MILESTONE TAX NEWS

ISSUE 40

31 May 2013

Clear. Concise. Commercial.

The MO

Welcome to the May edition of the MTN.

Another rollercoaster of a month in the life of Milestone: the Awards season saw us being pipped to the post at the International Tax Review Awards and Miles coming runner up in the Tax Writer of the Year category at the Taxation Awards. However, we did win International Tax Team of 2013 at the Taxation Awards (for the second time since Milestone was established by Miles and Andrew in 2008). A 1:3 success rate can't be sniffed and the picture opposite shows Miles and Sally collecting our award!

In and around the awards we have been busy commenting on the on-going tax debate culminating in TV and radio appearances by Miles on ITV, Channel 4 and BBC Radio 4. In addition to this, we hosted a public debate in the House of Commons, chaired by Guto Bebb MP (a member of Public Accounts Committee chaired by none other than the rather conflicted and bearer of double standards Margaret Hodge MP). For coverage of the debate please click here. This current tax debate shows little sign of waning with recent unprecedented and wholly unnecessary attacks on Marks and Spencer's online operations. Suffice to say this is likely to rumble on and on!

This month's MTN will be supplemented with a brief summary of some of the cases we have been working on recently to whet your appetite and spark your imagination. This edition contains the usual mish mash of news and cases. We take a look at the Cyprus fallout and what clients investing into Russia can do (assuming they no longer feel 100% comfortable with Cyprus). We also look at Sergio Garcia's recent run in with the IRS (we're leaving Tiger Woods out of this!) and image rights in general. In addition, Google India, FATCA and Deeply Discounted Securities all make an appearance.

As usual we welcome all feedback (positive, negative or indifferent) and hope you enjoy the May MTN.

Happy reading!
The Milestone Tax Team

International Tax Team of 2013 with host Tim Vine

ALSO IN THIS ISSUE...

Why not follow us on Twitter?
http://twitter.com/MilestoneTaxUK

CYPRUS

Russia / Sweden

In light of the recent financial meltdown in Cyprus, many investors into and out of Russia will be considering how best to restructure their affairs. Cyprus is, of course, the jurisdiction of choice for many Russian investors due, in the main, to the favourable terms of the Cyprus/Russia DTA. One particular area of concern will be how Russian real estate investments should now be held.

Russian Domestic Law

Under Russian domestic law, the general principle is that capital gains realised on a disposal of Russian real estate are liable to Russian tax at source, irrespective of where the owner is resident for tax purposes (i.e. there is no DTA override). So, despite the favourable terms of the Cyprus/ Russia DTA, such gains will be liable to Russian tax.

However, somewhat unusually, this general principle does not extend to the sale of shares in a foreign company that owns Russian real estate. For example, the sale of a Cypriot company by a non-resident of Russia is not subject to Russian tax even where the Cyprus company holds Russian real estate.

Equally, where a Cyprus holding company sells shares in a Russian company that in turn holds Russian real estate (a very common structure), this is also protected from Russian tax under the Cyprus/Russia treaty.

The Cyprus/Russia DTA & Protocol

However, Cyprus and Russia signed a Protocol to the existing DTA on 7 October 2010 that entered into force on 2 April 2012. The Protocol amends the DTA such that where a Cypriot company disposes of a Russian company that derives more than 50% of its value from Russian real estate, then Russia may tax the resulting gain. However, the Protocol provides that this amendment “shall have effect on the first day of January of the calendar year following the expiration of four years from the date on which the Protocol enters into force”. That is to say the amendment will only affect disposals on or after 1 January 2017.

Restructuring Options

The impact of the Protocol will be far reaching, but there is time to restructure so as to preserve the current tax benefits of the typical Cyprus HoldCo / Russia PropCo structure. In this regard there are two potential strategies by which Russian real estate gains arising after 2017 might be sheltered:

i) One could sell the shares in the Cyprus company. Under current Russian domestic tax law, Russia does not tax this transaction (irrespective of the Treaty provisions). However, it cannot be ruled out that Russia could amend its domestic tax law to impose tax on the indirect transfers of Russian real estate (as is the case in the US and Australia).

ii) We consider the more enduring solution is to insert a new holding company (either above Cyprus or immediately above the Russian company) in a jurisdiction with a more favourable treaty with Russia. In this regard, Sweden would be our preferred choice.

