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Clear. Concise. Commercial.

The Milestone Outlook

After a prolonged summer break the (unofficial) best tax newsletter in the world is back! Despite being "off-air" for a couple of months tax is still a very hot topic, especially here in the UK where morality and tax avoidance are being forced together by the press and politicians.

This raises some interesting questions, particularly for large corporates such as ebay, Amazon, Starbucks, Ikea etc all of whom have been branded bad corporate citizens due to the tax strategies they are alleged to have adopted. As ever the reporting of tax stories in the popular press verges on the woeful and is more often than not very often one-sided (but it does sell newspapers!). Labour, MP John Mann, has even attacked Facebook's latest tax return, telling The Independent that:

> *It's disingenuous and immoral for these hugely profitable companies not to be paying tax in the countries where they are based and make a profit.*

Starbucks was forced on 16 October to issue a statement clarifying that whilst it has not paid corporate tax in the UK over the past three years it has paid £160mn in business rates, NI and the like. Calls to boycott Starbucks in favour of Costa and Caffe Nero (UK chains) have been made by many bloggers, blaggers and commentators who claim that large corporates such as Starbucks must pay their "fair share". The problem with this is that they don't define what a "fair share" is.

Take Starbucks as an example: Its effective tax rate is 31.1%. Costa's effective tax rate is, by contrast…wait for it: 26.4%. The two corporate structures will be fairly similar, but what is important is that Starbucks is headquartered outside the UK and this allows it to charge its non-US operating subsidiaries interest on loans, license fees for IP know how and show how and the ability to locate purchasing functions in low tax jurisdictions. All this means that it has the ability – legally – to reduce its UK profits and thereby the tax it is required to pay in the UK.

Those that call for Starbucks and the like to pay their "fair share" very rarely suggest how the rules might be changed to accommodate their requirements or, for that matter, explain what is "fair". In the absence of any meaningful suggestions from those that cry foul play, we have taken a guess at what they must be on about:

- a blanket ban on intercompany financing;
- disallow deductions for intercompany use of IP;
- reintroduce exchange controls; and
- renegotiation of the UK's double tax treaty network.

None of the above is palatable. Transfer pricing is clearly at the heart of a large corporate's planning (as it will cover all the above intercompany transactions), and if there is any case to answer HMRC will be required to confirm whether it has scrutinised the transfer pricing policies of these companies.

If you wish to read more about Starbucks, Miles and Sally have written an article for Finance Monthly which you can find by clicking **here**. In addition to this, we have published our comments on the PAC hearing with Starbucks, Google and Amazon on 12 November 2012 on our website. This can be found by clicking **here**. Andrew takes "Writer of the Month" award for his excellent summary of the new CFC rules which will be published in the next edition of Tolley's Tax Digest. Please contact **Andrew** if you would like to receive a free copy.

Happy reading!
The Milestone Tax Team

ALSO IN THIS ISSUE...

DEAL OF THE WEEK

Controlled Foreign Company Rules in Practice

As mentioned above in the MO, the UK has introduced new Controlled Foreign Company (**CFC**) rules in an attempt to modernise (if not simplify) the current regime. The following Deal of the Week illustrates the complexity of the new rules and suggests a method of applying them in practice.

We were recently asked to advise whether a 100% Dutch subsidiary (**DutchCo**) was a CFC of a UK company (**UKCo**). DutchCo's only asset was development land in Brazil on which it intended to obtain planning permission allowing it to on-sell to a developer for a significant profit. DutchCo's profits would be liable to tax only in Brazil by virtue of the Brazil/NL DTA, but our client was concerned that DutchCo's profits could also be assessable to tax in the UK on the basis it was a CFC.

Having identified that DutchCo was, *prima facie*, a CFC, we had to consider whether one of the entity level exemptions was available. There are 5 exemptions contained in Chapters 10 – 14 TIOPA of the legislation:

1. The Tax Exemption (Chapter 14)

If DutchCo were taxable at 75% of the UK tax that would have been due if it were UK resident, no CFC charge would arise. We discounted this as DutchCo would not be taxable in the Netherlands as a result of the Brazil/ Netherlands DTA and domestic legislation.

