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THE APPLICATION OF THE CONVENTION TO PARTNERSHIPS, TRUSTS AND OTHER, NON-CORPORATE ENTITIES

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General Discussion[1]

The Commentary – at paragraphs 2 to 6.7 – discusses the application of the Model Convention to partnerships. This Commentary was substantially amended in the 2000 version following the first report of a working party set up by the CFA in 1993 to study the application of the Convention to partnerships, trusts and other non-corporate entities. That first report – the Partnerships Report – dealt with the application of the OECD Model to partnerships. Further reports are anticipated on trusts and other entities, through there are some principles discussed in the Partnerships Report which are relevant to all these entities.

The primary issue discussed in the Partnerships Report concerns the applicability of the Convention to partnerships. This is the issue which arises from Article 1 for partnerships, trusts and all non-corporate entities. Article 1 establishes that the Convention applies in general only to persons who are residents of one or both Contracting States. This generates two questions in determining the applicability of the Convention to any non-corporate entity:

(a) is the entity a person, as defined in Article 3(1)(a); and

(b) is the entity a resident of a Contracting State, as defined in Article 4(1)?

A person is defined in Article 3(1)(a) as including an individual, a company and any other body of persons. A non-corporate entity is not an individual; it may be a company, since Article 3(1)(b) defines a company as "any body corporate or <u>any entity that is treated as a body corporate for tax purposes</u>" (emphasis added): if the non-corporate entity is treated as a body corporate, then it will qualify as a person (and almost certainly be a resident of a Contracting State as well). Chiefly, a non-corporate entity will qualify as a person if it is a body of persons.

The Partnerships Report has now confirmed that partnerships constitute bodies of persons – and the Commentary to Article 3 has been amended accordingly.[2] However, the position with other non-corporate entities is less clear. Generally, trusts and other non-corporate entities will involve associations of persons, but not necessarily a <u>body</u> of persons (in the sense that the entity constitutes a body distinct from its members). Even assuming that a non-corporate entity is a person, it must still be a resident of a Contracting State. Article 4(1) defines this term to mean "any person who, under the law of that state, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature …". This phrase is discussed under Article 4 (Residence). The view is taken there that "liable to tax" does not mean that the person must be actually paying tax in the state; entities which enjoy a complete exemption from tax are still residents of a state so long as that state could assert jurisdiction to tax the entity on its worldwide income in accordance with one of the internationally accepted bases for full tax liability (such as the establishment of the entity under the laws of that state, or the location of the management of the entity in that state). Prima facie, therefore, non-corporate entities established under the laws of a state or having their management there could be subject to full tax liability in that state. However, the problem with many non-corporate entities is that they are partially or fully transparent[3] for tax purposes in their state of establishment or management. It would be entirely inconsistent for a state to accord full fiscal transparency to an entity and yet assert jurisdiction to tax that entity on its worldwide income. Non-corporate entities which are fully transparent cannot be residents of a Contracting State. In respect of transparent partnerships, the Partnerships Report has concluded that they are not residents of a Contracting State.[4]

Thus, for all non-corporate entities, the issue of the applicability of the Convention raised by Article 1 resolves itself into the questions:

(a) is the entity a body of persons or is it treated as a body corporate for tax purposes; and

(b) is the entity fiscally transparent?

This is not, however, the end of the matter. Many of the most complex problems arise where the entity is treated differently in the Contracting States involved. Thus the entity may be treated as a body corporate and opaque in one state, while it is treated as an unincorporated association and fiscally transparent in the other state.[5] The Partnerships Report considers several scenarios where different approaches are taken by the two Contracting States. Applicability is not the only issue which arises in connection with double taxation conventions and non-corporate entities. The Partnerships Report gives examples of other issues.[6] For example, can the entity constitute a permanent establishment of its associates or give rise to a permanent establishment if the entity operates in a third State? Can the entity constitute an employer for the purposes of Article 15 (Income from Employment)? If the entity is fiscally transparent, are its associates the beneficial owners of its income?

Partnerships[7]

The application of the Convention to partnerships is discussed at paragraphs 2 to 6.2 of the Commentary to Article 1; these paragraphs were substantially amended following the Partnerships Report.

