MILESTONE TAX NEWS

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Clear. Concise. Commercial.

The Milestone Outlook

Christmas is almost upon us…again!

As 2012 draws to a close it's fairly safe to say that this has been the year that tax really hit the headlines. It has been non-stop, especially in recent months with Amazon, Google, Starbucks and many others being hauled over the coals. The debate has, however, in our view reached a very low point; the abject ignorance of MP's and the press as regards tax has even spread into HMRC publications (the Autumn Statement using euphemisms such as "tax dodgers"). We can only hope that future pronouncements and any proposed legislation will be more considered and that the shameful "kangaroo court" convened by Margaret Hodge has not irreparably damaged the UK's standing as an investment destination for foreign multinationals.

We've enjoyed a very busy and productive year, especially in the media. Miles appeared on Channel 4 news (commenting on the use of EBT's and the Rangers tax case – which we report on in this edition of the MTN) and more recently on the Voice of Russia Radio on the MNC avoidance debate. We have also featured in various broadsheets and tax journals commenting on a wide range of topical tax issues (for all our comments please click **here**). Andrew has been busy writing an excellent detailed summary of the New CFC Regime for Tolley's Tax Digest and our latest recruit to the tax team, Sally Brown, has been putting pen to paper writing a series of private client Practice Notes for Lexis Nexis.

Meanwhile, Conor has been beavering away in Switzerland lecturing for the Université de Neuchâtel's International Tax Masters programme.

At the end of December we say farewell to the long-suffering Lynette who is returning to her native Australia with her partner Wayne and their twins (Sheila and Bruce) who are due to arrive in March. The office won't be the same without Lynette. She is replaced by Lianne who joins us from Berwin Leighton Paisner and whom many of you will get to know in the coming months and years. We wish them both luck!

As usual we are not sending Christmas cards out but donating our budget to Teenage Cancer Trust.

So that's it folks… have a wonderful Christmas and a very prosperous New Year.

Happy reading!
The Milestone Tax Team

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DEAL OF THE WEEK

We were recently asked to advise a multi-national company on the tax consequences of their inter-company loan relationships – akin to a spider web!

Brief facts as follows:

- Our client, headquartered in the Isle of Man, has a significant presence in China.
- To assist local working capital requirements, a series of inter-company revolving facilities (an understatement to say the least) were entered into.
- Recently, an offer was made by a third party to acquire one of the Chinese operating companies (**DebtorCo**).
- However, not surprisingly, DebtorCo had inter-company debt from its Chinese sister company (**LendCo**) which had to be dealt with prior to any sale.

The primary issue was that DebtorCo did not have access to sufficient free capital to repay the borrowings so alternative courses of action had to be considered.

Any tax adviser with experience in the Far East will know that the People's Republic of China (**PRC**) is unusually complex. While there are a general set of taxing provisions, each district tax office exercises considerable discretion in reaching their own interpretation and application of the law. This can prove difficult in providing clients with transaction security.

Two further complicating factors were that inter-group lending is prohibited in the absence of a registered banks involvement. Order No. 12 of the People's Bank of China [1996] prohibits non-financial enterprises from engaging in a financial business, such as accepting deposits or the making of loans. Where a non-financial enterprise engages in lending / borrowing without the permission of the People's Bank of China penalties can be imposed ranging from one to five times the 'illegal income' (i.e. the interest income).

In the absence of sufficient free capital, the remaining options would be to waive the debt (giving rise to income in DebtorCo) or capitalise it (creating a cross shareholding in the Group). Neither option was particularly attractive. However, DebtorCo also had a tax asset (carried forward tax losses) that would assist in limiting the adverse consequences of a debt waiver. In addition, capitalisation of the debt was likely to take 3–4 months.

The Chinese tax outcomes of a debt waiver can be summarised as follows:

i) a non-deductible loss in LendCo; and

ii) an income item equal to the debt waiver amount.

The primary concern we had was that, while the expected tax outcomes seemed clear, given the general prohibition on intra-group lending, the district tax office could refuse to allow the tax asset to be utilised. This would create a significant cash tax liability that would make the transaction unpalatable to the purchaser.

Chinese tax counsel confirmed our view that each step would generate the tax outcome we expected. In addition, we approached the district tax office on a no-names basis who also agreed with our analysis.

Although both options were available in dealing with the intra-group debt, our client wished to pursue the waiver course of action to utilise the tax asset and allow transaction completion to occur more quickly. What is critical for readers to remember, if engaged in similar activities, is that inter-group lending in China is, in general, not permitted in the absence of financial institution involvement. That said, we know of several cases where the Chinese authorities have turned a 'blind eye' to such arrangements. The downside, as illustrated here, is that where the options for dealing with existing intra-group debt are limited, it is likely that a one-sided tax result will occur.

