MILESTONE
TAX NEWS

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Clear. Concise. Commercial.

The Milestone Outlook

Over the years I have written the sentiment for our newsletters in some pretty exotic places (Bali, Beaulieu sur Mer, Lech, Koh Samui, New York and, of course, York railway station). However, never have I done this from the A&E ward where I am now sitting nursing two cracked ribs and feeling very sorry for myself. It wouldn't be so bad, but the injury was caused by an extremely low speed ice skating incident at Somerset House this weekend. It is almost too embarrassing to recant, but I'm amongst friends (and, I suspect, the odd enemy…) so there seems little harm in sharing now that the Festive season is upon us!

I'm now back at the office and slightly fuzzy having dosed up on my 'scrip and I've been reflecting on the past 12 months trying to find a philosophical segue from ice skating to tax! To an extent we have all been battered and bruised over the last year, the global economic turmoil leaving us skating on thin ice more than we'd like to (I'd take Somerset House ice rink any day of the week!). So, while it's a long shot, with any luck we'll see a pick-up in activity and confidence in 2012. Being the optimistic types, Andy and I have decided to add a further member to the tax team and we are very excited about Ewa Plesnar joining us in January. Ewa is a Polish tax lawyer who has completed both the ADIT and an LLM in International Tax Law and is currently doing a mini-pupillage at Gray's Inn Tax Chambers. Ewa will no doubt be impressed by Conor's collection of casual wear, especially the Run DMC-style adidas breakdancing hoody and "The Professionals" inspired tan leather. We've compiled a play-list to accompany whichever jacket Conor wears to the office and it never loses its magic (at least for Andrew, Lynette and me!).

This month we bring you a bumper edition of tax goodies from all over the place, the common thread being treaty shopping, more by accident than design we have to admit. Whoever said Christmas comes but once a year?!?!

So thank you to all our readers, clients and friends for your support over the last 12 months. We have had a lot of fun along the way and we look forward to helping you with evermore complex tax issues next year and beyond.

Happy Reading!

The Milestone Tax Team

Milestone Brochure

Our new flash brochure is available on-line.
Why not take a peek by clicking here?

Christmas 2011 Opening Times

Please note that we will be closing for a hard earned Christmas break from 22 December 2011 to 4 January 2012 inclusive.

ALSO IN THIS ISSUE…

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DEAL OF THE WEEK

Carrying on the reflective mood, it is fair to say that over the past 12 months we have seen a marked increase in corporate clients looking to "sweat" intangible assets such as intellectual property rights (**IPR**). Let's take, for example, a group holding company with various operating companies in high tax jurisdictions. The holding company (**HoldCo**) might have a brand, logo or methodology that the subsidiaries use, albeit on an informal basis (i.e. for no charge). In many instances the IPR in question sits on the balance sheet of HoldCo at no cost giving some opportunity of moving it into a tax benign environment – perhaps using an EU argument to defend the transfer. Once housed "offshore" the IPR can be exploited such that:

i) the high tax operating companies get a deduction in their accounts for the license fee payable; and

ii) the license fee income should be subject to no/low tax – thereby driving down the Group's effective tax rate.

A matter recently crossed our desks when we were asked by a client to advise on a structure to extract US source royalties with minimal tax leakage. The US is notoriously difficult because of the extensive domestic anti-avoidance rules that apply to conduit arrangements and the limitation on benefits provisions (**LOB**) it has negotiated into most (although not all) of its double tax agreements (**DTA**).

Of course, there are circumstances where a treaty with a LOB can be used, but these are few and far between and, generally, such arrangements require that the shareholders of the licensor company are also able to benefit from the relevant DTA (this "ownership test" is considered in the German anti-treaty shopping article below). In most instances this means that the income received is taxed at unappealingly high rates.

