MILESTONE TAX NEWS

ISSUE 34

20 June 2012

Clear. Concise. Commercial.

# The Milestone Outlook

**It's been a relatively eventful month for the Milestone team.** Of course, we've been working hard but we've also attended our first awards dinner of the year, Miles has been partying in Spain and acquired a new cat ("**Shylock**"…) that he is very enamored with. Conor is readying himself for the ruckus that will be Euro 2012 and Ewa has been deep water soloing in Mallorca (climbing with water to fall into for us normal folk). Meanwhile, I have been training for climbing Mt Blanc at the end of June. Workwise we have been busy on various interesting projects:

- advising a music app provider on how best to structure the delivery of digital content
- advising on the tax efficient disposal of UK land interests using unconditional contracts and guarantee companies
- advising a private equity firm on the pre-transaction reorganization of a Ukrainian target.

In addition we have written various articles that have been published in national papers and journals, all of which you can find in the Press/Media section of **www.milestonetax.com**.

In this month's edition of the MTN the common theme is corporate migration and the tax consequences and opportunities that this can give rise to. We look at migrating a UK trade to Hong Kong in Deal of the Week and return to Hong Kong in an article by Ewa that considers the corporate tie-breaker article in the Hong Kong/UK DTA. We also summarise the recent South African *Tradehold* case that will undoubtedly have far reaching effect in South Africa. In addition to all this Conor has given his views on the "Rubik" conundrum facing Swiss banks and an interesting solution for anyone holding UK residential property through an offshore corporate structure and concerned about the "Mansion Tax" proposals.

Happy reading!
**The Milestone Tax Team**

## DEAL OF THE WEEK

# Migration of IP from the UK

We were recently engaged to advise on the reorganisation of a UK group with a particular emphasis on migrating IP and associated functions to a suitable jurisdiction in the Far East.

As many readers will be aware, the UK has an exit charge that applies to corporate entities that migrate from the UK by becoming non-resident. The UK company (**UKCo**) that is transferring its HQ abroad is deemed to dispose of its assets at market value and reacquire them immediately prior to exit thereby triggering a charge to UK tax.

There is a good argument that migrating to another EU member state is not caught by these domestic rules but

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reliance on this argument is not a slam-dunk. There is, however, another option worth considering that is more robust than the EU argument and it works like this:

i) UKCo could establish a branch in Hong-Kong (**HKB**) to which it transfers all or a majority of its trade and assets. HKB must, for the purposes of the planning, conduct a trade in Hong-Kong. Because HKB is merely an extension of UKCo (i.e. it isn't a separate legal entity) there is no disposal for tax purposes in respect of the transfer from UKCo to HKB;

ii) HKB will, however, constitute a permanent establishment and, on the basis of the Hong Kong/UK DTA, its profits will be subject to tax only in Hong Kong; and

iii) because Hong Kong has a territorial system of taxation, the income of HKB will only be liable to Hong Kong tax if it has a Hong Kong source.

After a period of time HKB could be incorporated such that it becomes a wholly owned subsidiary (**HKCo**) of UKCo. At the point of conversion from branch to company the UK exit charge potentially still applies. However, provided UKCo remains *in situ* and holds at least 25% of the issued share capital of HKCo for a period of 6 years the exit charge is avoided.

Finally, to the extent that HKB is incorporated, it is important to remember the potential application of the UK's CFC legislation. A critical issue under the new CFC regime is whether there are any UK resident individuals involved in the operation of HKB such that some, or all, of the HKB profits can be attributed to the UK and taxed accordingly. Provided clear and genuine commercial objectives can be identified in establishing HKB and its subsequent incorporation, the UK's new CFC provisions ought not to apply.

If you have any queries relating to the above please contact **Ewa** or **Andrew**.

**STOP PRESS:**
We have been commissioned to write a comprehensive review of the UK's new CFC regime by Tolley's Tax Digest. Please contact **Lynette** to receive a free copy when it is published later this year.

## GENERAL ANTI-AVOIDANCE (ABUSE) RULES

# Some further thoughts on GAAR

As reported in MTN 32 on 22nd March 2012 the Irish Supreme Court (**ISC**) gave judgment in *O'Flynn Construction Ltd and others v. Revenue Commissioners* (the ***O'Flynn*** case). Amazingly, this is the first GAAR judgment of the ISC since its introduction to the Irish legal system in 1989.

What is interesting about the *O'Flynn* case is that the ISC attempted to determine how the principles of statutory interpretation should be applied from the perspective of a GAAR. This strikes us as counter-intuitive: by definition a GAAR presupposes a purposive interpretation. The judges, after much deliberation, concluded that *"the background of the GAAR"* should take priority over a literal interpretation (traditionally dominant in Irish jurisprudence and hence the time it has taken to successfully apply the GAAR).

