MILESTONE TAX NEWS

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Clear. Concise. Commercial.

The Milestone Outlook

Well that was a month to remember! The Budget, Channel 4 News, BBC Radio 4, Best International Tax Team Nomination and a week of spring skiing in Colorado…

The Budget has caused a huge amount of angst across all sections of society, not least because of its austerity measures. The Chancellor's own statement that *"I regard tax evasion and – indeed – aggressive tax avoidance – as morally repugnant"* has created significant debate. I was interviewed by BBC Radio 4 researchers for the Moral Maze on this very topic. As usual there is a huge amount of ill-informed tat written in the popular press about tax issues: the Sunday Times front page on 18 March (a few days prior to the Budget) was so misleading it was laughable. That said, they clearly had a heads-up from the Chancellor's office because only a couple of days later we had a new 15% SDLT rate to combat avoidance using offshore companies!

The collective gasps of astonishment as the Chancellor read his Budget Statement on 21 March will live long in the memory. The "attack" on offshore structures acquiring UK property was totally unexpected particularly because it seems unwarranted. Rarely in our collective careers have we come across the sale of an SPV's shares to avoid SDLT: it simply doesn't happen for reasons that are blindingly obvious. So, the hike in SDLT to 15% to prevent avoidance of this nature doesn't stack up. Unless, of course, it isn't really an attack on SDLT but, rather, a surreptitious attempt to extend the scope of UK inheritance tax to foreigners that buy investment property through offshore companies…this seems much more likely.

I've been able to keep my sanity through all of this by listening to a DJ called Jon Sa Trinxa who I first discovered in Ibiza (I know…mid-life crisis and what not) a few years ago at the eponymously titled beach club in Salinas. He plays a great set so check him out on Soundcloud! I suppose we're somewhat like a DJ in that we have to trawl through a load of material to bring you a newsletter that ebbs and flows and hopefully keeps you entertained from start to finish! This month we could rattle on about the EC referring Germany to the ECJ over its fiscal unity regime, we could bore you to death about Guernsey's TIEA's with a bunch of irrelevant countries and we could regurgitate the UK's recent budget ad nauseum. But we won't. Instead we've found some interesting and, dare we say, unusual snippets of information that you wouldn't find in your common or garden newsletter.

If there's anything in this edition of the MTN that floats your boat and you would like to discuss with us in more detail we would be delighted to hear from you. If not, why not pack your bags, head to Ibiza and chill to the sounds of Jon Sa Trinxa…all your troubles will ebb away!

Happy reading!
The Milestone Tax Team

ALSO IN THIS ISSUE…

SEMINARS

Jersey, Guernsey and the Isle of Man

We are planning to run topical and informative seminars in Jersey, Guernsey and the Isle of Man during June. These will be free (yes…FREE!) and we will be sending out further details in the coming weeks: time, location and so on.

Please click **here** to download a draft programme. If you are interested in attending please contact **Lynette** to be placed on the shortlist as places will be limited.

DEAL OF THE WEEK

Property Acquisition Structure Post Budget 2012

We were engaged, just prior to the budget, to advise a wealthy client from the Far East on a residential property acquisition. Relatively simple advice: use an offshore special purpose vehicle (**SPV**) so that the exposure to UK inheritance tax (**IHT**) is eliminated, fund with debt rather than equity to ensure whatever rental income is subject to reduced income tax exposure and the capital gains tax (**CGT**) exposure takes care of itself (non-residents not being liable to CGT even on real UK assets).

Of course, all this was thrown up in the air because of George's attack on SDLT avoidance. The basic structure for non-residents acquiring UK residential / investment property now carries a 15% surcharge. Some might consider this an acceptable cost. However, most clients we have spoken to consider this a step too far. To avoid the charge the foreign investor simply acquires the property personally. CGT continues to take care of itself, but the IHT exposure of 40% is a real issue, especially taking into account the significant price tags of London property. It isn't rocket science to cover off the IHT exposure, one simply needs to fund the acquisition with as much debt as possible. Of course, to the extent that the property increases over time this "upside" will be exposed to IHT. On very expensive properties this is a genuine tax risk. Whilst this "vanilla" structure is manageable from a tax perspective it doesn't provide any degree of confidentiality for the purchaser - an issue that should not be underestimated especially where the property in question could be worth tens of millions.