The effect of these provisions is that in order to extract royalties / license fees from the US without withholding tax at 30% it is, more often than not, necessary to:

i) identify a DTA that does not have a LOB provision; and

ii) ensure that the licensor is not a conduit (i.e. it is not under an obligation to pay away the majority of what it receives to a head-licensor leaving only a margin subject to tax).

Iceland and Hungary were once considered the best options for in-bound US licensing structures. However, these treaties have both been modernized and now contain the standard US LOB article (although notably the new Hungary treaty has yet to come into force). The number of DTAs left that don't have a LOB article are very limited. The Pakistan/US DTA is one, but you'd be hard pressed to convince a client to establish a licensing company in downtown Islamabad (let alone find a trust company that can help!). The only viable treaty that doesn't contain a LOB under which royalties are payable gross (i.e. without deduction of US tax) is the Norway/US DTA.

The drawback with this "simple" Norway/US structure is that despite there being no LOB article in the US DTA, the Norwegian company cannot be a mere conduit because it would otherwise be caught by the US domestic provisions (see s894-1(d) IRC), which means 28% Norwegian tax on the full amount of royalties received. Is there a solution? One option is to establish a branch of the Norwegian company in a jurisdiction that has a favourable DTA with Norway (i.e. one that):

i) contains the exemption method for avoidance of double taxation; and

ii) does not contain anti-triangular provisions.

As you would imagine there aren't many to choose from, but a couple do fit the bill and work well in practice. Another option is to use a hybrid instrument to fund the licensor company (and not necessarily a Norwegian company). In this way the upstream licensor payment should be considered a dividend by the US, but as an interest payment for the purpose of the licensor. As such, the anti-conduit rules ought not to apply and the licensor gets a deduction in its accounts. Planning such as this is highly technical and specialist advice should always be taken before implementing treaty-based structures. Furthermore, the use of hybrid instruments is tantamount to giving the IRS the bird – not advisable in most circumstances!

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SOUTH AFRICA

Abolition of STC and Introduction of Withholding Tax

South Africa recently passed legislation to abolish the Secondary Tax on Companies (**STC**) and will replace it with a classic withholding tax on dividends from 1 April 2012.

By way of background, South Africa does not impose withholding tax on dividend payments to non-residents, but levies a secondary tax on companies (hence STC). The STC is triggered when a South African company makes a distribution of its profits and, because it is a tax on the payer, the recipient does not get any relief (i.e. credit). The new withholding tax regime will, however, be subject to the provisions of the relevant South African DTAs.

Because STC is incurred by the payer company and is not a 'creditable' tax for the recipient, using a company that benefits from a DTA with a nil rate of withholding tax on dividends has not previously been a priority. The Mauritius/ South Africa DTA reduces withholding tax to 5% for a minimum 10% holding which is low; however, other DTAs reduce the withholding tax no nil.

With the introduction of dividend withholding tax (which will be creditable) investors may now look more closely at the options open to them, including:

- Ireland
- Cyprus
- Luxembourg
- Malta
- Seychelles

All of the above have DTAs with South Africa that reduce dividend withholding tax to nil or 5%. In our view, Cyprus may well find itself being the new "front runner" for in-bound South African investments because of its favourable DTA (nil rate of withholding tax on dividends), its user-friendly participation exemption and lack of withholding tax on outbound distributions. A word of caution, however: we understand that the South African authorities may seek to renegotiate treaties with nil rates of withholding tax and impose a minimum rate of 5%. As they say…"watch this space".

GERMANY

Relaxation of Anti-Treaty Shopping Provisions

With the global recession biting and the threat of the Euro going into melt-down a number of countries are doing what they can to attract in-bound investment. Germany is, unsurprisingly, no exception. We have reported a couple of times over the past three years on the treaty / directive shopping rule contained in s50d(3) of the German Income Tax Act (ITA). This rule has now been relaxed pursuant to infringement procedures initiated by the European Commission in March 2010. The new rules apply to payments made from 1 January 2012, but, before looking at the changes, it is worth re-capping the provisions of s50d(3).