The Partnerships Report analyses the application of the Convention to partnerships largely by considering its application in eighteen scenarios. It is impossible to reproduce that discussion here, and reference is best made to the Report itself. It is not always easy to see what principles the working party applied in reaching its conclusions on each scenario. Some of the conclusions seem more pragmatic than principled. As a consequence, it is very difficult to summarise the Report. However, the following points appear from the Report, some of which have been reflected in changes to the Commentary:[8]

(a) partnerships should be considered to be "persons" within the definition in Article 3(1)(a) either because they fall within the definition of a company or because they are bodies of persons;[9]

(b) where a partnership is treated as fiscally transparent in a state, it cannot be a resident of that state for purposes of the Convention;[10]

(c) in determining whether a partnerships is fiscally transparent, the question is whether the amount of tax payable on the partnership income is determined in relation to the personal characteristics of the partners;[11]

(d) where a partnership is not entitled to the benefit of a Convention because it is fiscally transparent, the partners are entitled to the benefit of the conventions entered into by their states of residence to the extent of the partnership's income allocated to them.[12] In that situation the income derived by the partnership shall be considered to keep the nature and source it had in the hands of the partnership.[13] The income is also regarded as paid to or derived by those partners;[14]

(e) the source state, in applying a convention where partnerships are involved, should take into account the way in which an item of income is treated in the state of residence of the taxpayer claiming the benefit of the convention (i.e., broadly, the state of source should take into account whether the state of residence treats the partnership as transparent or opaque).[15]

Some of the issues arising in the application of double taxation conventions to partnerships can be illustrated from decided cases.

One can see the approach of a country of source to a foreign partnership in the decision of the French Conseil d'Etat in *SA Diebold Courtage*.[16] The French company paid rental payments to a Dutch limited partnership – a commanditaire vennootschap (CV) – in respect of an agreement for the sale and leaseback of computer equipment. The limited partner and the general partner of the CV were both companies (BV's – limited liability companies) resident in the Netherlands. Approximately 65% of the rental payments were paid on to a Swiss company. The French company contended that the rental payments were exempt from French tax under Article 12 of the France-Netherlands double taxation convention of 16th March 1973. The Conseil d'Etat held that, as the CV was fiscally transparent <u>under Dutch tax law</u>, it could not be a resident of the

Netherlands for treaty purposes. However, the rental income was to be treated as paid to the two BV's, who were residents of the Netherlands, and could benefit from the Convention. There was insufficient evidence to conclude that the BV's were not the beneficial owners of the rental income. The case shows the state of source looking at the tax treatment in the country of residence, and also operating a flow-through or derivative benefits approach by looking through the transparent entity to its associates.[17] This is all consistent with the Partnerships Report (though not with the French Government's reservations on the Report[18]).

One can contrast with this case the decision of the French Conseil d'Etat, where France was the source country but a French entity was involved, in *Re Société Kingroup*.[19] In that case, a Canadian company was a 33% participant in a groupement d'intérêt economique (GIE) established under French law. The GIE carried on a business in France. Under French law a GIE may have separate legal personality, but is transparent for tax purposes. The Canadian company argued that it was exempt from French tax on its share of the GIE profits under the business profits, dividends or royalties Articles of the France-Canada double taxation convention of 2nd May 1975. A GIE is not a partnership, but is taxed in a manner similar to most partnerships in France. It is not fully transparent;[20] the GIE must submit tax returns but it does not pay income tax, its associates are liable to the tax in proportion to their rights. The Conseil d'Etat noted that the GIE had its own legal personality and its own business. The Court then held that the business profits article only applied to profits derived directly by a Canadian company, and not to the share of the profits of a GIE to which the Canadian company was entitled. The share of profits of the GIE did not fall within the meaning of dividends or royalties. The Canadian company was not, therefore, exempt under the convention.

There have also been several decisions in the Netherlands concerning partnerships formed under Netherlands law.

The first case – a decision of the Hoge Raad of 10th March 1993[21] - concerned a commanditaire vennootschap (CV) – formed between a Swedish company and two Dutch companies (BV's). The Swedish company was a limited or silent partner; one of the BV's was the general partner. The CV was a closed CV which is treated as fully transparent under Dutch fiscal law; the general and limited partners are taxed directly on their share of the profits. The Swedish company argued that its share of the income was exempt from tax in the Netherlands under the business profits article of the Netherlands-Sweden double taxation convention of 12th March 1968. The Hoge Raad noted that the Swedish company held its participation in the CV as part of its worldwide business, and concluded that the income was derived through a permanent establishment in the Netherlands: the income was not, therefore, exempt under the convention.

The second case – a decision of the Hoge Raad of 23rd March 1994[22] – concerned a Belgian resident individual who was a limited partner in a Dutch closed CV. The Belgian resident was entitled to a share of the profits and to interest on his capital and current accounts; he contended these were exempt from tax in the Netherlands. The Belgian-Netherlands double taxation convention of 19th October 1970 contained an express provision stating that limited partnerships formed under Netherlands law, whose place of management is in the Netherlands, are regarded as residents of the Netherlands. Reasoning from this, the Hoge Raad concluded that the Netherlands could tax the profit share and interest on the capital of the silent partner since these were profits of an enterprise carried on by a Netherlands resident.