2. The Excluded Territories Exemption (Chapter 11)

As the Netherlands is on what is known as the "grey list", no CFC charge would have arisen if 90% or more of DutchCo's income was not:

a) income that is exempted in some way (apart from distribution exemptions, i.e. if exempt under the Dutch partial exemption);

b) investment income that receives a notional interest deduction;

c) partnership profits that accrue to a settlement of which the CFC is a settlor/beneficiary; or

d) unilateral transfer pricing adjustments or tax rate reductions.

In our case, it was unlikely that any of the conditions would be met as the income is exempted under the Brazil/NL DTA

3. Other Entity Level Exemptions

Other entity level exemptions include the low profit exemption, low profit margin exemption and the exempt period exemption. These were not relevant in our case.

As DutchCo was not able to benefit from any entity level exemptions, we then had to consider the Trading Profits Safe Harbour. The safe harbour would come into play if DutchCo:

- had business premises in the Netherlands (that were occupied or intended to be occupied with a reasonable degree of permanence, i.e. for 12 months);
- had no more than 20% of its income, management expenditure or exports deriving from the UK; and
- had no IP rights transferred to it from the UK within the last 6 years.

By way of example, if DutchCo had its own dedicated office space (e.g. renting a desk within the office of a trust/fiduciary provider), this would be sufficient to constitute 'business premises', but there has to be a member of staff (e.g. a local resident director) occupying it. HMRC guidance indicates that the member of staff should be sufficiently skilled and qualified to carry on the activities of DutchCo. This ought to be possible by engaging the services of a local trust company.

Assuming DutchCo did not have any income, management expenditure or exports deriving from the UK and had no IP transferred to it, there was a strong likelihood that it would meet the safe harbour. It would, of course, be possible to apply for non-statutory clearance for this reason. UKCo would need to claim on its tax return (CT600B) that DutchCo was not chargeable as a result of this safe harbour.

For completeness, we also considered whether DutchCo's profits would "pass through" the Initial Business Profits Gateway (Chapter 3, s.371CA). Essentially there are 4 conditions and if just one condition is met, there would be no CFC charge:

A. Purpose test – it was unlikely that DutchCo would meet this condition in our case.

B. No UK managed or controlled assets or risks – there would be no one in the UK to contribute to the development, creation, exploitation or acquisition of DutchCo's assets, or take on or bear its risks. Therefore, there was a strong chance that DutchCo would meet this condition and there would be no CFC charge.

C. Even if DutchCo did have UK managed or controlled assets or risks, provided it could outsource such functions to an unconnected party, without having to change the nature and scope of its business and have the capacity to select and manage the unconnected party, no CFC charge would arise.

D. If DutchCo generated property business profits - no CFC charge would arise. The aim of this condition is to carve out property investment income from the CFC charge, presumably because it is usually taxed at source and a credit given in the UK, i.e. no significant additional UK tax to collect. It is possible that this exemption would also apply as the profit would be subject to Brazilian tax. It is interesting to note that HMRC guidance is silent as regards gains on a land "flip".

In summary, we found that there was a strong chance that DutchCo's profits would not pass through the Initial Business Profits Gateway as it would likely meet Conditions B (C, and possibly D). However, only one of the conditions must be met to fall outside the CFC charge. Taking into account the fact that we considered that the Trading Profits Safe Harbour test would also be met, it was our view that DutchCo would not be a CFC for UK tax purposes.

The above case study illustrates the complexity of the new rules but also that they do provide generous and much welcomed exemptions on various levels.

SWITZERLAND

The end of the Forfait?

Not only is bank secrecy looking like a thing of the past but the lump-sum tax rulings used by the likes of Schumacher, Hamilton, Phil Collins and so could also be on the way out. As we have previously reported, five Cantons since 2009 have abolished this practice, most notably Zurich. By contrast five Cantons have reinforced their offering of lump-sum deals, perhaps waiting for the influx of miserable Frenchies unhappy with Monsieur Hollande's hike in income tax rates (interestingly it seems that London is winning the race over Geneva). Two of the Cantons happy to keep offering forfaits, Bern and Lucerne, have increased the lump sum to seven times the rental value of the Swiss residence and in the case of Thurgau this has been increased to 10 times.