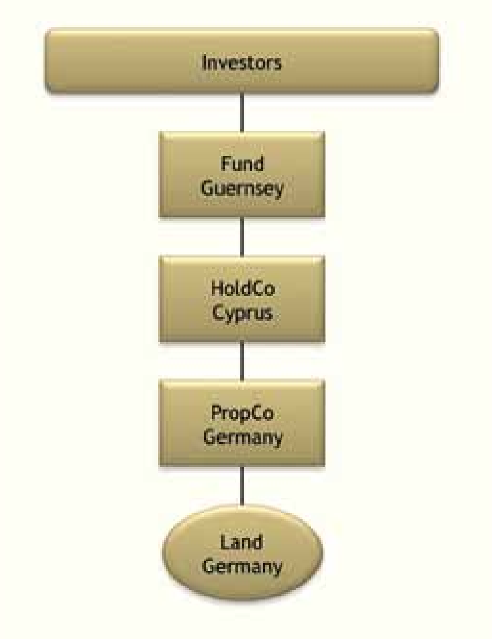
Section 50d(3) was introduced in the 1990's to prevent treaty / directive shopping (i.e. using entities established in favourable jurisdictions to obtain a tax benefit with no (or limited) overriding commercial purpose). Section 50d(3) operates by denying relief for German withholding tax on outbound payments **unless** the foreign company:

i) is owned by shareholders that are entitled to the same relief as if they had received the income directly; or

ii) has:

   a) economic or other sound reasons for being interposed; and
   b) generates more than 10% of its gross receipts from its own genuine business activities (**the 10% revenue test**); and
   c) has adequate business substance.

Where the above conditions were not met the benefits of the relevant DTAs and Directives would not be available. Parallels can of course be drawn with the domestic US anti-conduit provisions and LOB provisions referred to above in the Deal of the Week. Section 50d(3) had far reaching consequences. Take the following structure (which was very typical in the halcyon days of the mid-2000's when German property was all the rage) as an example:



The vast majority of intermediate holding companies used in similar structures would not have been able to meet the conditions under the business test in ii) above and, assuming the Guernsey fund had a disparate group of shareholders that were not entitled to the same relief as under the Cyprus/Germany DTA or the Parent-Subsidiary directive, dividends paid to the Cyprus company would have suffered German withholding tax.

The recent amendments have diluted s50d(3) by abolishing the 10% revenue test from 1 January 2012. It will therefore be easier for those companies with passive income (e.g. asset managers) to obtain full or partial relief.

It should be noted, however, that where the income in question is not derived from the foreign company's own business activities withholding tax relief will only be available where the foreign company's inclusion in the structure is commercially justifiable and it, itself, undertakes a commercial activity. In respect of a pure holding company, for example, it will be necessary to prove that it actively manages its German subsidiaries to claim the DTA or Directive benefits. In some respects this provision is similar to Art 17,3 of the Dutch Tax Code (known as the "substantial interest rule").

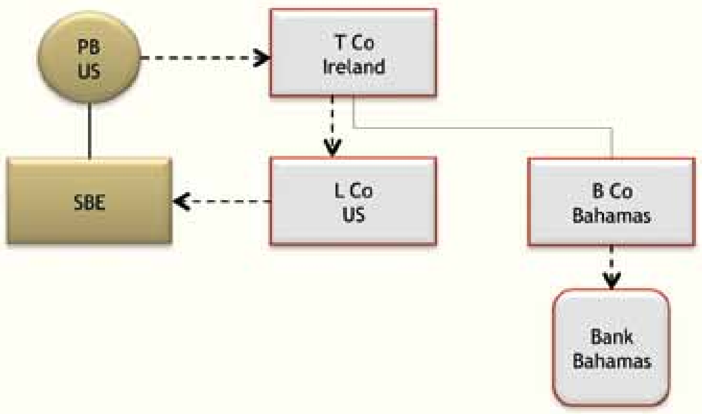
Of course, the fact that the Germans have watered down s50d(3) is no guarantee that the ECJ won't still find it contrary to EU law. In this regard *Cadbury-Schweppes* established the principle that benefits can only be justifiably denied in relation to *"wholly artificial arrangements"*. In our view, the diluted version of s50d(3) has the potential to catch arrangements that are not wholly artificial and may still, therefore, be subject to further amendment.