Several cases have concerned the state of residence considering the application of conventions to foreign partnerships. In *NV Immo-Part v. Belgium*,[23] the Court of Appeal of Brussels had to consider a Belgian resident which owned a share in a US general partnership (which in turn owned a share in a US limited partnership). The limited partnership owned land in the US. The Court concluded, by examining provisions of the general partnership agreement, that it was fiscally transparent. The income was therefore derived from land in the US, the taxpayer also having a permanent establishment at the office of the partnership in the US: the income was therefore exempt from tax in Belgium.

The English Court of Appeal in *Memec Plc v. IRC*[24] had to consider income derived by a UK company which was a silent partner in a German silent partnership formed with a German limited liability company. The silent partnership received dividends from shares in underlying companies. Under German law, the silent partnership had no separate legal personality and the general partner was the owner of the partnerships assets. The UK company claimed a foreign tax credit in respect of the dividends received by the silent partnership. The Court of Appeal examined the rights of the silent partner under German law. It rejected the claim for a tax credit, holding that the source of the UK company's income was the partnership agreement, not the dividends from the underlying companies. The distributions from the silent partnership were also not "dividends" within the terms of the tax credit article of the UK-Germany convention of 26th November 1964.[25]

An illustration of the practical application of a double taxation convention to a partnership comes from an Indian case, *Clifford Chance (UK) v. Deputy Commissioner of Income Tax*.[26] The UK partnership sent its partners and employed staff to advise in India. Article 15 of the UK-India double taxation convention of 25th January 1993 provides that a partnership is not taxable in India if members of the partnership are present for less than 90 days in a year. The Tribunal ruled that members included employed staff as well as partners, so that this limit was exceeded.

The U.K. approach to partnerships and double taxation conventions

The approach in the United Kingdom to partnerships and double taxation conventions has changed as a result of the decision in *Padmore v. I.R.C.*[27] In that case a U.K.-resident partner of a partnership managed and controlled in Jersey sought exemption from his share of the partnership profits under the terms of the 1952 double taxation arrangement between the United Kingdom and Jersey. In the High Court, Peter Gibson, J. held that a partnership was a "body of persons" so as to be capable of satisfying the definition of "resident" and benefit from the Arrangement: he focused particularly[28] on the fact that the Arrangement used the formula "body of persons, corporate or not corporate" as indicating that the expression did not have the meaning given to it by the Taxes Act.[29] Having held that the partnership income was exempt under the Arrangement, Peter Gibson, J. then went on to hold that the profits were similarly exempt in the hands of the individual partners. This decision was upheld on appeal.[30] The decision in *Padmore* has now been reversed by section 112(4) and (5) ICTA 1988.[31] Those sub-sections provide that, where a partnership resident outside the United Kingdom is relieved from United Kingdom tax on income or capital gains by virtue of a double taxation convention, a resident partner shall be taxed without regard to such convention. Thus these sub-sections reverse the specific impact of the *Padmore* decision without overruling the general holding that a partnership may be a body of persons, at least if words similar to those in the U.K.-Jersey Arrangement are employed. The OECD Model itself defines a person as including "an individual, a company and any <u>other body of persons</u>". The words employed are not the same as those in the United Kingdom-Jersey Arrangement ("body of persons, corporate or not corporate") so that it would be open to argument in England[32] that in conventions based upon the OECD Model "body of persons" does not include a partnership. However, the Commentary to the OECD Model, Article 3(1)(a) – at paragraph 2 – now states the view of the CFA that a partnership is a body of persons.

As a result of the *Padmore* case, the United Kingdom has begun to include specific references to partnerships in treaties recently negotiated.[33] Where neither state regards a partnership as a taxable entity separate from its partners, partnerships are excluded from the definition of a person.[34] Where, however, the other treaty state recognises a partnership as a separate entity, such a partnership is regarded as a person but a specific provision similar to the following is included:[35]

> "**Partnerships**
>
> Where, under any provision of this Convention, a partnership is entitled, as a resident of [ ], to exemption from tax in the United Kingdom on any income or capital gains, that provision shall not be construed as restricting the right of the United Kingdom to tax any member of the partnership who is a resident of the United Kingdom on his share of the income and capital gains of the partnership; but any such income or gains shall be treated for the purposes of Article ** (Elimination of Double Taxation) of this Convention as income or gains from sources in [ ]."