CHINA

Beneficial ownership

Earlier this year, the Chinese State Administration of Taxation ("SAT") issued "Announcement 30" on the interpretation of the term "beneficial owner" under China's tax treaty network (Announcement [2012] No.30). Previously, in 2009, the SAT issued "Circular 601" on the same topic (Circular Guo Shui Han [2009] No. 601).

These documents affect the availability of tax treaty reliefs for anyone who is seeking to repatriate income from Chinese investments (whether by dividend, interest or royalties) since to rely on an exemption or limitation from Chinese withholding tax under a tax treaty the recipient must be a person resident in the treaty jurisdiction and also the "beneficial owner" of the income.

What is interesting is that China appears to be "going it alone" in terms of unilaterally defining the concept of "beneficial ownership". By contrast, the OECD is striving towards a universal understanding of the concept of "beneficial ownership" through the issue of its recent discussion draft and amendments to the OECD Commentary.

In general terms, the Chinese test of "beneficial ownership" is tougher than that advocated by the OECD. For example, Circular 601 lists a number of "adverse factors" including matters such as whether the recipient is subject to low tax in the treaty jurisdiction and whether the recipient conducts other business activities apart from the holding of the investment. It is difficult to see what such factors have to do with the concept of "beneficial ownership" of an item of income and an overseas investor might reasonably complain that by unilaterally defining beneficial ownership in such a restrictive manner the Chinese are reneging on their pre-existing tax treaty obligations, although one cannot imagine such complaints are likely to bother the Chinese. In this respect China follows in the grand traditions of any self-respecting global superpower by unilaterally shifting the goalposts set out in their international agreements.

Announcement 30 builds on the terms of Circular 601 by promising rigorous investigation of financial statements, cash movements, contracts and other factors in determining whether a person is the "beneficial owner". However, there is some respite in the form of a "safe harbour" whereby public companies are presumed to be the beneficial owner of dividend income from their Chinese investments. This potentially opens the door for some dividend planning whereby investors might sell Chinese shares to a public company in a treaty jurisdiction cum dividend, but subject to a repurchase agreement.

Another interesting feature of Announcement 30 is that a recipient can declare itself not to be the beneficial owner of an item of income on the basis that the recipient is an "agent" in which case the "principal" can (if resident in a treaty jurisdiction) potentially claim treaty benefits. This is subject to the Chinese reserving the right to impose taxes and penalties in the event that they find out that the "agent" is not really an agent and is in fact receiving the income on its own behalf. This develops an idea already set out in the OECD Commentary, although the procedure for a declaration of agency is novel.

Perhaps the broad message for investors into China is to bear in mind that, as borne out by the "Deal of the Week", the Chinese tax system can present some unique challenges in terms of structuring inbound investments.

UKRAINE

New Cyprus double tax treaty

We reported in our September 2010 MTN that Ukraine and Cyprus were involved in lengthy negotiations for a new tax treaty to replace the old USSR / Cyprus treaty.

The new treaty is expected to take effect from 1 January 2014. The current USSR / Cyprus treaty permits Cyprus to be used very favourably for holding company operations as there is no withholding tax on dividends. However, the future withholding rates will be:

1. Dividends – 5% (if the beneficial owner holds at least 20% or has invested at least €100,000); and 15% in all other cases;
2. Interest – 2%;
3. Royalties – 5% (for the use of any copyright of scientific work, trade mark, patent, secret formula, etc. and 10% in all other cases; and
4. Capital gains are taxed in the state in which the person making the disposal is tax resident.

As a result, Cyprus will no longer be as attractive a holding company jurisdiction for Ukrainian investments (although the new Cyprus treaty will continue to provide exemption from capital gains on Ukrainian real estate investments).

However, as we also reported, Panama is still on the white list (remarkably) and provides an attractive alternative. We have also had experience of using a Labuan company (Malaysia), which, still operating by the old USSR treaty, provides favourable treatment for the taxation of dividends distributed by Ukrainian companies. As with the current Cyprus treaty, the result is no withholding tax on dividends.

ECJ RULING ON ACT

Judgment passed down on Test Claimants in the FII Group Litigation v Commissions of Inland Revenue, HMRC

This case has been on-going since 2006 when the ECJ examined the UK's old advanced corporation tax (**ACT**) regime and its compatibility with EU law. In a judgment delivered on 13 November, the ECJ held that ACT must be regarded as a restriction on freedom of establishment and on capital movements prohibited by Articles 49 and 63 (respectively) of the Treaty on the Functioning of the EU (**TFEU**). The ECJ also considered that the objectives could have been achieved by less restrictive measures. The implication of this judgment could see unlawfully levied ACT being repaid. This bill may run to billions.

ACT on dividends was abolished from 6 April 2009. Prior to that, UK resident companies that paid dividends to shareholders were liable to pay ACT on the amount or value of the distribution (s.14 ICTA 1988). Together with the dividend, any corporate shareholder would be entitled to a tax credit in respect of the ACT already paid. This was known as "franked investment income" in the hands of the receiving company.