US

Offshore Employee Leasing Arrangements under Attack

It's odd, but somewhat gratifying, when you see a structure that you thought was pants, being taken to the cleaners. We remember seeing such a structure about ten years ago. It was an employee leasing scheme established in Ireland that was being punted to US dentists and surgeons as a means of tax deferral on income that would otherwise be liable to US income tax. We looked at similar arrangements undertaken by two "Kiwi" surgeons in MTN 29, but this Irish ruse was on another level. We thought it was flakey ten years ago (not least because of our overriding fear of the IRS and the US tax system!) and it appears to have come home to roost for Mr Perry Browning (**PB**), the unsuspecting (non) taxpayer.

PB was not a dentist or a surgeon, he was in fact the CEO and, believe it or not, the majority shareholder in a US company based in Vermont. Way back in 1995, his tax adviser punted Perry a wheeze to mitigate his income tax exposure. The wheeze in question required Perry to provide his services to his own company via two independent leasing companies, one based in Ireland (**T**) and one in the US (**L**).



The diagram shows Perry leasing his services to T that in turn sub-leased his services to L that sub-subleased his services to SBE! Hey presto, a tax coup (or so I'm sure he'd been told)!

You would think that's the worst of it, but, actually it gets better…for providing Perry's services, SBE paid L amounts equivalent to what SBE had been paying Perry in salary. L paid a portion of these amounts to Perry on which he naturally paid US income tax. L paid on the balance to T which then contributed the sums into a Bahamian subsidiary that operated a deferred compensation arrangement (retirement account) for P's benefit. The retirement account was essentially a bank account in the name of the Bahamas company that provided a back-to-back facility for credit cards issued to Perry and his wife…who then enjoyed the benefits of the arrangement but didn't pay any tax (and that folks, is the beauty of undeclared income!).

Generally, the IRS would be time-barred under s6501(a) IRC, which states that any tax due must be assessed within three years of the filing of a return. However, this three year limit falls away where the taxpayer files a false or fraudulent return. The US Tax Court held that by not declaring the benefit of the arrangements, Perry had filed fraudulent tax returns during the years the scheme was in place. As a result Perry was held to have been in constructive receipt of:

i) the excess of SBE's payments to L over amounts he reported as salary; and

ii) the capital gains and investment income generated by the assets in the retirement account.

A takeaway from this case is as follows…tax enquiries can and do go on for years. Providers of tax schemes and products generally don't make their unsuspecting prey aware of this, simply glossing over the reality and focusing on the pots of tax free gold at the end of the rainbow. As always, if it seems too good to be true, it generally is…buyer beware!

INDIA

The Ardex Case – Applicability of India/Mauritius Double Tax Agreement

The Indian Authority for Advance Rulings (AAR) recently issued a ruling in the case of Ardex Investments Mauritius Limited (Applicant) [AAR No. 866 of 2010]. Ardex UK (a UK company) owned 100% of Ardex Investments Mauritius Limited (**Ardex Mauritius**) that in turn owned shares in Ardex Endura (India) Pvt Ltd (**Ardex India**) a limited company incorporated in India. Ardex Mauritius intended to sell Ardex India to a group company established in Germany and sought a ruling from the AAR on the following issues:

i) whether India would, notwithstanding the provisions of the India/Mauritius DTA, seek to charge any gain on the sale of the shares to Indian capital gains tax (the domestic rule being that a non-resident is liable to Indian CGT on a disposal of Indian shares);

ii) whether any withholding tax obligation existed under s195 of the Income Tax Act, 1961; and

iii) whether it was obliged to file an Indian income tax return.