Trusts

The OECD Model and its Commentaries give virtually no guidance as to the application of double taxation conventions to trusts, trustees or their beneficiaries. The Model Articles make no mention of trusts, nor do the Commentaries as prepared by the Committee on Fiscal Affairs. The only express references to trusts and trustees are found in Observations and Reservations made by members of the OECD. Thus, for example, prior to its removal in 2000, New Zealand appended an Observation to Article 3[36] to the effect that dividends, interest and royalties received by a trustee and on which he is taxed are regarded as beneficially owned by that trustee.[37] The United Kingdom and Ireland have entered a Reservation to Article 21 concerning the right to tax income paid from a trust to a non-resident.[38] The working party established in 1993 which produced the Partnerships Report is considering the application of the Model Convention to trusts and other non-corporate entities.

Some states make express provision in their tax conventions for trusts. Thus, Canada and the United States generally provide in their treaties that a trust is within the definition of a "person".[39] The U.S. often follows this up by providing that a trust comes within the definition of a "resident" only to the extent that the income or capital gains of that trust are taxed in the hands of the trust or of the beneficiaries.[40] The United Kingdom provides in a number of its treaties that income paid out of a trust is excluded from the equivalent of Article 21 (Other Income).[41] There are a small number of judicial decisions and rulings around the world relating to trusts and international taxation,[42] however there are no cases which provide any significant clarification of the application of double taxation conventions to trusts.[43] There is a small academic literature, of which the major contribution is an article by John Avery Jones and others.[44]

A relatively straightforward trust situation may give rise to a large number of treaty issues. For example, suppose that a trust receives income and derives capital gains from different sources or property situated in different states (States S_1, S_2, S_3). The trust itself may have several trustees, some individual and some corporate, resident in different territories (States T_1, T_2, T_3). Finally, the beneficiaries may be resident in different states (States B_1, B_2, B_3) and may have different entitlements to income or capital under the trust. For the purposes of analyzing and applying double taxation conventions to trusts, the situation can be greatly simplified by examining each source of income (or capital gain) separately and each beneficiary's receipt separately. The complexity of multiple trustees can also be simplified by attributing to the trust itself, or to the trustees as a body of persons, a single residence for treaty purposes. In the absence of any authoritative guidance from the Commentaries or other sources on the application of double taxation conventions to trusts, the best one can do here is to indicate some of the questions which arise with respect to this issue.

1: Should a distinction be made between different types of trust?

Several jurisdictions make a distinction in their domestic law between the taxation of different types of trust; this distinction has been followed in the literature concerning the application of the Model Convention to trusts.[45] There is clearly something to be said for treating a trust where the beneficiary is entitled to the income as it arises (minus trustees' expenses) differently from trusts where the beneficiary has no immediate right to the income. In the latter case – where trustees may accumulate income or pay income or capital out at their discretion – no beneficiary has a right to the income or capital until the trustees decide to make a distribution. In an ideal world, it would be desirable if a single solution to the application of double taxation conventions to trusts could be reached which would apply to all types of trusts.

2: Is a trust a "person"?

According to Article 1 of the OECD Model, a convention only applies to "persons who are residents of one or both of the Contracting States". There has been some discussion in the literature whether or not a trust is a "person" within the definition provided by Article 3(1)(a) of the Model. There seems to be a consensus forming that a trust is such a person by virtue of the inclusion of a "body of persons" within the definition in Article 3.[46] One is inclined to wonder whether this issue is really as important as has sometimes been made out. If the trust itself is not a "person", surely the trustee or trustees - whether corporate or individual - are persons. If the trust as such is not entitled to the benefit of the treaty, it is hard to say why the trustee or trustees (who are in receipt of income or derive capital gains) should be excluded from the scope of the convention. There is one clear advantage, however, in favour of the view which regards the trust as a person entitled in its own right to come within the scope of the convention. If one looked at each trustee separately, and the trustees were resident in different states, it might be possible to take advantage of different treaties by paying items of income to different trustees. This could not occur if the trustees as a body were allocated to a single jurisdiction.

3: Where is the trust or the body of trustees resident?

Following on from the last point comes the issue of allocating a single residence to a trust or body of trustees. This issue arises where there is more than one trustee and those trustees are residents of different states for treaty purposes. Assuming that the trust is within the definition of a "person" but clearly not an individual, then Article 4(3) should apply to determine issues of dual residence.[47] The trust is then deemed to be a resident of the state in which its place of effective management is situated.