A parallel can be drawn with the UK and the taxation of non-doms in that this is an issue that has been a thorn in the side of the Government of the day for many years. The British way of doing things though is quite different to the Swiss and we doubt we will see a referendum on the subject any time soon. Whilst the benefits of being a non-dom here in the UK have been slowly eroded over the past decade, the non-dom regime is still taxpayer-friendly and continues to set an incentive for foreign doms settling in the UK.

USA

FATCA: The Isle of Man, Jersey & Guernsey sign up…

To assist the US with its pursuit of international tax transparency, the Governments of the Isle of Man, Jersey and Guernsey have been the latest to (unsurprisingly) announce their intention to enter into agreements with the US to implement The Foreign Account Tax Compliance Act (**FATCA**). More on these agreements later, but first let's look at FATCA and what this means for US individuals.

FATCA was introduced by the Hiring Incentives to Restore Employment Act signed on 18 March 2010 and becomes effective on 1 January 2014. It introduces rules aimed at preventing tax abuse by US taxpayers using offshore accounts. The US hopes to gain mutual assistance with other governments to improve international tax compliance and, in particular, ascertain information about US taxpayer's affairs outside the US. It has achieved this by essentially pointing a gun at the head of Foreign Financial Institutions (**FFIs**) that maintain financial accounts for US taxpayers. An FFI, as you might imagine, includes banks, trust companies, fiduciaries and so on. Somewhat generously, on 24 October 2012, the IRS announced a delay in FATCA's implementation to give FFIs more time to prepare.

FATCA will not be able impose a direct legal obligation on FFIs to disclose the information (since this is prima facie unenforceable outside the US). Instead, from 1 January 2014, US source income received by a FFI (e.g. US dividends, interest, royalties, rents etc) will be subject to a 30% withholding tax. The IRS has said that FFIs have until 30 June 2014 to properly comply. This is a considerable period of time for FFIs to get their houses in order.

So, by way of example, let's assume John Doe is the grantor settlor of a foreign grantor trust. JD is a US citizen and the naughty boy established the trust on the recommendation of his trusty Swiss private banker back in the mid-1980's. Not only will US source income be subject to US domestic withholding at 30% but such income will also be subject to a further 30% FATCA withholding. Coupled with interest, penalties and back taxes there won't be much left of JD's trust fund after the IRS has had their way!

From 30 June 2014, FFIs will be obliged to:

i) undertake certain identification and due diligence procedures with respect to its US accountholders;

ii) report annually to the IRS; and

iii) withhold and pay over to the IRS 30% of any payments of US source income, as well as gross proceeds from the sale of securities that generate US source income, made to

a) non-participating FFIs,

b) individual accountholders failing to provide sufficient information to determine whether or not they are a US person; or

c) foreign entity accountholders failing to provide sufficient information about the identity of its substantial US owners.

The extent of the identification and due diligence procedures required will depend on the balance of the account. For instance,

- pre-existing individual accounts with a balance or value of less than $50,000 OR pre-existing entity accounts with a balance of less than $250,000 are exempt from reporting;
- accounts up to $1 million are subject only to a review of electronically available records (i.e. those available on a database search); and
- accounts in excess of $1 million require a manual review of paper records.

The FATCA agreements with the Isle of Man, Jersey and Guernsey will follow the draft model intergovernmental agreement "**Model 1**" published by the US on 26 July 2012 and will be in similar form to that agreed between the UK and the USA signed on 12 September 2012.

Under Model 1, it is the Governments who are required to exchange information regarding accounts held by US account holders. The impacts of this will be far-reaching: FFIs will have to divulge information about US account holders (including the US taxpayer's address, taxpayer identification number, account number and balance) to the UK authorities, who will then in turn disclose it to the US.