Somewhat surprisingly, given India's relatively aggressive approach to the taxation of non-residents (see *Vodafone* and various others), the AAR ruling held that any gain realised by Ardex Mauritius on the transfer of its shareholding in Ardex India would be exempt from Indian tax under the capital gains article in the India/Mauritius DTA. The AAR cited the 2003 ruling of the Supreme Court in the case of *Azadi Bachao Andolan* (also involving the India/Mauritius DTA) that confirmed an appropriately worded DTA will grant sole taxing rights in respect of gains arising from the disposal of Indian shares to the other state. The *Azadi* judgment is interesting on a number of levels, not least because it held that, unless a DTA contains a Limitation on Benefits provision, its benefits should be freely available even in cases that could be perceived to involve treaty shopping.

The Ardex Ruling provides some degree of comfort that the India/Mauritius DTA can be relied upon in respect of Indian share disposals. However, it should be treated with caution for the following reasons:

i) rulings from the AAR are binding only in respect of the particular transaction and with respect to the particular taxpayer (although such rulings have persuasive value in the courts);

ii) the ruling makes reference to the fact that the Ardex structure had been in existence for some 10 years prior to the proposed transaction and had been established by an unrelated company from whom Ardex UK acquired the holding in the Mauritian company (in turn holding the Indian investment). In our view, it is reasonable to expect that the Indian tax authorities will distinguish this fact pattern from a scenario where a taxpayer has established a Mauritian structure over a shorter timeframe with a view to a disposal to a third party;

iii) the Supreme Court decision in the *Vodafone* appeal is expected in the coming weeks. This case does not concern a Mauritian holding structure (but rather the sale by an offshore company of another offshore company which in turn held an Indian investment). However, any pronouncement by the Supreme Court in *Vodafone* may well have wider implications in setting the scope for the Indian tax authorities to tax non-resident investors on Indian gains; and

iv) India will introduce a General Anti Avoidance Rule from 1 April 2012 (or perhaps sooner). The GAAR will include a business purpose test and, as such, it will be interesting to see to what extent this domestic provision will impact on and curtail the use of double tax treaties.

Milestone Comment:

One interesting side note to the *Ardex Ruling* and the *Vodafone* case is the extent to which the Indian tax authorities are attempting to expand their right to tax all gains (regardless of asset class) extra-territorially. The Indian approach can be compared to the Australian position in *Lamesa Holdings BV v FCT* (**Lamesa**). Lamesa involved a Dutch company (**DutchCo**) that owned an Australian mining operation through a chain of Australian holding companies. DutchCo subsequently disposed on the shares in the top Australian holding company and successfully claimed relief from Australian capital gains tax under the Australia/Netherlands DTA.

The Australian's understandably went "troppo", "spat the dummy" and cried "strewth cobber"! The asset in question derived its value, albeit indirectly, from Australian immovable property and had escaped Australian taxation by virtue of the DTA. The result was an almost immediate change in Australian domestic legislation to prevent a similar occurrence.

By comparison, the Indian tax authorities approach to capital gains arising from both moveable <u>and</u> immovable property seems to be to:

i) ignore the clear provisions of tax treaties that remove the Indian taxing rights; and

ii) extend, as far as possible, the right to tax any disposal of Indian assets.

The aggressive approach to extra-territorial taxation adopted by the Indian authorities may, despite the enormous domestic growth potential, dampen enthusiasm for foreign investment in India. In our view, while tightly drawn, the recent tax ruling in Ardex should provide a greater degree of comfort to non-resident investors – this can only be viewed as a step in the right direction.