4: Business profits - the application of Articles 7 and 5:[48]

It is perfectly feasible that a trust may carry on a trade and this trade may be carried on where the trust is resident or in another state. Issues then arise with respect to Article 7 of the Model; in particular, whether a trust is an "enterprise of a Contracting State".[49] A further issue is whether a beneficiary may be an enterprise of a Contracting State and, if so, whether the beneficiary has a permanent establishment either where the trust is resident or where the business activities are carried on.[50]

5: Dividends, interest and royalties - the application of Articles 10, 11 and 12:

The essential issue here is whether the trustee in receipt of the dividends, interest or royalties is the "beneficial owner" of them. The view is taken elsewhere[51] that the term beneficial owner should not be given the technical meaning it has in some common law jurisdictions but should be given a broader, treaty meaning. Thus a trustee (other than one who is obliged to pay on all that he receives to a beneficiary) should be regarded as a beneficial owner. The fear is expressed, however, that judges in some common law jurisdictions would be inclined to give the domestic, technical meaning to the term "beneficial owner" and balk at the idea of regarding a trustee as the beneficial owner of income he receives. Prior to the 2000 version of the Model, New Zealand had entered an Observation to Article 3 that a trustee should be regarded as the beneficial owner of dividends, interest and royalties. This was a helpful clarification and should not be thought to imply that other states would not regard a trustee as the beneficial owner.

6: Capital gains - the application of Article 13:

It is primarily paragraph 4 of Article 13 which is at issue here, and the question which then arises is: who is the alienator of the property, the trustee or the beneficiary?[52] It seems correct (with the exception of the situation where a trustee is a bare trustee for a beneficiary) that the trustee should be regarded as the alienator of the property. The trustee would always be the owner of the asset in question, and it would usually be the trustee who decides if and when to dispose of the asset. It would be difficult to regard the beneficiary as the alienator except where the trustee is operating essentially as the nominee of the beneficiary.

A separate issue arises where the beneficiary disposes of his beneficial interest under the trust. Some states are concerned that the alienation of a beneficial interest under a trust might be used to circumvent the specific provisions dealing with immovable property or a permanent establishment in Article 13(1) and (2). Thus, for example, a beneficiary might own land in State S through a trust; if the beneficiary disposed of his beneficial interest he might argue that this was not the alienation of immovable property (taxable in State S in accordance with Article 13(1)) but rather the alienation of “other property”, falling within Article 13(4) (taxable - if at all - in the state of residence of the beneficiary). Certain specific treaties therefore provide that the alienation of an interest in a trust, the property of which consists primarily of immovable property, may be taxed where that property is situated.[53]

7: What is the nature of payments made out of the trust?

Assume that a trustee receives various items of income which would be classified under different articles of the Model - dividends, interest, royalties for example. The trustee may make payments to beneficiaries at his discretion or may accumulate the income and make subsequent payments to a beneficiary out of capital. How are those payments from the trust to the beneficiary to be classified under the OECD Model?

There are at least three possible answers to this question. The first is that the payment to the beneficiary retains its original nature. Thus, for example, if the trustee received a dividend from State S, the payment to the beneficiary is also regarded as a dividend derived from a company in State S. This raises obvious difficulties of identification, particularly where the trustee has a power to accumulate income and makes a payment several years after its receipt. A second solution is that the payment to the beneficiary is classified differently from the receipt by the trustee, but that it falls within one of the specific Articles (i.e. Articles 6 to 20) of the Model. The primary candidate is likely to be Article 10 (Dividends), regarding the beneficiary as having received a dividend from the trustee; the result would be to permit the state of residence of the trustee to tax the payment up to a maximum level. The third possible answer is that the payment to the beneficiary does not come within any of the specific Articles but falls under Article 21 (Other Income). There is some basis for assuming that this is the correct answer to the classification of income paid out of a trust.[54] If so, then payments out of a trust are taxable only where the beneficiary is resident.

8: Capital - the application of Article 22:

For those States which impose a tax on capital, the issue arises as to whether the capital of a trust fund should be attributed to the beneficiary or to the trustee. In particular, under Article 22(4), "All other elements of capital of a resident of a Contracting State shall be taxable only in that State". Is the trust fund to be regarded as the capital of the trustee or the capital of the beneficiary? Since trust laws regard the assets of a trust fund as separate from the trustee's personal assets,[55] it seems more appropriate to regard the trust fund as the capital of the beneficiary. This raises problems, however, where - as is often the case - there are a class of beneficiaries entitled to benefit only at the trustees' discretion or on the happening of some future event.

9: Elimination of double taxation - the application of Article 23:

The issue here is the application of the credit or exemption provisions in the context of a trust. To take the triangular situation where a trustee in State T receives income from a source in State S and makes a subsequent payment to a beneficiary in State B. In those circumstances, there may be tax at source in State S, there may be tax in State T on the receipt of the income by the trustee and on the payment of sums to the beneficiary, and there may be taxation in State B on the receipt by the beneficiary. The relevant tax treaties may preclude or reduce some or all of these levels of taxation. However, a question may finally arise whether the trustee or the beneficiary is entitled to credit or exemption on the income each receives.

