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Clear. Concise. Commercial.

The Milestone Outlook

Welcome to the revised, updated and more user-friendly MTN. It has taken some time to finalise the new format but we think the wait is worthwhile. We've had a couple of extremely hectic months with a marked increase in private equity-backed transactions ranging from difficult take-overs of oil-related assets to significant UK property development deals (see Deal of the Week).

We are also busy preparing to act as an Expert Witness in an Upper Tribunal hearing on a dual-residency matter under the Spain/UK DTA. Residency seems to be on HMRC's hotlist at the moment. The Gaines-Cooper case has finally been decided and we give our view on the judgment below. We are working on another residency case at the moment where our client became non-resident by moving to Switzerland several years ago. HMRC are claiming our client breached the 91-day test and in order to support this claim are denying those days (approximately one month) he spent in the UK due to the terminal illness of his father (who subsequently passed away whilst our client was in the UK). The attitude of HMRC in denying what the average person would clearly regard as "exceptional", i.e. days spent in the UK due to the impending death of a parent, should not surprise anyone. It does, however, beg the question of what HMRC consider "exceptional".

HMRC's aggressive and morally repugnant attitude has, however, been echoed by the courts, most recently in the disturbing First Tier Tribunal case of Mr Nicholas Ogden. We cover the case in the UK section and draw comparisons with Gaines-Cooper and our own client's circumstances. Dare we say it, but leaving the UK has never been harder to achieve – if you are considering becoming non-resident you cannot underestimate:

i) the information gathering powers of HMRC;

ii) the aggressive attitude of HMRC; and

iii) the extent to which HMRC will go to prove you have never actually left.

In addition, we have been busy dealing with a couple of Liechtenstein Disclosure Facility matters and presenting a training course on UK personal anti-avoidance legislation. If you want a copy of the slides please contact **Lynette**. We have also been recovering from our annual sojourn to the West Highlands (the whisky has just about left our systems) and are now readying ourselves for the new ski season. The lack of white, powdery stuff across Europe, is however, cause for great concern. At least the US is good for some things!

Happy reading!

The Milestone Tax Team

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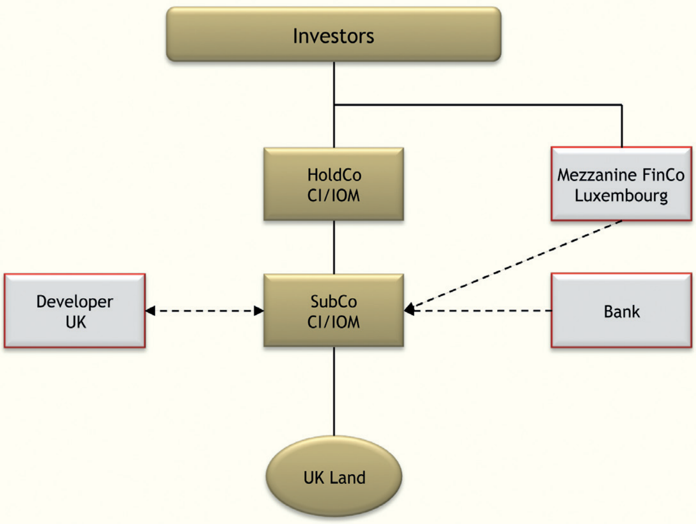
DEAL OF THE WEEK

Advising on property transactions, be they development or investment, were *de rigour* for us before the credit crunch hit home (boom boom!). The lack of credit, coupled with investors wondering when prices will hit rock bottom, has meant our focus has been on matters other than property for nearly three years! So, it has come as a welcome relief and something of a surprise that we have been retained to advise on three UK property transactions in the space of as many weeks. Whether this is just coincidence or investors are finally taking the plunge we don't know, but we are pleased nonetheless.

What sets the UK apart from most other countries is the rule that non-residents are not liable to capital gains tax on the disposal of UK *situs* real estate assets. Couple this with the rule that a non-resident company is not liable to UK corporation tax unless it is trading in the UK through a PE – even if the trade relates to UK land (provided an appropriately worded double tax treaty applies) – and there is potential to structure the transaction so it falls outside the scope of UK taxation. The common structure used for UK property developments undertaken by foreign (i.e. non-UK investors) is as follows:



The investors establish, say, a Channel Islands Holding company (OK, OK, the Isle of Man works too…) with an underlying subsidiary company. SubCo acquires the land and enters into a development contract with an unrelated third party developer. The Jersey/Guernsey (and Isle of Man) treaties with the UK are all silent as regards construction PE which, under the OECD Model Convention, is 12 months. Arguably, therefore, the development could last for several years without becoming a PE. HMRC may well take a different view and their line of argument would be that the construction site is in fact a PE through which the offshore company is trading in the UK.