The use of Sweden as a holding company jurisdiction is not well known, mainly due to the fact that the country has not gone out of its way to market itself as having an overty beneficial tax regime. Its key features can be summarised as follows:

- good reputation
- politically stable
- well-developed treaty network
- non-blacklisted
- EU Member State
- a full participation exemption

In the next month’s MTN we focus on the use of Scandinavia in international tax structures, including an overview of the Swedish participation exemption.

UK

Deeply discounted securities v Eurobonds

The UK imposes withholding tax at 20% on payments of UK source “yearly interest”. A number of exemptions are available under UK domestic law, EU law and applicable tax treaties.   However, where yearly interest (otherwise referred to as long interest) is paid from the UK to a person or entity in an offshore jurisdiction (i.e. tax haven not benefiting from a DTA) then such exemptions are unlikely to be available.

Over the years, taxpayers and their advisers have utilised a range of strategies to address such exposure. However, the options are becoming limited due to two trends:

i) First, the OECD has been instrumental in evolving the concept of beneficial ownership (without which tax treaty claims are denied. In this regard, see *Indofood, Prevost, Royal Dutch* and so on). The result is that tax treaty planning using conduit entities in benign tax treaty jurisdictions is becoming increasingly tenuous. For example, Dutch finance companies once *de rigeur* are having to be revisited (despite claims that such companies are indeed the beneficial owner of all the interest they receive where, in reality, they may actually only retain a minimal “spread”); and

ii) Second, HMRC has sought to tighten the scope of the UK domestic charge to interest withholding tax. For example, following a recent consultation, Finance Act 2013 will introduce rules that will seek to capture debts previously considered to be non-UK source (such as specialty debt and the location of the loan instrument is outside the UK).

There are, however, two options still available to minimise UK interest withholding tax on payments to offshore entities (leaving aside treaty-based solutions).

i) First, the exemption from UK interest withholding tax on Quoted Eurobonds remains available. However, HMRC’s recent consultation points the finger at stock exchanges *“in territories such as the Channel Islands and Cayman Islands”* where bonds are listed but not actually traded and on which gross interest is paid as a method of stripping profit from a UK company to a related offshore entity. The Finance Act 2013 does not include provisions that seek to unwind the Quoted Eurobond exemption, but clearly this is an area in which HMRC perceive that change may be required.

ii) Second, to the extent that finance is issued at discount or repayable at a premium, the discount or premium element is potentially outside the charge to UK interest withholding tax, provided of course that any such discount or premium is not in the nature of interest. This distinction between “discount” or “premium” and “interest” was considered in a 2011 tax case (*Nicholas Pike TC 01151*) in which the “discount” in a badly drafted security document was held to be “interest”.

With careful drafting, deeply discounted securities remain a viable way of financing a UK business from an offshore jurisdiction without exposure to UK interest withholding tax (and without enriching territories such as the Channel Islands and Cayman Islands with listing fees!) Now what could be better than that?

The Sergio Garcia Case

Despite the protestations of various swivel-eyed loons of the tax world, intellectual property of all forms does have intrinsic value. The value of Starbucks' logo and shop layout is just as important to its success as Amazon's distribution model and Google's algorithms. Equally a sportsperson or an entertainer can have very valuable image rights. The football world is rife with tattooed prima donnas whose agents claim they have image rights worth megabucks. In some cases this is warranted: Beckham is the classic example where his brand has eventually swamped his footballing prowess.

The same might not be said of Bastian Schweinsteiger of Bayern Munich whose name roughly translates to "pig mounter" and who was embroiled in a court case several years ago with a salami manufacturer who used his nickname "Schweini" on one of their piggy products. Anyway, we digress… golfers like other sports stars are often instantly recognisable and are ideal walking billboards for their sponsors (more so than footballers it could be claimed).

Sergio Garcia is one of the world's most recognisable golfers (he is also quite adept at putting his foot in his mouth but that's another story) and has long been associated with the US club and apparel manufacturer TaylorMade. Just before this year's Masters at the Augusta National, the US Tax Court issued a decision that will potentially have far-reaching implications for foreign sportsmen and entertainers performing in the US. It has to be said, however, that the case was a success for Garcia more than the IRS.