Concluding remarks on trusts

The questions set out above are the principal issues relating to the application of the Model Convention to trusts. After examining a number of these issues, John

Avery Jones and his colleagues came to the following conclusion:[56]

> "In view of the nature and flexibility of the trust relationship, the degree of uncertainty in applying treaties to trusts is not surprising even in countries where trusts are frequently used. Major problems arise over such elementary matters as what provision avoids dual residence of trustees, or the meaning of beneficial ownership, with countries taking opposite views on whether, for example, trustees of an accumulating trust are beneficial owners of the income, quite apart from the more advanced problems of trading trusts."

Further clarification of the application of the Model Convention to trusts will probably have to await the report of the working party.

Whatever future approach is adopted, it is important to recognize that it would be wrong to assume that all trusts are set up with a tax avoidance motive. However, the resolution of the issues of the application of double taxation conventions to trusts should not open up new avenues for treaty shopping.

Other, Non-Corporate Entities[57]

The working party set up by the CFA is also examining the application of the OECD Model to other, non-corporate entities. There are a range of these entities, including joint ventures, economic groupings,[58] estates, limited liability companies and various forms of collective investment schemes.[59] The general discussion above applies to these entities. Under Article 1 of the Model, for a convention to apply to these entities they must show that they are persons – i.e., generally they must show that they are bodies of persons – and that they are not fiscally transparent. The Partnerships Report also gives some indications of the approach the working party may suggest to adopt towards them. An issue – which is also relevant to partnerships and trusts – is of particular relevance to some of these entities: states recognise and apply varying degrees of fiscal transparency. It is too simplistic to regard an entity as either opaque or transparent – there is a spectrum of transparency.[60] The OECD Partnerships Report recognises that degrees of transparency exist, but left this issue for the follow-up to the Report.[61]

Briefly, one might identify at least four types of transparency:[62]

(a) complete transparency – where the entity has no existence (such as a contractual joint venture, which may not exist as an entity at all), or where the entity is completely disregarded for tax purposes;

(b) transparency with reporting obligations[63] - where the entity has a relationship with the tax authorities, under which it reports income or gains, but the tax liability is exclusively that of the participators[64];

(c) optional transparency – where the entity or its participators may elect for transparency. This may arise because the entity is prima facie opaque but can elect for transparency, or vice versa;[65]

(d) partial transparency – where part of the income of the entity is taxed in the hands of the entity and part in the hands of its participators.[66] The amount which is taxable in the hands of the entity may be variable, an example would be a trust where accumulated income is taxed in the hands of the trustees but distributed income taxed only in the hands of the recipient beneficiaries.

It is interesting to speculate whether entities which enjoy these various levels of fiscal transparency are residents of a Contracting State (always assuming that they are persons – i.e. bodies of persons). The Partnerships Report indicates that entities with complete transparency are not residents, and the same would be true according to that Report for those subject to transparency with reporting obligations.[67] Where transparency is optional, it would be a pragmatic approach to recognise that entities which elect to be taxed as corporations[68] are residents, while those that elect for transparency are not residents. There is an argument that these entities are "liable to tax" since they fall within the jurisdiction to tax of the state of incorporation but are given the option to elect for transparency. However, the better view is probably that, once they elect for transparency – so long as the election is in place - they are not liable to tax. Entities with partial transparency are clearly liable to tax on the income on which the entity is liable to tax. With respect to that part of the income which is taxed in the hands of the participators only, a "flow-through" approach would seem to be pragmatic and consistent with the Partnerships Report.

The United States is one of the few countries which has adopted a provision in its Model tax treaty and domestic legislation dealing with the application of double tax conventions to hybrid entities.[69] Broadly, this adopts a "flow-through" approach. Article 4(1)(d) of the 1996 US Model provides as follows:[70]

> "An item of income, profit or gain derived through an entity that is fiscally transparent under the laws of either Contracting State shall be considered to be derived by a resident of a State to the extent that the item is treated for the purposes of the taxation law of such Contracting State as the income, profit or gain or a resident."