In computing the profits of the PE one would need to ascertain the assets and liabilities attributable to it. The development finance is clearly a liability and to this end, assuming the development cost is being funded by bank and investor debt (gone are the glory days of Irish banking and 120% LTV debt facilities!), only the investor debt need be structured so as to fall within the UK's transfer pricing rules. Unsecured, subordinated investor debt is essentially mezzanine finance and can have the effect of "mopping up" a large amount of the profit allocable to the PE (you only need to run a tax model to see this in action).

HMRC might then argue that the loan interest is UK source and would no doubt cite the *National Bank of Greece* case. If the loan interest is UK source, UK withholding tax at 21% will be incurred. So, locating the mezzanine finance vehicle in the right jurisdiction is very important. Various treaties with the UK provide for 0% withholding tax on interest, but the entity itself, if relying on a treaty, must be the **beneficial owner** of the income and not merely a conduit, otherwise *Prevost, Indofood* and similar such rulings will bite.
The benefit of avoiding a conduit arrangement is that that the interest will not be liable to UK withholding tax. The flipside is that the income will be liable to tax in the country of receipt. This is where the choice of jurisdiction and entity become critical. Our favoured option, ticking both boxes, is a Luxembourg Securitisation Vehicle.

If you have a real estate case that you would like to discuss with us please feel free to get in touch... no fishing please!

Tax Residence and the Gaines-Cooper Case

After what seems like a lifetime the Supreme Court has finally put Mr Robert Gaines-Cooper to the sword. We have reported on this matter since it first came to our attention in 2006 and are certain that the Court's decision will lead to a raft of enquiries being opened by HMRC (we have in fact witnessed this first hand – see The MO).

The facts are probably well-known to all our readers but it is worth recapping them, albeit briefly, once more:

i) Mr G-C was a British citizen, born and educated in the UK where he lived for a substantial part of his life;

ii) in 1974 Mr G-C began to establish overseas interests on the basis he felt that the UK tax system was not particularly palatable (with a top rate of 98p in the £ he wasn't wrong);

iii) he left the UK for Canada and subsequently moved to the Seychelles in 1976, where he bought a house and obtained a residency permit; and

iv) Mr G-C never stayed more than 91 days in the UK in any given tax year.

Until the most recent decision, the 91 day-rule was widely accepted as being a reliable yardstick of UK residence. The Supreme Court, however, held that notwithstanding the fact that Mr G-C never breached the 91-day rule it was also necessary for him to demonstrate that he had made a "distinct break" from the UK (this being a principle established by leading cases such as Levene v IRC; Lloyd v Sully etc).

In Lord Wilson's view, in order for an individual to relinquish UK residency he must:

i) leave permanently or indefinitely or for full time employment;

ii) give up his usual residence in the UK;

iii) subsequent returns must be no more than "visits"; and

iv) property retained for use by an individual who leaves the UK must be used for the purpose only of visits rather than as a place of residence.

The result: Mr G-C's appeal was dismissed by a 4-1 majority.

What many practitioners (especially those not versed in the dark arts of HMRC bending the rules to their advantage) will find hard to swallow is the fact that the court held that IR20 was guidance only and could not be relied upon by the taxpayer and that critical concepts, such as "distinct break" were not more clearly expressed in HMRC's "guidance".

It seems that the concept of residence is almost becoming blurred or blended with that of domicile. The extent to which an individual must now go to change his residency status is not a million miles away from shedding domicile. If an individual is not present in the UK for more than 91 days on average over a rolling period of more than 30 years, but is still considered tax resident in the UK because he hasn't made a distinct break one wonders to what length Mr G-C would have had to go to become non-resident. The fact is that whilst Mr G-C maintained social and business ties in the UK he also had extensive ties in the Seychelles and spent considerably more time there than he did in the UK. It seems perverse that an individual can spend c.260 days outside the UK every year and still be considered UK resident. In such circumstances can it be said that his habitual abode is in the UK? Surely the opposite must be true? The answer seems to be that you follow the route of Dave Clarke in 1978 and clear off for an entire tax year (or more). Perhaps then you might be able to also argue you are non-domiciled!

Nicholas Ogden

In the second of our residency cases we turn our attention to the case of Mr Nicholas Ogden. This case was reported earlier this year but is included in this edition of the MTN to illustrate how aggressive HMRC and the courts have become on matters of residency and because it mirrors a case we are currently advising on.

Mr Ogden was a resident of Jersey and, in 2002, his son was admitted to a specialist hospital in Cambridge for a heart and lung transplant. In August 2002 Mr Ogden came to the UK to spend time with his son in hospital, taking leave from his business (WorldPay) to do so.