FFIs can alternatively enter into direct agreements with the US authorities themselves ("an FFI Agreement"), although this would be unnecessary where there is an intergovernmental agreement in place, such as in the UK. Switzerland, for example, has agreed to enter an agreement with the US but only to the extent that the obligation to report to the IRS lays directly on the FFI ("**Model 2**"), not the Swiss government.

The US has not yet released a draft Model 2, so it will be interesting to see how the provisions differ from Model 1. There is still much to distil between now and the implementation of FATCA, however we have fortunately been blessed with a little more time.

FRANCE - THIN CAPITALISATION

A Growing EU Trend in Limiting Deductibility of Interest

France is the most recent EU member state to introduce further measures limiting tax deductible interest. This follows other EU countries such as Germany, Finland, the Netherlands, Spain and Sweden who have also introduced measures to further tighten these rules.

Presently, France restricts the ability to deduct interest expenses from related-party debt or third party debt guaranteed by related parties when calculating corporate income tax. However, the Finance Bill 2012 (adopted on 28 September 2012) has introduced further restrictions to limit the deduction of interest on any type of debt to:

- 85% of the total amount of deductible interest paid in 2012 and 2013; and
- 75% of the total amount of deductible interest paid from 2014.

These restrictions will also only apply if over €3mn of interest is deducted (apart from where the interest relates to intra-group loans).

Elsewhere in Europe, Germany, has introduced a bill limiting its interest deductibility rules - the original proposal that net interest expenses would be deductible to the extent that they do not exceed 30% of the result of business, plus interest expenses etc has been watered down. Finland and Spain currently limit interest deductibility to 30% of taxable income before EBITDA. The Netherlands, taking a somewhat different approach, prohibits "excessive participation interest expenses" where over €1mn of interest is deducted.

Despite these variations in approach, the common aim here is to reduce the extent to which group structures can use intercompany debt and claim excessive interest deductions to reduce their tax liability.

The UK's approach is based on section 152 of the Taxation (International and Other Provisions) Act 2010 which provides that the payment of interest by a company funded principally with debt is subject to transfer pricing rules. The UK rules essentially require an assessment of what the rate of interest would have been as between unconnected parties and whether the loans would have been made either at all, or if made, for a lesser amount.

Will there be an announcement that the UK will follow suit in the upcoming autumn statement? We shall see…

TAXATION OF SPORTSMEN

Usain Bolt Raises the Sportsmen Worldwide Tax Conundrum

Following the Olympics this summer, Usain Bolt announced that he will not race in the UK again until our tax laws are changed.

Usain objects to the law that means he is taxed on worldwide sponsorship, endorsement earnings and appearance fees when he competes in the UK. Likewise, Nadal pulled out of this year's Aegon Championships (his usual warm-up for Wimbledon) due to the UK's tax regime which means he loses money when playing in the UK. For instance, say worldwide earnings are £10mn per year, and Usain is in the UK competing for 2 weeks, he would be taxable on 2/52 of £10mn. As this would be approximately £400,000, and as it is unlikely any appearance fee would be substantially more, it does not make his appearance worthwhile (from a financial perspective). Of course the Olympics was the exception to the rule. For some reason, not fully made clear by HMRC, the above rule was waived for the Olympics and has now been restored to its full glory.

Generally, sportsmen are considered in a separate category when it comes to source of income and residence. Article 17(1) of the OECD Model Convention with respect to Taxes on Income and Capital 2003 states that income derived by a resident of one state from his personal activities as such exercised in another state, may be taxed in the other state. This extends to income received by companies or any other entity (Article 17(2)), such as a "loan out" corporation.

The case of *Agassi v Robinson* was interesting in that Agassi (neither resident or domiciled in the UK) was faced with the same issue, so entered into endorsement contracts with Nike and Head Sports AG (neither with a residence in the UK) via Agassi Enterprises Inc (again, not UK resident). Pursuant to these contracts, Agassi Enterprises received the endorsement payments.