[1] The text of this article will appear as an update to the author's *Double Taxation Agreements and International* Law (Sweet & Maxwell) and is reproduced by permission of the publishers. Aside from the specific literature on partnerships, trusts and other entities which is mentioned below under those headings, there are several articles which consider the application of double taxation conventions to all non-corporate entities. On this, see P. Lassard, C. Kyres and C. Gagnon, "Treaty Benefit Entitlements of Trusts, Partnerships and Hybrid Entities" (1997) 49 Tax Conference Report of the Canadian Tax Foundation, Chapter 33; R. Tremlay and K. Wharram, "Partnerships, Trusts, and Other Entities: Treaty Benefits" in B. Arnold & J. Sasseville (eds.) *Special Seminar on*

Canadian Tax Treaties: Policy and Practice (Canadian Tax Foundation, 2000); A. Eason, "Entity Entitlement to Treaty Benefits: A Conceptual Approach to Some Practical Problems" in B. Arnold and J. Sasseville op.cit., chapter 12; and R. Critchfield, N. Honson and M. Mendelowitz, "Passthrough Entities, Income Tax Treaties and Treaty Overrides" (1999) Tax Notes International, page 587. There is a very full discussion of the treatment of partnerships and joint ventures in international tax law in (1973) 58B Cahiers D.F.I. See also Vogel, Intro., paras. 104-107 and Art.1, paras. 18-30.

[2] At para.2.

[3] The degrees of transparency are discussed below in the discussion on non-corporate entities.

[4] At paragraph 34 and paragraph 5 of the Commentary to Article 1.

[5] For a discussion of some of the issues that arise in such cases, aside from the Partnerships Report, see also F. Engelen, "International Double Taxation Resulting from Differences in Entity Characterization: A Dutch Perspective" (1998) Intertax 38-43

[6] Examples 11 and 12 in the Report.

[7] There is a growing literature on the application of double taxation conventions to partnerships. The starting point is now the Partnerships Report, but that Report has itself generated a literature. See, for example, M. Lang, *The Application of the OECD Model Tax Convention to Partnerships: A Critical Analysis of the Report Prepared by the OECD Committee on Fiscal Affairs* (Linde Verlag, Vienna, 2000); J. Schaffner, "The OECD Report on the Application of Tax Treaties to Partnerships" (2001) Bull. IBFD 218 - 226; F. Engelen and F. Pögens, "Report on 'The Application of the OECD Model Tax Convention to Partnerships' and the Interpretation of Tax Treaties" (2000) ET 250 - 269; M. Clayson, "OECD Partnerships Report: Reshaping Treaty Interpretation?" [2000] BTR 71 - 83. There is also an older discussion in D.Tillinghast, "Tax Treaty Issues" (1996) 50 U.Miami L.R. 483 at 467 - 474. See also R. Loengard, "Tax Treaties, Partnerships and Partners: Exploration of a Relationship" (1975) 29 Tax Lawyer 31 - 67.

[8] There is also a very good summary of the Report in R. Tremblay and K. Wharram, "Partnerships, Trusts, and Other Entities: Treaty Benefits" in B. Arnold and J. Sasseville, op.cit., at paragraphs 14:32 - 35.

[9] Para.30 of the Partnerships Report, reflected in amendments to the Commentary to Art.3.
[10] Paras.34 and 35 of the Partnerships Report, reflected in amendments to para.5 of the Commentary to Art.1.
[11] Para.40 of the Partnerships Report.
[12] Paras.35 and 47 of the Partnerships Report and para.5 of the Commentary to Art.1.
[13] Para.42 of the Partnerships Report.
[14] Para.6.4 of the Commentary to Art.1.
[15] Paras.52 and 53 of the Partnerships Report and para.6.3 of the Commentary to Art.1.
[16] Decision of 13th October 1999, No.191 191, reported in RJF 12/99 No.1492. Also reported (with translation) in (1999) 2 ITLR 365. There are notes on this case by B. Gouthière (2000) ET 195 to 198 and N.Not (2000) 20 Tax Notes International 1817.
[17] One might compare this case with the decision of the Conseil d'Etat in *SA Quartz d'Alsace* – decision of 6th May 1996, No.154 217, reported at RJF 6/96 No.731, Droit Fiscal 1996 No.30 comm.988. That case concerned a Swiss partnership – originally formed as a société en commandite, but later becoming a société en nom collectif, which owned 54% of a French company. Under Swiss law the partnership had no legal personality. The Swiss partnership sought repayment of the avoir fiscal on dividends under Article 11(3) of the France-Switzerland Convention of 9th September 1966. This paragraph extended the avoir fiscal to physical persons and to companies (sociétés) owning less than 20% of French companies. The Conseil d'Etat held that the Swiss partnership was a person within the terms of the Convention since it constituted a body of persons. However, it was not a physical person for the purposes of Article 11(3) and could not benefit from the repayment of the avoir fiscal.
[18] See Reservations of France at p.63 of the Partnerships Report.
[19] Decision of 4th April 1997, No.144 211, reported in RJF 5/97 No.424 and reported (with translation) in (1997) 1 OFLR 399. There are comments on the case by A-S Croustel and P. Croudin in (1997) ET 463 - 465 and by E. Milhac in (1998) 15 Tax Notes International 1407. There are also some earlier cases on related issues: see Conseil d'Etat, decision of 4th July 1973, No.78 197, Dupont 1973,