Facts

Garcia (a Swiss tax resident) initially entered into a license agreement with TaylorMade (TM) for the use of his image rights, under which it made him its only golfing "Global Icon" (despite never having won a Major and being prone to the odd "meltdown"). In return for allowing TM to use his name, likeness, voice and so on, Garcia was obliged to wear TM apparell on and off the course.

The initial endorsement agreement entered into between Garcia and TM did not allocate the compensation between personal services and royalty income. However, the contract was subsequently amended whereby both parties agreed that 15% of the compensation was for Garcia's personal services and 85% was for Garcia's image and likeness. The importance of this split is that the compensation for Garcia's image and likeness was potentially payable gross under the royalty article of the Switzerland/US DTA (but more of that later) with the personal services income being subject to tax at source in the US.

Accordingly, Garcia filed US tax returns in 2003 and 2004 reporting the TM income as to 15% from personal services and 85% as royalty income. The IRS subsequently audited the returns and, in accordance with published guidance, it adjusted the income to 100% from personal services, all of which was assessed to US income tax at 35%.

US Tax Analysis

A general principle of US tax law is that non-residents, such as Garcia, are only liable to US taxation if they are engaged in a US trade or business (i.e. if the income they receive has a US source). The performance of personal services (e.g. playing in the Masters) amounts to a trade or business and as such income derived from such sources, in the form of salary, fees, compensation, bonuses and prize money for performances in the US is subject to US taxation.

So, while personal service income is sourced where the services are performed, a royalty is sourced where the property is exploited. To this end, royalty income is also subject to US taxation if it is connected with the performance of services in the US. If there is no such connection, it is liable to tax at the flat rate of 30% unless the royalty article of a relevant double tax treaty applies. In Garcia's case, it was the Switzerland/US DTA.

Tax Court Decision

Interestingly the Tax Court rejected both parties' allocation (Garcia's 15/85 and the IRS's 100/0) noting in particular that the agreement with TM was not intended to compensate Garcia only for his personal services. The Tax Court held that the correct allocation under the TM agreement was:

Personal services income: 35%
Royalty income: 65%

This is the second "golf case" in as many years where the Tax Court has disagreed with the IRS's position that all income under an endorsement agreement is personal service income. Retief Goosen, the South African golfer and two-time Major champion, was subject to a similar re-allocation, albeit in his case the Tax Court ruled that a 50/50 split was appropriate.

The Sergio Garcia Case…cont

The Tax Court came to its conclusion by taking into consideration Garcia's on-course success and concluded that more value should be attributed to his image / brand than to his ability as a golfer (Garcia no doubt swayed the Tax Court by blowing the TPC Sawgrass tournament with a quadruple bogey on the par 3 17th!).

The approach of the Tax Court in these two golf cases is interesting. Despite Goosen being arguably the more successful golfer because of his Major successes (although career earnings are very similar to Garcia's), the Tax Court noted that Garcia was the Global Icon of TM whereas Goosen was a mere "Brand Ambassador". Garcia was therefore the bigger star and a larger allocation should be made to royalty rights than under the Goosen contract.

Interestingly, Garcia was obliged to use TM's products in only 20 tournaments a year whereas Goosen was obliged to use TM products in 31 tournaments a year. In allocating between personal services and royalties, the Tax Court put significant emphasis on the use of TM products during professional play (as opposed to advertisements and off-course promotion). Because Goosen was obliged to use TM products more than Garcia was, the Tax Court allocated a lesser percentage to personal service income for Garcia than it did for Goosen.

The Switzerland/US DTA

In order to have the royalty element of the TM contract paid gross (i.e. without deduction of US withholding tax), Garcia had to argue that Article 12 (Royalties) of the DTA applied in preference to Article 17 (Artistes & Sportsmen).

Under Article 12 of the Switzerland/US DTA royalties can be paid gross irrespective of whether they are attributable to personal services performed in a different country. Under Article 17 (which the IRS argued was the appropriate provision) royalties are taxable in the state in which the personal activities to which they are attributable are performed.

The issue for the Tax Court was whether the TM income was predominantly attributable to Garcia's personal services performed in the US. In a decision that reeks of common sense, the Tax Court held that while Garcia's US personal services were connected to his image and likeness, the TM income derived from the exploitation of his image was not predominantly attributable to his performance in the US. The Tax Court held that this being the case, Article 12 was the applicable article and the royalty income was payable gross.