In October 2002 Mr Ogden's son died and when he returned to Jersey he was fired from his job (notably his business had recently been taken over by none other than RBS under the control, at the time, of Fred "the Shred" Goodwin). HMRC, with information supplied by RBS (yes 'tis true), opened an enquiry concluding Mr Ogden was resident and ordinarily resident in the UK in the 2002/3 tax year on the basis that he had spent more than 183 days in the UK.

Mr Ogden argued that exceptional circumstances applied in his case (as if the poor guy needed to spell it out). The only reason he breached the 183 day rule was because of his son's illness. Section s336 ICTA 1988 provides that an individual is resident in the UK in any year of assessment if he spends 183 days or more in the UK. HMRC relied upon this and the fact that HMRC guidance booklet IR20 (which we now know, thanks to the efforts of Mr G-C, isn't really guidance and isn't worth the paper it is written on if you are a taxpayer) stated at para 1.2:

"You will always be resident if you are here for 183 days or more in the tax year. There are no exceptions to this."

Not even a life threatening illness of a child.

Of course exceptional circumstances can be taken into account in respect of the 91 day rule, but not the 183-day rule. Why this is the case isn't clear. What is also unclear is what HMRC and the Courts will consider as "exceptional circumstances". Our client, whose case centres on the 91-day rule, is being told that time spent in the UK because of the impending death of his father is not exceptional. For once we are almost lost for words.

In summary, parallels can be drawn with Gaines-Cooper in that the Court disallowed Mr G-C's appeal on the grounds that IR20 was not binding. In Ogden IR20 was binding – there were no exceptions to the 183-day rule.

Cases such as these demonstrate the real need to create a statutory test for residence and one that is clear, fair and reasonable. Furthermore, if HMRC are going to publish guidance it has to be capable of being relied upon (at least to some meaningful extent) by the taxpayer. Otherwise, like IR20, it simply isn't worth printing.

ANTIPODEAN "PERSONAL SERVICES" CASE LAW

The "Penny and Hooper" Case

Two recent Antipodean cases on the diversion of personal income into business structures provide contrast and context to recent UK developments in the tax avoidance area and, specifically, the UK's newly formulated disguised remuneration rules as well as the UK's current exploration of a general anti-avoidance rule ("GAAR") through a study group led by Graham Aaronson QC (that has presumably reported its findings to HMRC given the deadline of 31 October 2011).

The New Zealand Supreme Court considered the application of New Zealand's GAAR in the *Penny and Hooper case.*

The case was in fact two cases rolled into one because the two taxpayers in question (Mr Penny and Mr Hooper) were both surgeons who had implemented structures by which their professional practices were held by companies which in turn were held by family trusts. Both surgeons were then employed by the relevant companies, but at "artificially low salaries". This allowed a tax saving due to tax rate differentials between employment income derived personally by Mr Penny or Mr Hooper (taxed at 39%) compared to profit distributed to the family trust (taxed at 33%).

Mr Penny arranged for the family trust to lend him back the money (though in practical terms Mr Penny typically wrote out cheques to himself drawn on the company's bank account, and then regularised this at year end by declaring a dividend from the company to the trust and then creating a loan from the trust to Mr Penny). This loan arrangement, were it to occur in the UK, would clearly be caught by the UK's disguised remuneration rules and various other targeted anti-avoidance provisions. By contrast, New Zealand does not have disguised remuneration rules nor would the loan be otherwise taxable under specific anti-avoidance rules.

Mr Hooper utilised the family trust money not by making loans, but rather by making distributions to his daughters and also investing in the family home and a holiday home. Again, if such a strategy were used in the UK, it would be caught by the disguised remuneration rules (and prior to such rules by the benefits code and/or the residual charge at s201 ITEPA).

New Zealand's GAAR is broadly drafted and applies whenever there is a "tax avoidance arrangement" which includes any arrangement that directly or indirectly has tax avoidance as one of its purposes or effects. Although the NZ tax authorities accepted that taxpayers could make a choice as to how to structure their business, they argued that fixing the salaries at “artificially low levels” constituted tax avoidance. The Supreme Court accepted this argument and ruled against the taxpayers.

While many commentators have argued that the case is limited to a ruling on what constitutes a “market salary”, the decision highlights the power of a widely drafted GAAR and provides a degree of ammunition to those who might argue that a GAAR produces too much uncertainty for taxpayers. In response, the NZ tax authority has issued guidance on when diverting personal income to business structures to take advantage of tax rate differentials will constitute tax avoidance. However, this approach of having widely drafted and interpreted primary legislation limited by practical guidance issued by a tax authority is never an entirely satisfactory approach for a taxpayer (and even less so for a tax advisor).

The Russell Case

Russell v Commissioner of Taxation of the Commonwealth of Australia concerned the diversion of personal income to a business within an international context. In particular the court considered whether Australia’s domestic anti-avoidance provisions (and specifically its personal service company (“PSC”) rules) could be blunted by a tax treaty where an Australian resident accountant derived income through a New Zealand resident PSC.

