the purposes of tax on chargeable gains

28. Where an asset is acquired or disposed of as a result of an option being exercised, the tax rules for chargeable gains and losses provide that the grant or acquisition of the option and the disposal or acquisition of the asset on the exercise of the option are treated as being parts of a single transaction.

Cases where the relevant transactions are at arm's length

29. Where the transactions to which the grantor is a party (that is, the grant of the option and its exercise) are at arm's length, any gain or loss arising to him on the disposal of the USM of a call option as a result of the option being exercised is calculated on the basis that the disposal proceeds are the sum of the amount received for the grant of the option and the amount received when the option was exercised (the "exercise price"). Similarly, where the transactions to which the person who exercises the option is a party (that is, his acquisition of the option and its exercise) are at arm's length, the cost of acquiring the USM on the exercise of the option is treated as being the sum of the exercise price and the amount given to acquire the option.

30. For example, if a person received £100 for granting an option entitling its holder to purchase an asset from the grantor for £500, the disposal proceeds of the asset are £600 – that is, the sum of £100 received for the grant of the option and the £500 exercise price. If the person exercising the option is the person to whom it

was granted, the cost to that person of acquiring the asset is also treated as being £600. If the person exercising the option did not acquire it directly from the grantor, the acquisition cost of the asset, for such purposes, is treated as being the sum of the amount that person paid to acquire the option from the previous holder and the £500 exercise price. (All transactions mentioned in this paragraph are assumed to be at arm's length.)

31. Corresponding rules apply in relation to put options in such cases.

Other cases

32. It is possible for an option to be granted (or otherwise acquired) by way of an arm's length transaction, but exercised otherwise than at arm's length, or vice versa. This can occur because the option has changed hands in the interim, or because the relationship between the grantor and the person exercising the option has changed between grant and exercise of the option. In all these cases, section 144ZA applies to give a treatment which corresponds broadly to that described in paragraphs 28 to 31 above. Paragraphs 33 and 34 below provide further details.

33. For **the grantor of the option**:
    - <u>if the option is granted at arm's length</u>, the following outcomes apply if it is not exercised at arm's length:
        - if it is a **call option**, the amount of the proceeds of the disposal of the USM on exercise is treated as the sum of the exercise price and the amount received for the grant;
        - if it is a **put option**, the cost to the grantor of acquiring the USM on exercise is treated as the amount of the exercise price less the amount received for the grant.
    - <u>if the option is not granted at arm's length</u>, the outcomes are:
        - if it is a **call option**, the amount of the proceeds of the disposal of the USM on exercise is treated as the sum of the exercise price and the market value of the option at the time it was granted;
        - if it is a **put option**, the cost to the grantor of acquiring the USM on exercise is treated as the amount of the exercise price less the market value of the option at the time it was granted.

34. For **the person who exercises the option**,
    - <u>if the option was acquired at arm's length</u>, the following outcomes apply if the exercise is not at arm's length:

  - if it is a **call option**, the cost to him of acquiring the USM on exercise is treated as the sum of the exercise price and the amount paid to acquire the option;
  - if it is a **put option**, the amount of the proceeds of the disposal of the USM on exercise is treated as the exercise price, and the amount paid to acquire the option is treated as an incidental cost of the disposal of the USM.
- <u>if the option was acquired otherwise than at arm's length</u>, the outcomes are:
  - if it is a **call option**, the cost to him of acquiring the USM on exercise is treated as the sum of the exercise price and the market value of the option at the time he acquired it;
  - if it is a **put option**, the amount of the proceeds of the disposal of the USM on exercise is treated as the exercise price, and the market value of the option at the time he acquired it is treated as an incidental cost of the disposal of the USM.

<u>The defect in the current rules</u>

35. The use of the exercise price in calculating the amount of a gain arising on the disposal of the USM of an option when it is exercised may have inappropriate results where the option would not be exercised at that price in normal commercial circumstances. This can happen where, broadly:
    - in relation to a **call option**, the exercise price exceeds the value of the USM at the time the option is exercised, and
    - in relation to a **put option**, the exercise price is less than the value of the USM at the time the option is exercised.

36. This effect is illustrated in the following example. C and D are connected persons. C grants to D an option that allows D to sell an asset worth £90,000 to C for £30,000 in two months' time. D pays nothing for the option, which, at the time it is granted, has no value. D paid £30,000 for the asset three years ago. D exercises the option and sells the asset to C. The current rules provide that D's disposal proceeds are treated as the price prescribed by the option, £30,000. So D has disposal proceeds of £30,000, from which are deducted his acquisition cost of £30,000. This means that there is no chargeable gain. C's acquisition cost of the asset is treated as the price paid on exercise of the option, £30,000. But D has effectively given away an asset worth £90,000. If he had

simply disposed of it to C without using an option he would have been liable to tax on a gain (ignoring incidental costs of disposal and any reliefs to which he was entitled) of £60,000 (the market value of the asset less his acquisition cost of £30,000).

The effect of the revised rules

37. In the circumstances described in paragraph 35 above, if the option is exercised on or after 2nd December 2004, each party to the transaction will be treated as having disposed of or, as the case may be, acquired the asset at its market value at the time the option is exercised.

38. But the current rules will continue to apply in the case of certain options over shares or securities that are acquired by an individual in connection with his or her employment.