GAAR GUIDANCE

The Duke is Not Dead

The introduction of the General Anti Abuse Rule is nearly upon us and, in anticipation of this, HMRC has issued its own GAAR Guidance Notes (as "Approved by the Advisory Panel") - all 194 pages. It provides a broad summary of what the GAAR is designed to achieve, how it operates and various examples of when the GAAR will and won't apply, all of which is very welcome.

However, the Guidance notes (for that is what they are) attempt to subvert the rule of law by saying that certain principles established by long standing tax cases such as the Duke of Westminster, no longer apply. It was in the Duke that Lord Tomlin famously said: *"every man is entitled if he can to order his affairs so that the tax attracted under the appropriate Act is less than it otherwise would be"*.

HMRC uses the opportunity to state:

> *"It [The GAAR] therefore rejects the approach taken by the Courts in a number of old cases to the effect that taxpayers are free to use their ingenuity to reduce their tax bills by any lawful means, however contrived those means might be and however far the tax consequences might diverge from the real economic position."*

This has been trumpeted by several swivel-eyed loons as being the end to all tax avoidance. This is clearly a preposterous proposition to adopt. The quote from the Duke is often taken out of context and, in our view, Tomlin is talking about the rule of law: he considers that discretion by the authorities in respect of taxation is open to abuse and, as such, individuals can arrange their affairs so as to minimise their tax liabilities. Notwithstanding HMRC's protestations, this rule of law principle still exists under the GAAR albeit subject to a double reasonableness test referred to in para B2.4 of the Guidance notes as follows:

> *"Accordingly, it is essential to appreciate that, so far as the operation of the GAAR is concerned, Parliament has decisively rejected this approach, and has imposed an overriding statutory limit on the extent to which taxpayers can go in trying to reduce their tax bill. That limit is reached when the arrangements put in place by the taxpayer to achieve that purpose go beyond anything which could reasonably be regarded as a reasonable course of action."*

In our opinion the Duke is far from dead. He is simply subject to an overarching statutory limitation. It must be noted that the GAAR legislation provides that the Courts must take account of the Guidance Notes when considering a GAAR case. This is a highly unusual approach to take as far as introducing new legislation is concerned, especially when one considers HMRC's own argument in the Gaines-Cooper case. In this case (which will be well known to our readers) HMRC argued that the taxpayer, Mr Gaines-Cooper, could not reply on published guidance on residence (booklet IR20). Interestingly, the successor to IR20, HMRC6 (now defunct due to the introduction of the Statutory Residence Test) contains the following ambiguous health warning:

> *"These notes are for guidance only and reflect the position at the time of writing. They do not affect the right of appeal."*

Notably the GAAR Guidance Notes do not contain such wording!

And finally…

HMRC's guidance also states that *"all taxpayers should pay their fair contribution"*. It is difficult to reconcile the concept of 'fairness' with taxation and, in our view, this is a worrying inclusion in the document. As David Goldberg QC pointed out in the Debate on International Corporation Tax Avoidance:

> *"It is never truly possible to say that one form of tax is, inherently, fair or morally right and another is not: to say something like that is to confuse concepts – in particular, morality and politics".*

INDIA

Google and Yahoo in the Indian courts: ITO v Right Florists Limited

The complex issues that internet companies are posing to tax authorities are not just limited to the UK. The Kolkata Tax Tribunal (the "**Tribunal**") recently had to consider whether payments made by an Indian florist for advertising on the respective search engines were subject to withholding tax.

Facts

Right Florists Limited, an Indian company, paid for adverts on the Google and Yahoo websites. It made payments to Yahoo (in the US) and Google (in Ireland) and claimed a deduction for those payments in its accounts.

The Indian tax authority disallowed the deduction on the basis that the payments were fees for technical services ("**FTS**") and that tax should have been withheld at source.

By contrast, Right Florists claimed that the payments were in fact in the nature of business profits in the hands of the recipient and, in the absence of a permanent establishment ("**PE**") in India of either Google or Yahoo, no tax should be withheld.