The Australian tax authorities attributed the income directly to Mr Russell under the Australian PSC rules for the purpose of taxing him as an Australian resident. The court considered whether such attribution to Mr Russell was consistent with the business profits article in the Australia/New Zealand tax treaty. The court held that Australian domestic law attribution rules (as contained in the PSC legislation) applied for the purpose of attributing income to Mr Russell and taxing him as an Australian resident. The court also observed that the income attributed to Mr Russell would, under the Australian tax rules, be excluded from the profits of the PSC itself. Therefore it follows, that the taxation of Mr Russell’s PSC income is not taxation of the profits of the PSC and therefore the business profits article in the treaty is not in point.

In this sense the reasoning in *Russell* harks back to the decision of the Court of Appeal in *Bricom* and effectively paves the way for jurisdictions to retain taxing rights in relation to its residents through appropriately drafted attribution rules, whether in relation to PSCs or CFCs.

UK

Legislation on DTA Avoidance

In the summer we wrote about the proposed UK legislation that would seek to address tax avoidance through the use of the UK’s double tax treaties. Government statements during Budget 2011 indicated that the legislation would be designed to “ensure that relief from tax is not given where a claim is made under UK double taxation treaties and where tax avoidance arrangements have been made in relation to the claim”. In plain language, the effect of the proposed legislation would have been to allow UK domestic legislation to take precedence over the UK’s obligations in respect of its double taxation agreements (DTAs). This is the opposite of the normal constitutional position in most countries where international agreements prevail over purely domestic legislation.

However, prior to the scheduled close of the consultation process, the Government pulled the plug. The Treasury said responses received so far had made it clear that the proposed legislation, as drafted, could cause “significant uncertainty for compliant UK businesses and overseas investors about its intended scope and its practical effect” with the result that any proposed legislation will not be included in Finance Bill 2012. While backtracking on this proposal, HMRC has made it clear that specific arrangements that ‘clearly seek to abuse provisions in a DTA will still be challenged. We expect to see similar proposals on this in due course.

THE ECJ

Dutch Exit Tax rules

Advocate General Kokott of the European Court of Justice (ECJ) issued an important (and relatively taxpayer friendly) opinion on 8 September 2011 in the case of *National Grid Indus v. Inspecteur van de Belastingdienst Rijnmond* (C-371/10). The opinion concerned the imposition of Dutch exit taxes where a Dutch incorporated company relocated its place of effective management to the UK. The AG concluded that the imposition of an exit tax is, under certain circumstances, in breach of the freedom of establishment principles.

Facts

i) National Grid Indus (NGI), was incorporated under Dutch law and had its statutory seat in the Netherlands. NGI was incorporated to act as the UK group's finance company.

ii) On 15 December 2000, NGI transferred its place of effective management and its business activities to the United Kingdom. From that day on, the United Kingdom regarded NGI as a company resident in the UK, whereas the Netherlands took the view that NGI had a permanent establishment in the UK.

iii) At the time the place of effective management was transferred, NGI held a substantial sterling denominated receivable.

iv) The appreciation of the British Pound against the Dutch Guilder meant that NGI's transfer crystallised a foreign exchange gain that was taxable under the Dutch exit tax mechanism.

The Advocate General (AG) concluded that a company established under the laws of an EU Member State could invoke the freedom of establishment provisions if a Member State imposes an exit tax where domestic companies are not subject to the tax and the exit tax is imposed without the option to (i) postpone the tax payment and (ii) to take into account subsequent losses on the assets transferred.

However, the AG considered that an exit tax is appropriate in achieving a balanced allocation of taxing rights because capital gains realised during the period of establishment in the Netherlands are taxed there, whereas profits and gains realized after emigration are taxed in the new host Member State (in this case the UK).

However, in order to further determine whether there is proportionality of taxation, the AG made a distinction between the determination and the collection of tax. The AG held that an immediate exit tax would only be proportionate where the assets of the emigrated company, due to their nature and/or their size, could not be easily tracked post emigration such that any resulting gain or loss could not be reasonably determined. By contrast, the tax collection point for easily tracked assets should be postponed until the moment of realisation of the actual capital gains.

That said, in balancing the competing factors of the present case, the AG said that an immediate exit tax could be justified in the present circumstances even though the assets could be easily tracked provided the Netherlands gave relief for any subsequent losses on the asset. That principle must, however, be determined on a case by case basis and accord with the domestic tax treatment of a non-emigrating company (i.e. at the point the actual realisation event occurs).

The judgment is relatively taxpayer friendly. While the 'case by case' approach is not particularly helpful, the parameters under which an exit tax could be successfully applied to a company transferring within the EU are sufficiently restrictive to have limited application in practice.

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