There is, however, an exemption from the 15% rate for offshore companies that acquire UK real estate provided the company does so in its capacity as trustee of an offshore settlement. This is a somewhat unusual exemption, particularly so if the new rate was introduced to combat SDLT avoidance – using an offshore company as trustee doesn't prevent the property (or rights in the property) being transferred without an SDLT charge. It does, however, expose the property to UK inheritance tax – taxation by stealth if you ask us.

The IHT exposure takes the form of a periodic 10 year charge. 6% is charged on the net value of the trust property on every 10 year anniversary of the trust and is payable by the trustee. The use of debt secured against the property will assist in mitigating the IHT exposure, but once again the increase in property price over time will bring this tax back into play.

If you have any queries relating to the above please contact **Conor**.

ASSET PROTECTION

Horses for Courses

Of late we've had a number of clients asking us for advice on asset protection structures. Asset protection I hear you say… that must be dodgy! Offshore tax havens, small islands in the middle of nowhere where the judiciary meets once a blue moon and crazy US attorneys – all trying to convince us that asset protection trusts do actually work. All joking apart, in many instances such structures are appropriate, but they are not a panacea and often their real value is in the form of a bargaining tool and getting parties to a negotiating table. Trusts are of course the typical vehicle of choice, but these often trigger reporting obligations on their establishment and are perhaps capable of being set aside by a civil law court to which the trust concept is alien.

There are, however, alternatives to trusts. One structure we are aware of uses a Cook Islands company. The Cooks are, as many will know, on the other side of the world – literally. They are known principally as being one of the last real tax havens and perennial thorn in the side of the New Zealand revenue. Interestingly, the Cooks aren't part of the Commonwealth and this is a significant factor in the "security" of the structure.

Alternatives do exist and we favour a Hong Kong based structure that is both tax effective and robust from an asset protection perspective. For more information please contact **Miles**.

UK / EUROBONDS

Quoted Eurobond Withholding Tax Exemption Under Scrutiny?

On 27 March 2012 HMRC issued a consultation document which, among other issues connected with interest payments, considers the withholding tax exemption on quoted Eurobonds. The Consultation deadline is 22 June 2012 and we expect new regulations to be introduced later this year. The aim of the proposed changes is to prevent the 'artificial' use of Eurobonds.

Interest payments made by a UK company on quoted Eurobonds are not subject to withholding tax. This exemption, which is aimed at facilitating overseas financing, is very broadly drafted and has led to the use of Eurobonds in ways that were not, shall we say, originally envisaged.

Quoted Eurobonds have been widely used within group structures to facilitate intra-company financing. Less obvious uses include property development structures; the bond interest being a deductible expense thereby reducing the development profits subject to tax. One might reasonably conclude that in such circumstances the Eurobond exemption is being stretched to breaking point!

In most cases the Eurobonds are listed on a "friendly" stock exchange in territories widely regarded as ahem…tax havens (like the Channel Islands and Cayman Islands). In many instances the company issuing the bonds has no other material connection with the exchange and moreover the Eurobond is highly unlikely to ever be actually traded.

We anticipate that the consultation process will result in a significant tightening of the rules to prevent abuse going forward.

AVIATION

EU Ruling

The Korkein hallinto-oikeus (Supreme Administrative Court of Finland) has asked the European Court of Justice for a preliminary ruling on three questions concerning the interpretation of the VAT exemption applicable to the supply of aircraft to be 'used by airlines operating for reward chiefly on international routes'.

An opinion given by the Advocate General in the European Court of Justice supports work being done with the British and European Aviation bodies (BBGA and EBAA) on the interpretation of the VAT regulations relating to the definition of a "qualifying aircraft". In very simple terms, qualifying aircraft can be imported at 0% VAT by an "airline".

The opinion states that:

i) the term "airline" is not limited to scheduled airlines and will include business and private jet operators (contrary to the opinion of HMRC!). The consistent approach has been that those with an air operators certificate should be recognised as an airline and the AG opinion supports that view; and

ii) the fact that an owner is transported by the airline does not affect the VAT status provided the airline is using the aircraft in its business (i.e. the aircraft is not used exclusively for the private use of the owner and is available for charter).

The opinion of the Advocate General has been sent to the European Court of Justice and it is hoped the ECJ will follow the essence of his opinion when they make their ruling.

Thanks to Aoife O'Sullivan at Gates and Partners for this article.

THE UK

Section 185 TCGA 1992 – Exit Taxes

UK tax law provides for the immediate taxation of unrealized capital gains when a company migrates out of the UK (s185 TCGA 1992). The European Commission considers this provision to be in breach of the EU freedom of establishment provisions.