The approach of the ISC is similar, but not identical, to the Supreme Court of Canada's (**SCC**) approach in *Copthorne Holdings Ltd. v. Canada* (**The Copthorne case**). The Canadians have had a GAAR for almost 25 years but this is only the fourth case in which the SCC has considered its application. The SCC, finding in favour of the Canada Revenue Agency, held that for GAAR to apply three conditions must exist. There must be:

– a "tax benefit";
– an "avoidance transaction"; and
– misuse or abuse of the Act.

While the SCC has considered each condition separately in the previous three cases, *Copthorne* is the first case in which all three were considered by the Court.

Despite differences in approach, both the Irish and Canadian Courts agreed that:

- a GAAR does create some uncertainty for taxpayers; and
- that the *"legitimate tax mitigation of a genuine commercial transaction"* falls outside the scope of a GAAR. In this regard *Copthorne* followed *Duke of*

> *Westminster,* the seminal tax case that established the well-known general principle that *"...every man is entitled if he can to order his affairs so that the tax attaching is less than it otherwise would be."*

In our view, a UK GAAR will likely follow the recommendations embodied in the Aaronson Report with a focus on the principles of the enacting legislation and Parliament's intention rather than the black and white letter of the law (as outlined in Andrew's recent article on General Anti Avoidance Rules; please click **here** for more).

What is interesting is the number of GAAR cases that are currently being taken by the respective revenue authorities and the fact that the Courts are giving the legislation the teeth to bite. Whether we have to wait 25 years for the first UK GAAR case remains to be seen.

## SWITZERLAND

# Rubik Puzzle

We are currently advising a number of Swiss banks and their customers on the likely impact of the Swiss-UK and Swiss-German tax agreements (aka the Swiss "disclosure facilities" or *Rubik Accords*). The agreements (previously reported in MTN 28) allow taxpayers to choose between maintaining bank secrecy (at the cost of a one-off tax of up to 41% to legalise untaxed assets and on-going withholding taxes on income) or disclosure of the offshore funds to the taxpayer's residence state. The new agreements will become effective in early 2013.

The concern for Swiss banks is that customers may choose a third option – moving their money out of Switzerland before the agreements are effective. The concern for customers exercising this third option is that Swiss banks are also obliged to transmit a consolidated report of the "top ten" countries receiving wire transfers from Switzerland to the UK and German tax authorities between signature and entry into force of the agreements. Any jurisdiction on this list is likely to be subject to intense scrutiny and political pressure from the UK and German tax authorities (and in this regard it is noteworthy that many traditional bank-secrecy havens have recently been "bullied" into concluding tax information exchange agreements with the UK and Germany). Just to make life a little more difficult for the Swiss banks, the agreements place a duty on them not to *"knowingly manage or encourage the use of artificial arrangements"* to avoid tax arising under the agreements. So Swiss banks, already nervous following the *UBS* case, are in a state of paralysis.

The new agreements only apply to assets that are beneficially owned by German or UK resident persons. So, in theory, it is possible to sidestep the impact of the agreements by transferring ownership of non-compliant assets to a structure where there is no beneficial owner (such as an offshore discretionary trust or foundation). However, discretionary trusts carry their own baggage, both from a tax and regulatory perspective (not least because creation of a discretionary trust may be subject to reporting obligations) and it will be interesting to see what steps are taken by the banks and their clients between now and the end of the year.

## POLAND / CYPRUS

# DTA Amended

In MTN 33 we commented on the changes to the Cyprus/Russia Double Tax Agreement (**DTA**) that has resulted in the removal of Cyprus from Russia's tax haven 'blacklist'.

Shortly after, on 16 March 2012 (with effect from 1 January 2013) Cyprus and Poland signed a protocol to their 1992 DTA. The most important amendments are as follows:

i) the withholding tax rate on dividend payments between connected companies is reduced from 10% to 0%. The 0% rate applies where the "beneficial owner" of the dividends is a company that holds directly at least 10% of the capital for a period of at least 24 months. Notably, the amendments extend the DTA beyond the scope of Parent Subsidiary Directive because entities not listed in the Annex to the Directive can potentially benefit from the DTA;

ii) the current wording of the DTA allows Cypriot dividend withholding tax to be credited against the Polish tax charged on a Polish resident recipient. This means, for example, that a Polish resident recipient of Cypriot source dividend income bears an effective tax rate of 9% (rather than the full tax rate of 19%). This is because under the DTA the Cypriot dividend withholding tax is deemed to be 10% even though Cyprus does not actually impose any dividend withholding tax. In this regard, Poland has been providing a "tax-sparing" credit in respect of Cypriot source dividend income. These "tax sparing" arrangements are normally agreed by developed countries to encourage investment into developing countries. We find it curious why Poland's treaty negotiators agreed to this in the first place. One might assume that the tax sparing credit offered by Poland in respect of dividends arising on Cypriot investments has merely encouraged investment in Cypriot based tax arbitrage structures by Polish residents. So the wording has now been amended to ensure that only dividend withholding tax actually charged by Cyprus will be creditable for Polish tax purposes (of course currently no withholding tax is levied by Cyprus); and

iii) directors' fees will now be taxable in the State were the director is resident (or has its seat in the case of a corporate director). The language used in the current treaty is somewhat 'woolly' and allows the double non-taxation of director's fees in circumstances where a Polish resident director undertakes his functions for the Cypriot company outside Cyprus.