The Case

The case centred on the character of the payments being made to the two non-resident companies. The Tribunal therefore, rightly, had to analyse the nature of the services being provided and concluded that:

- on-line advertisement services provided by the likes of Google and Yahoo were automated; and
- relied upon algorithmic code rather than any human intervention.

The next step was to consider the services in light of various domestic provisions that would create a tax liability in respect of the payments.

Business Connection

Under s9(1)(i) Income Tax Act 1961 ("**ITA**") the income of Google and Yahoo could be taxed in India on account of a business connection there. The Tribunal concluded that there was no evidence that the revenues of either company were supported by, serviced by or connected with any entity based in India. As such, tax could not be levied under this section of the tax code. Interestingly, Google Ireland sells its services in the UK but it does so with the assistance of its UK sales and marketing company. Had such a structure been adopted in India it is very likely that the revenues in this case would be taxable under s9.

Permanent Establishment

The Tribunal referred itself to and considered the PE provisions of both the US and Irish treaties as well as to the OECD Commentary. As readers will know, a website by and of itself cannot amount to a PE due to the absence of a fixed place, but that a server, from where the website functions can amount to a fixed place of business and therefore give rise to a PE. Because neither company had servers in India, the basic premise to establish a PE was not satisfied.

Fees for Technical Services

Technical services are those that generally involve a human element. Whilst such services can be rendered without human intervention, the Tribunal held (contrary to a number of recent cases) that a restricted approach must be taken. Because the services were rendered without any human intervention, the payments could not be considered as FTS.

Summary

The case is a welcome development in the taxation of on-line businesses and comes at a time when clarity is much needed. The Tribunal noted that the Indian Government had made a reservation to the OECD's commentary on the issue of websites amounting to PE's. However, the Government had not specified the circumstances in which a PE would be considered to exist. In the absence of any specific reasoning the Tribunal held that the reservations could not be taken into account.

This case neatly shows that internet companies are operating within the letter and spirit of the law. In our view, the attack on such companies in the UK is wholly unjustified and rulings such as this prove that if Governments want to extend the reach of tax law to internet companies they need to change the law (not just argue about fairness) . Perhaps most interestingly, in this case, the Tribunal might have reached a different decision had the Indian Government specified the circumstances in which it considered a website constituted a PE. The fact that they had not might lead to developments in this area.

EUROPE

FATCA

In a series of events over the last couple of months, the European crackdown on tax evasion and increased transparency has been ramping up. The UK, France, Germany, Italy and Spain (collectively, the "G5") have written to the European Commission announcing that they would like to work together to promote automatic information exchange to assist catching and deterring tax evaders. In addition, the EU Economic and Financial Affairs Council (Ecofin) has agreed to amend the European Savings Tax Directive (the Directive).

The idea of automatic information exchange in the letter from the G5 strikes an uncanny resemblance to the idea behind the FATCA legislation introduced in the US. The US has forged the path for legislation that requires the automatic sharing of information across jurisdictions and imposes a penal 30% withholding tax for non-compliance. As a result, the idea of automatic information exchange in Europe has been likened to a "European FATCA". Clearly, a European FATCA would have its advantages to the tax authorities of European countries by increasing cross-border tax transparency.

With respect to Ecofin's agreement to amend the Directive, it should be remembered that the aim of the Directive, even at its conception back in 2008, was to close tax loopholes, prevent tax evasion and better identify fraud. This latest announcement has allowed the European Commission to make amendments to the Directive and re-focus on tackling tax evasion, fraud and the automatic exchange of information. The momentum is fast building towards increased transparency and greater international cooperation.

MILESTONE

Milestone International Tax Partners LLP.
Registered office: 45 Clarges Street, London W1J 7EP
Registration number: OC 342622
VAT Reg no. 944 478291

LONDON

Milestone International Tax Partners LLP
45 Clarges Street
London
W1J 7EP

Phone: +44 (0)20 7016 5480
Fax: +44 (0)20 7016 5481
Email: info@milestonetax.com
www.milestonetax.com

DUBLIN

Milestone International Tax Partners Ltd
4th Floor
Ulysses House
Foley Street
Dublin 1

Phone: +353 (0) 1 876 4550
Fax: +353 (0) 1 888 1171
Email: info@milestonetax.com
www.milestonetax.com

UK Alliance Partner

Transfer Pricing Associates