39. And the current rules will continue to apply in the case of other options in circumstances where:
    - the exercise of the option is non-commercial;
    - the value of the USM changes between the grant and exercise;
    - the change results to any extent directly or indirectly from arrangements to which any of the following persons is a party:
        - the grantor of the option
        - any person who has at any time held the option, and
        - any person connected with the grantor or any person who has at any time held the option;
    - the exercise of the option would not be non-commercial if such of the change in value of the USM which results directly or indirectly from such arrangements were to be disregarded; and
    - if the revised tax treatment were to apply, the grantor of the option or the person who exercises it would, or might be expected to, obtain a tax advantage in relation to capital gains tax, or corporation tax in respect of chargeable gains, in consequence (directly or indirectly) of the exercise.

40. The circumstances described above could arise if, for example:
    - a call option is granted on terms favourable to the option-holder (for example, an option to acquire USM worth £1,000 for £100) so that the option has a high market value when it is

granted: a sum equal to the amount of that value is paid to the grantor by grantee, and

- before the option is exercised arrangements are made by the grantor which have the effect of reducing the value of the USM to £50, and the option is exercised non-commercially, so that the effect of the new rules would be to treat the grantor as having disposed of the USM for £50.

41. In such a case, under the current rules, the grantor is potentially liable to tax in respect of chargeable gains on virtually the full value of the asset as it stood before that value was reduced in consequence of the arrangements. (This is because the full value of the option at the date of grant and the exercise price are taken into account in calculating the amount of the chargeable gain arising on the disposal of the USM.) But, if the new rules were to apply as described in paragraph 37 above, the amount of any chargeable gain or loss which arises to him on the disposal of the USM would be computed by reference to the market value of the USM at the time of exercise, an amount (£50) which is much lower than the original value of the asset (£1,000). The arrangements that reduced the original value of the USM could be unwound after the option has been exercised, so that its full value is restored and the person exercising the option gets the full value of the asset. The exception to the new rules described in paragraph 39 above prevents this outcome.

EXPLANATORY NOTE

CLAUSE 36: NOTIONAL TRANSFERS WITHIN A GROUP

SUMMARY

1. Clause 36 enables companies within a group to elect for a disposal of an asset to be treated as if it was made by a non-UK resident group member that is carrying on a trade in the UK through a permanent establishment, rather than by the company that owned the asset. In that case, the asset is treated as being chargeable to tax in the hands of the non-UK resident company. As a result, capital losses of the non-UK resident company can be set against a gain on the disposal of the asset. Alternatively, a loss on the disposal of the asset may be set against a current-period or future capital gain made by the non-UK resident company.

DETAILS OF THE CLAUSE

2. Subsection (1) introduces a new subsection 3ZA to be inserted in section 171A of the Taxation of Chargeable Gains Act 1992 (TCGA).

3. Subsection (2) sets out the new section 171A(3ZA). It provides that where a disposal is deemed to be made by a non-resident group member that is carrying on a trade through a UK permanent establishment, the asset is deemed to have been acquired by that company for use by or for the purposes of the permanent establishment. The deeming will apply for the purposes of section 171A(2)(c) and (3). However, this will not affect any question as to whether or not the asset is situated in the UK at any time.

4. Subsection (3) provides that the amendment made by this clause has effect in relation to disposals made on or after 16 March 2005.

BACKGROUND NOTES

5. There is no provision by which a company can surrender capital losses to be set against the chargeable gains of another group member. However, an equivalent effect can be achieved by using the rules that allow transfers of assets between group members for a deemed consideration that gives rise to no gain and no loss ("tax-neutral transfers"). These rules are contained in Section 171 TCGA.

6. If, for example, company A wishes to dispose of an asset standing at a gain to a non-group company C, and another group company B has capital losses available, A can first make a tax-neutral transfer of the asset to B. B can then make the disposal to C. The gain will accrue to B, which can cover the gain with its losses. (The same transactions can, if the group wishes, be undertaken regardless of whether or not the asset stands at a gain, and regardless of whether or not B has losses.)

7. So long as the transfer from A to B would have been tax-neutral under Section 171, a group can instead use Section 171A TCGA to avoid the need for an actual transfer from A to B. Instead, if A disposes of the asset directly to C, companies A and B can jointly elect that for the purposes of corporation tax on chargeable gains, the asset shall be deemed to have been transferred from A to B and then disposed of by B to C. The election must be made within two years of the end of the accounting period of A in which the disposal to C was made.

8. The election can only be made if section 171 would have applied to an actual transfer from A to B, making such a transfer tax-neutral. One condition for section 171 to apply is that either company B is resident in the UK at the time of the transfer, or the asset is a chargeable asset in relation to B immediately after the transfer.

9. The new subsection 171A(3ZA), inserted by this clause, covers the case where company B is not UK-resident, but carries on a trade in the UK through a permanent establishment. The new subsection treats the asset deemed to have been transferred to B as having been acquired by B for use by or for the purposes of the permanent establishment. Applying this treatment for the purposes of section 171A(3) ensures that the asset would have been a chargeable asset in relation to B if it had actually been transferred to B, so that a section 171A deemed transfer will be possible. Applying the treatment for the purposes of section 171A(2)(c) ensures that the deemed disposal by B will in fact be a deemed disposal of a chargeable asset. This means that a chargeable gain on the asset can arise in B's hands rather than in A's hands, enabling B's losses to be used to cover the gain. (If the asset is being sold at a loss, it will enable a loss on the asset to arise in B's hands, so that the loss can be used to cover a current-period or future capital gain made by B.)