UK

Publication of report on GAAR

Whilst India has taken the decision to adopt a General Anti-Avoidance Rule (**GAAR**), here in the UK, HM Treasury commissioned Graham Aaronson QC to advise on the pros and cons of such a rule. The report, published on 21 November 2011, recommended that the UK should adopt a narrowly focused GAAR. Aaronson rejects *"a broad spectrum general anti-avoidance rule", instead recommending "a moderate rule which does not apply to responsible tax planning, and is instead targeted at abusive arrangements."*

The rule would be subject to a number of safeguards *"to ensure that the centre ground of responsible tax planning is effectively protected."* These include:

i) protection for "reasonable tax planning";

ii) burden of proof on HMRC to show the arrangement is not "reasonable tax planning";

iii) protection for arrangements without intent to reduce tax; and

iv) an advisory panel (including majority of non-HMRC members) to vet the use of the GAAR.

Initially, the GAAR would apply to income tax, capital gains tax, corporation tax, petroleum revenue tax and national insurance contributions. At a later stage, once a GAAR was operating fairly and effectively, it could be extended to stamp duty land tax. However, VAT would be outside the GAAR, since it has its own anti-abuse rules derived from EU law.

In our view, the emphasis on targeting abusive arrangements and protecting the centre ground of responsible tax planning should be applauded. The report highlights the need to preserve the competitiveness of the UK's tax regime, particularly in the current economic environment.

It also talks of creating a *"level playing field"* for:

i) businesses whose competiveness should not be undermined by others who seek to reduce their tax burden by contrived and artificial schemes; and

ii) for tax professionals whose client base should not be eroded by unscrupulous advisors who are prepared to recommend such schemes.

The report also anticipates that introduction of the GAAR should enable future tax rules to be drafted more simply and, in time, allow simplification of existing laws. On this point, we think that simplification may be a distant hope since it will take a long time before the application of the GAAR has been "road tested" through the court system to a point where HMRC feel confident enough to do away with specific anti-avoidance rules.

The report envisages further consultation before potential enactment. As such there is no certainty as to when (or, indeed, if) a GAAR will be adopted. If one were of the view that the Conservative party is minded to abolish the 50p rate of income tax, then one might expect that the Conservatives may offer up the GAAR in conjunction with such a move as a sop to their Liberal coalition partners. However, the current economic climate means that the timing is clearly not right for such a move. As such, it may be that the introduction of a GAAR is kept in abeyance until a time when the political capital garnered by its introduction can be maximised.

Of course, one may also ask whether the report is addressing the right question. We would certainly applaud taking a tough stance on contrived and artificial schemes and the advisers who promote them. However, one also has to acknowledge that the avoidance industry flourishes partly as a consequence of an over-complex tax system whose income tax rates ensure that half (or over half including NICs) of a high-earner's income can be snaffled by the taxman. The broader question that perhaps should be asked is a GAAR's role in achieving tax simplification and the maintenance of fairness and efficiency.

Withdrawal of VAT Low Value Consignment Relief on imports into the UK from the Channel Islands

Potentially bad news for those who spend their time buying CDs on the internet (ahem…Miles). From 1 April 2012 Low Value Consignment Relief (**LVCR**) will no longer apply to goods imported into the UK from the Channel Islands.

In recent years, internet retailers have located their delivery centres in the Channel Islands thereby taking advantage of LVCR which allows goods below a threshold of £18 (recently reduced to £15) to be imported into the UK free of VAT. This has allowed shoppers to buy cheap CDs and video games albeit to the detriment of onshore retailers who are put at a competitive disadvantage. Long suffering independent record stores have been particularly vocal in lobbying for abolition of LVCR.

This move has been widely expected and is, perhaps, some explanation for the recent sale of once-mighty www.play.com for a knock-down price of £25m to Japanese internet retailer Rakuten.

Interestingly, LVCR remains in place for imports from other non-EU countries. However, HMRC consider that relocation of delivery functions to other non-EU countries is unlikely because the Channel Islands benefits from streamlined postal and import processing systems that would not be available to other non-EU countries. We think that HMRC might be kidding themselves…which country ticks the following boxes:

- outside the EU;
- low tax rates;
- rulings available; and
- ruthlessly efficient?

Erm…Switzerland?

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