Exit taxes have been examined by the ECJ on several occasions – never particularly favourably for the Member State in question. We predict that s185 will suffer the same treatment as various offending exit tax provisions before it and that it will be amended such that it only applies in cases where tax avoidance is the main or one of the main motives for migration.

THE EVEN MORE CURIOUS CASE OF GEORGE ANSON

Application of s739 ICTA 1988

We have been following with interest the case of George Anson who found himself in the unenviable position of paying tax in the US and the UK on the same income but without a credit for the US tax. Conor's excellent **article** published in Tax Planning International Review last year provides the background facts and some interesting thoughts on the application of the UK/US DTA.

One aspect of the case that was set aside to be considered separately was the argument put forward by Mr Anson's Counsel that the US income was caught by s739 ICTA 1988. Section 739 (which has been rewritten as s714 *et seq* ITA 2007) is an anti-avoidance provision that attributes income of offshore entities to UK resident individuals on an arising basis. The section operates where the purpose or one of the main purposes to the transaction is the avoidance of tax. Where it applies a credit is given for any foreign tax suffered. In Mr Anson's case his Counsel attempted to argue that s739 was in point and that therefore the US tax was creditable in calculating the UK tax charge.

The Upper Tribunal held that Mr Anson could not invoke s739 in order to claim double tax relief. The judgment of Mr Justice Mann is worth reading not least for the obvious irritation he felt in respect of this attempt to claim double tax relief. He rightly points out that ordinarily it is for HMRC to invoke an anti-avoidance provision not the taxpayer! The Court, likening Mr Anson's argument to a trip through Wonderland, said the attempted inversion of s739 should fail especially when it had already been admitted and accepted that there was no tax avoidance motive to the arrangements.

GIBRALTAR

ECJ decision on state aid

In November 2011, the European Court of Justice issued a judgment that Gibraltar's corporate tax reform (proposed in 2002, and long since abandoned) would (if implemented) have constituted state aid. The judgment was actually welcomed by the UK and Gibraltar governments since it implicitly accepts Gibraltar's constitutional relationship with the UK and its freedom to establish an independent tax regime.

However, while Gibraltar lies at the epicentre of the judgment, the secondary effects may potentially impact on the tax systems of all EU member states. This is because the judgment seems to depart from the previously accepted view of what constitutes state aid.

The proposed Gibraltar corporate tax system would have abandoned corporate tax, instead replacing it with a payroll tax and a business property occupation tax. The judgment considered that this regime in practice discriminates between companies since it "excludes from the outset any taxation of offshore companies, since they have no employees and also do not occupy business property."

The concern is that where a tax regime is devised to exclude from the outset certain types of company then there is a risk that the ECJ could make a finding that there is state aid. One might be concerned that tax regimes whereby finance companies or IP holding companies are excluded from charge (perhaps by way of interest or patent box regimes) could also be vulnerable to a challenge by the ECJ on the grounds of state aid.

So one might expect that it will become standard practice for tax advisors to caveat their advice in respect of state aid risk and time will tell whether the Gibraltar case marks the dawn of an era in which the ECJ becomes increasingly pro-active in using state aid as a new stick with which to beat Member States.

More Illegal State Aid

In a case likely to compound the Greek populace's already difficult finances, the ECJ has recently held that Greece needs to do more in recovering tax exemptions previously allowed to Greek businesses on the basis they constituted illegal state aid. The Greek's had argued that determining the amounts due and who had actually benefitted from the arrangements was rather difficult and therefore should be allowed to wriggle free from its obligation. Not surprisingly, the ECJ were having none of it and asked Greece to enforce its collection rights. Blood from a stone anyone?

INDIA

Withholding tax case

The Indian Income Tax Appellate recently overturned a decision of the Indian tax authorities that denied deductibility for contract payments made by an Indian company to its US branch office. The Indian tax authorities, adopting their usual dogmatic approach, argued that payments to the branch office were not deductible on the basis no tax had been withheld on those payments. The Appellate disagreed stating that an entity 'managed and controlled' from India was Indian tax resident and, therefore, payments made to it could not be subject to withholding tax in the manner suggested. While this decision reaches a common sense outcome and rests on clear tax principles, it is again another example of the the Indian tax authorities adopting a perplexing approach to international taxation.