However, where a company received income from an overseas subsidiary, it would not be able to set off all or any ACT. Where a substantial amount of income was received, the ACT liability on its distributions could exceed its UK corporation tax liability (as reduced by double taxation relief on the overseas income). In this case, the company could elect that a distribution paid to shareholders would be treated as a "foreign income dividend" (**FID**) and it could claim a refund of surplus ACT. The election meant that while nationally-sourced dividends were taxed according to the exemption method, FIDs were taxed according to the imputation method.

The crux of the argument was whether, in light of Articles 49 and 63 TFEU, the "exemption" method and "imputation"

method were equivalent. Under the exemption method, resident companies receiving nationally-sourced dividends did not have to pay corporation tax on those dividends. By contrast, when a resident company received FIDs, it was liable to corporation tax. While this additional corporation tax liability could be offset against its profits in its country of residence, the ECJ held that they were not equivalent.

The ECJ considered that the ACT reductions for FIDs were not granted at an equivalent stage so nationally-sourced income had the benefit of a lower tax base (due to reliefs granted at an earlier stage). Given the current perilous state of the UK's finances, we anticipate that this judgment will not be warmly received in Whitehall!

UK

Rangers' Employee Benefit Trusts ruling

Another case of HMRC attempting to crack down on a perennial thorn in its side – the Employee Benefit Trust (**EBT**). Perhaps surprisingly, given the way in which many of these vehicles have been used and sold, the First-Tier Tribunal (**FTT**) ruled (albeit not unanimously) that an EBT structure is legitimate tax planning.

This case has been much reported in the press (and Channel 4 News – Miles!) due to the on-going Rangers insolvency saga and is set to continue as HMRC are likely to appeal. However, we thought it may be of some interest to readers for us to summarise what an EBT is and the majority view of the FTT.

FACTS

Rangers engaged a company in the Murray Group that established an "Employee's Remuneration Trust" (the **Trust**) for the benefit of its employees and their families. The Murray Group consisted of around 100 companies, such as Rangers FC, which would pay monies into the Trust. The Trustees would then create a sub-trust for the family of a particular employee (the footballers as opposed to the ground staff and tea ladies of course!). Loan facilities (at commercial rates on a discounted basis) were also made available to the employee from the Trust. Besides the obvious income tax benefits this provided to the employee and his family, it would also be a debt on his estate on death and could offer an inheritance tax advantage.

MILESTONE COMMENTARY

HMRC claimed that the payments into the Trust and/or benefits taken by the employee should fall to be taxed as earnings from their employment, with PAYE and NIC liabilities arising for the employer.

Interestingly, the *Ramsay* principle formed the essence of HMRC's contentions. However, the majority believed that:

> "it would seem that even in cases of "aggressive" tax avoidance, such as the present case, the application of the *Ramsay* doctrine to strike at tax saving arrangements may be fettered in a context where there is already a highly prescriptive statutory code and, also, enforceable legal structures in place which are of fundamental practical effect, and not merely incidental or artificial for tax avoidance purposes only."

The majority also considered that the arrangements here were just that – the trust structure and loans were regarded as "genuine legal events with real legal effects" (quoting *CIR v Mayes [2011] EWCA Civ 407*.) They held that the employees did not obtain an absolute legal entitlement to the monies – the payment to the Trust was merely an expectation and what was received was a loan. As a result, payments made to the Trust were not to be treated as earnings and therefore not taxed as such.

Given recent case law in this area, the outcomes, while possibly surprising to the "man on the Clapham Omnibus", were relatively predictable. What is likely to change is the approach a court may be allowed to adopt under a General Anti-Avoidance Rule (GAAR). While the legal form of a transaction cannot be wholly ignored in reaching any tax conclusion, it's likely a court might reach a different conclusion for 'egregious' planning under GAAR.

INDIA

Cadbury's accused of tax evasion

Drum roll please…the most recent corporation to hit the headlines over alleged tax avoidance / evasion (at the time of writing) is the renowned chocolatier – Cadburys (this time Indian tax evasion). Although the line between avoidance and evasion has become, at least for the media, blurred here in the UK, the Indian Minister of Finance, Mr Palanimanickam has announced that "two cases of tax evasion by Cadbury India have been detected … during the years 2009–10 to 2012–13."

One case relates to service tax evasion involving £1.5mn. The other case relates to central excise duty evasion at a plant controlled by Cadbury involving £22.5mn. It is understood that Cadbury will argue that the location of the plant was in an excise duty exempt area. However, the Indian tax officials have disputed this. Now that proceedings are under way, we will follow this case with interest but doubt very much that evasion will be proven.

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No responsibility can be accepted by Milestone for action taken as a result of information provided or opinions expressed in this publication. Readers are strongly recommended to take advice on their particular situations.

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