Proceeding to the House of Lords, it was ruled that the payments by Nike and Head Sports AG were within sections 555(2) and 556(2) ICTA 1988 (the domestic law provisions in respect of Articles 17(1) and 17(2)). Agassi's activity was to be treated as performed in the course of a trade, profession or vocation exercised by him within the UK even though the payments were between all non-resident companies.

The dissenting judgment of Lord Walker expressed some doubt that a sportsman should have to pay UK tax on merchandising income received from overseas non-UK resident companies; however, the majority agreed it should be.

Although the Government did waive these rules for the Olympics, it will be interesting to see whether the Government would consider relaxing the rules for good. As Lord Walker pointed out in 2006, "*it is important to bear in mind that these provisions were first introduced 20 years ago, and the facts of economic life for […] sportsmen may have changed during that time.*" We are now a further 6 years on from the Agassi judgment, and perhaps it is time to consider making other exceptions to the general rule. Given the current economic climate, however, it is unlikely that the whining of very well paid sportsmen and entertainers will be sufficient reason to change UK tax policy.

UK / EUROBONDS

Quoted Eurobond Withholding Tax Exemption Plans Dropped

We reported in our **May 2012** newsletter that HMRC had issued a consultation document which, among other issues connected with interest payments, considered the withholding tax exemption on quoted Eurobonds. HMRC's original proposal to remove the quoted Eurobond exemption in certain circumstances has now been withdrawn. Critics argued that it would reduce the UK's competitiveness, present a burden for the private funds industry and would not bring in the yield expected.

Presently, interest payments made by a UK company on quoted Eurobonds are not subject to withholding tax. This exemption, aimed at facilitating overseas financing, is very broadly drafted and had led to the use of Eurobonds in ways that were not originally envisaged. HMRC proposed to introduce a withholding tax on such payments to prevent the abuse of 'artificial' use of bonds, as we reported.

The reactions to HMRC's proposal, it transpires, have been mostly unanimous: The removal of the exemption would make the Eurobond market in London unattractive and uncompetitive with the rest of Europe. As such, this development is welcome news.

REMITTANCE BASIS

Draft Legislation for Individuals Using Remittance Basis in the UK

HMRC has also published draft legislation to give statutory footing to the Statement of Practice (SP1/09). It will set out how transfers can be made from an offshore account holding only income or gains relating to a single employment and the apportionment of earnings where an employee is taxed on the remittance basis.

Under SP1/09, employees who are resident, but not ordinarily resident, in the UK are only taxed on foreign-source income if it is remitted to the UK. Where such employees pay all their income into a single off-shore account (and the account becomes a mix of foreign income and UK income), SP1/09 provides that the tax liability will be based on the amount transferred out of the account on an annual basis (rather than on a transaction-by-transaction basis which is more burdensome).

SP1/09 applies to any employment income including foreign relevant earnings, termination payments, the proceeds from employee share schemes, employment income subject to a foreign tax and bank interest arising on the account. It does not apply to transfers made from a mixed account containing income or gains from more than one employment or more than one individual; however, it can apply where an account is held in joint names so long as the second person has no income or gains of his/her own.

The proposed legislation is intended to simplify and clarify these rules. It will only apply where an employee:

- qualifies for Overseas Work-day Relief (replacing the requirement that the individual is “resident and not ordinarily resident” (the concept of “not ordinarily resident” which is being abolished on 6 April 2013);
- claims remittance basis and has earnings for UK and non-UK work-days;
- nominates an account for use as a mixed fund to which the rules will apply; and
- pays only the types of income and gains above into the account.

We welcome the clarification this will bring. Nominating a bank account is not currently required by the existing SP1/09 rules, so practical difficulties are anticipated for individuals arriving in the UK who have not received tax advice in time (back-dating in nominating an account is not allowed) and sometimes it is not clear when an individual becomes or ceases to be resident (for the purpose of making the nomination). Similarly, the rules on apportionment of earnings between UK and non-UK work days will still be treated on a ‘just and reasonable basis’.

HMRC is seeking views on the draft legislation by 7 December 2012, so we will continue to monitor this development.

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