EUROPEAN UNION

Losses of PE ought to be an allowable offset

In a case closely correlated with the principles established by the Marks & Spencer ruling (2002), the ECJ has stated (in a preliminary ruling) that the losses of a UK resident PE (of a Dutch parent – Philips Electronics) ought to be allowable in relieving profits of a UK resident group company. Perhaps unsurprisingly, given the extent to which HMRC has attempted to restrict the M&S decision, HMRC declined to allow the loss offset. Less surprisingly, the ECJ were clear that any domestic restriction on the availability of the PE losses would amount to an infringement of the freedom of establishment and, further, that the restriction could not be justified.

RUSSIA / CYPRUS

Protocol to the DTA

Russia has ratified the Protocol to its Double Tax Agreement (DTA) with Cyprus. In doing so, Cyprus has been removed from Russia's tax haven 'blacklist', meaning dividends received by Russian companies from Cypriot subsidiaries are now tax exempt.

Removal from the blacklist arises as a result of a revised exchange of information article in the DTA. The new article is based on the OECD Model and provides a degree of protection to the taxpayer on the basis that 'fishing' expeditions are not permitted: an enquiring tax authority must demonstrate reasonable cause before embarking on a request for information.

The withholding tax rates remain the same:

- 5% on dividends (where investment is in excess of €100,000, otherwise 10%); and
- 0% on interest and royalties.

Interestingly the DTA now includes a Limitation of Benefits article that applies to deny treaty benefits if the main purpose or one of the main purposes of establishing tax residency was tax avoidance – essentially a treaty shopping provision. However, it only applies where non-Cyprus entities move their tax residency to Cyprus. So, in theory a Cyprus company could be established by a Russian company / individual solely to take advantage of the treaty and the LOB would not apply. A toothless LOB if you ask us!

DENMARK / CYPRUS

Beneficial Ownership

We have been keeping an eye on developments in Denmark as regards beneficial ownership cases and reported way back in MTN 19 of a case involving a Luxembourg parent company of a Danish holding company. In that case the Danish Tax Tribunal (*Landsskatteretten*) found in favour of the taxpayer (i.e. that the Luxembourg company was the beneficial owner of the dividends it received). It arrived at this conclusion because the Luxembourg company did not simply pay out all the dividend income it received to its shareholders; in other words it didn't act as a conduit for the Danish dividends.

The facts of the two cases are somewhat similar:

- Danish company (**DCo**) was owned by a Bermuda holding company (**BCo**) which in turn was held by a listed company resident in the US;
- in 2005, BCo established a subsidiary in Cyprus (**CyCo**) that acquired the DCo shares;
- DCo subsequently distributed dividends to CyCo; and
- CyCo used the dividends to pay the loan it received from BCo to acquire the shares.

Unsurprisingly CyCo had no substance in Cyprus. It was essentially a brass plate company with “fiduciary” directors and its only function was to hold the DCo shares.

The Danish tax authorities considered that Danish withholding tax of 28% applied to the dividend payments and challenged the structure accordingly. The 28% withholding tax is capable of being significantly reduced by operation of:

i) the Cyprus/Denmark DTA; and

ii) the EU Parent Subsidiary Directive (**PSD**).

The DTA

Art 10(1) of the DTA imposes a beneficial ownership requirement for the reduced withholding tax rate of 10% to apply. The Court held that CyCo was **not** the beneficial owner of the dividends but merely a conduit per para 12.1 of the Commentary to the OECD Model Convention. Unlike the earlier case (Denmark/Luxembourg) the holding company redistributed the dividends received to its parent company. One might naturally conclude that an intermediate holding company would distribute some, if not all, of its income upstream and in the absence of a requirement to pay (i.e. a provision in the articles of the intermediate company) it strikes us as being a poor decision – although one has to bear in mind it was a Danish tax court, not known as being particularly sympathetic to the taxpayer!

The Directive

The PSD, as many readers will know, exempts dividends from withholding tax subject to various conditions being met. Similar to the DTA, the PSD contains an anti-abuse provision which, if invoked, would deny the benefits of the PSD. However, the Danish law implementing the PSD does not contain any beneficial ownership requirement and as such a form over substance rule applies.

In this regard the Court held that CyCo was a legally established company in Cyprus and it was the legal owner of the DCo shares. The fact that CyCo had no commercial activity per se and was simply a passive holding company was neither here nor there. Accordingly, Denmark could not impose withholding tax on the dividend payments.

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