Interestingly, and somewhat surprisingly, the protocol does not amend the capital gains or income from immoveable property articles. As such, it is still possible under the amended DTA, to invest in Polish real estate via a Poland/ Cyprus corporate structure and avoid Polish capital gains tax by disposing of the Polish shares. Of course, this potential planning opportunity might well be purely theoretical for many years to come given the parlous state of Europe's real estate market.

## FOCUS ON DOUBLE TAX TREATIES

# The "Tie Breaker" Rule

Many years ago it was possible to very easily structure both Irish and UK companies as non-resident for tax purposes. This was achieved by moving the central management and control outside the respective jurisdictions of incorporation. This gave rise to the "Sark Lark" where vast numbers of UK and Irish companies were administered by one man and his dog on an Island full of sheep and an exhausted gene pool.

As far as the UK is concerned all this was knocked on the head in 1988 when legislation was enacted providing that any company incorporated in the UK was automatically resident here for tax purposes. The one exception to this rule is where the place of effective management of the UK company is in a country with which the UK has concluded a suitably worded DTA (see s18 CTA 2009 formerly s249 FA 1994). Where this occurs, the UK company will, *prima facie,* be dual resident (under domestic legislation) with the corporate tie-breaker provision in Art 4 of the relevant DTA (with domestic support in the form of s18) determining tax residence solely in one state or the other.

Hong Kong, as many readers will know, has a territorial system of taxation which means that the corporate tax rate of 16.5% only applies to the extent the company has Hong Kong source income. In the event that a Hong Kong tax resident but UK incorporated company has no Hong Kong source income, the effective rate of tax on profits will be nil (i.e. no UK tax and no Hong Kong tax).

Ideally, one would establish effective management in Hong Kong from the date of company's incorporation rather than migrating an existing UK company (so as to avoid the application of the UK's exit charge on corporate migration – see Deal of the Week **above**).

For more information, please contact **Conor**.

# The Tradehold Case

On 8 May 2012, the Supreme Court of Appeal of South Africa (**SCA**) delivered its controversial judgment in *Commissioner for the South African Revenue Service v Tradehold Ltd;* 132/11 [2012] ZASCA 61 (the ***Tradehold*** case).

The facts of the case can be summarised as follows:

i) Tradehold (**TH**) was an investment holding company incorporated in South Africa (**SA**). On 2 July 2002, the board of directors held a meeting in Luxembourg and resolved to move the place of effective management to Luxembourg;

ii) notwithstanding effective management moving to Luxembourg, TH remained tax resident in SA by virtue of s1(2) Income Tax Act No58 of 1962 according to which a company incorporated in SA is resident there for tax purposes (similar to the UK rule discussed above);

iii) the definition of residence as found in s1(2) was amended such that from 26 February 2003, TH ceased being resident in SA and became resident in Luxembourg; and

iv) SA tax law provides for immediate taxation of unrealized capital gains when a company ceases to be resident in SA (i.e. an exit charge applies). On that basis the SA revenue found TH to be liable to the SA exit charge.

TH argued that the exit charge should not apply by virtue of art 13(4) of the Luxembourg/SA DTA which gives an exclusive right to tax capital gains on non-immovable property to the state of residence of the taxpayer (i.e. Luxembourg). On the other hand, the SA revenue argued that the exemption in question did not apply to TH because the word *"alienation"*, as used in art 13(4) of the DTA, does not include a deemed disposition.

The Commissioners' found in favour of TH, a decision upheld by the SCA which dismissed the SA revenue's appeal. According to the SCA:

i) the DTA takes precedence over domestic law in cases of incompatibility. The SCA rejected the SA revenue's argument that the words *"for purposes of this Schedule"* found in the domestic deeming provision did not preclude it from applying in the context of the DTA;

ii) the DTA should be interpreted according to its object and purpose which is avoidance of double taxation;

iii) the DTA does not draw a distinction between capital gains arising from actual or deemed dispositions, as a result of which the term "alienation", as used in art 13(4), includes deemed distributions; and

iv) the DTA applied from the date of relocation of TH's effective management to Luxembourg, giving Luxembourg exclusive taxing rights in respect of all TH's capital gains.

While of some interest as regards deemed disposals and DTA interpretation, the same result is unlikely to have occurred in the UK. According to the UK exit tax provisions (s185 TGCA92) a company that ceases to be resident in the UK is deemed to dispose of all of assets <u>immediately</u> <u>before</u> it leaves the UK , not <u>'at the time of event'</u> as it is under the corresponding SA tax provisions. The effect of the UK's exit charge is that the deemed disposition occurs immediately before migration, i.e. when the company is still UK tax resident and prior to the provisions of the DTA being relevant.



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