page 330; and Conseil d'Etat, 7th March 1990, No.91 573, *Société Canny Bowen*, RJF 5/90, No.528.
[20] For a discussion of the degrees of transparency, see the discussion of other, non-corporate entities below.
[21] BNB 1993/227. There is a note on this case by R. Betten (1993) ET 312 - 314. Both of the cases mentioned here are mentioned in S. van Weeghel, "Recent Case Law" (1994) Bull. IBFD 637 - 644 at 639.
[22] BNB 1994/192; (1994) V.N.1442. There is a note on this case by P. Smit (1994) ET 234 - 237.
[23] Decision of 30th April 1998, reported in (1998) 1 ITLR 463.
[24] [1998] STC 754 confirming the decision of the High Court reported at [1996] STC 1336. There is a comment on the High Court decision in [1997] BTR 188 - 200 by J.D.B. Oliver and J.F. Avery Jones.
[25] It is interesting to contrast this with the decision of the Danish Tax Council (the Ligningsradet) of 22nd February 1994 that distributions from a Spanish limited partnership were dividends for the purposes of Article 10 of the Denmark-Spain Convention of 3rd July 1972 – see 8 Tax Notes International 1560.
[26] Income Tax Appellate Tribunal, 27th September 2001, reported in (2001) 4 ITLR 711.
[27] [1987] S.T.C. 36, affirmed by the Court of Appeal [1989] S.T.C. 493. The UK's general approach to partnerships is discussed in an exchange of correspondence printed in [1995] B.T.R. 111-114. The Inland Revenue confirmed that a partnership cannot be regarded as a UK resident for treaty purposes as it is not liable to tax in the UK.
[28] At p.48 b-c.
[29] In s.526(5) ICTA 1970, now s.832(1) ICTA 1988, which indicates that "body of persons" does not include a partnership.
[30] [1989] S.T.C. 493.
[31] Originally s.62 Finance (No.2) Act, 1987. Similar legislation was also enacted in Canada as section 6.2 of the Income Tax Conventions Interpretation Act to ensure that the *Padmore* result could not arise in Canada.
[32] Though there may be a different position in Scotland since a partnership is a separate entity under Scots law.

[33] Some earlier treaties also dealt expressly with partnership. Thus the Conventions with Cyprus (1974, Art. 3(1)(h)) and Bulgaria (1987, Art. 3(1)(e)). expressly exclude partnerships from the scope of the treaty, while that with the United States (1975 Art. 3(1)(c)) expressly included partnerships (the Convention of 1973 with Malaysia, Art. 2(1)(g), originally excluded partnerships; this was amended by Protocol in 1987).

[34] For example, Art.3(1)(e) of the U.K. - Ghana Convention of 1993 provides: "the term 'person' comprises an individual, a company and any other body of persons, but does not include a partnership;".

[35] See Art. 25(1) of the U.K. - India Convention of 1993, Art. 24 of the U.K. - Ukraine Convention of 1993.

[36] Formerly, para. 14 of the Commentary to Art. 3.

[37] Doubts have been expressed whether this Observation was really necessary and whether a trustee would be regarded as the beneficial owner in any event. See the further discussion below. New Zealand follows this Observation by providing in some of its treaties that a trust is to be regarded as the beneficial owner of dividends, interest and royalties - see, for example, Art. 2(2) of the Australia-New Zealand Convention of 1972.

[38] Para. 15 of the Commentary to Art. 21 - the same Reservation was included in the 1977 Model. Other Reservations relating to trusts have been made by Australia and New Zealand (Art. 7, Commentary para. 42) and Canada (Art. 13, Commentary para. 34).

[39] See, for example, Art. 3(1)(e) of the Canada-U.S. Convention of 1980.

[40] A "subject to tax limitation" - see, for example, the U.S.-Cyprus Convention of 1984, Art. 3(1)(a)(ii).

[41] See, for example, the U.K.-Belgium Convention of 1987, Art. 21(1).

[42] For some examples in Switzerland and the Netherlands, see the chapters by van Mens and Leemreis in Sonneveldt and van Mens (eds.); *The Trust - Bridge or Abyss between Common Law and Civil Law Jurisdictions?* (Kluwer: Deventer, 1992).

[43] There is some guidance as to the application of double taxation conventions to trusts in the UK Special Commissioner's decision in *Wensleydale's Settlement Trustees v. IRC* [1996] STC (SCD) 241. That case concerned a trust, with a trustee resident in Ireland and a trustee resident in the UK, which sought protection on capital gains.

Though the decision focused on the tie-breaker of the place of effective management, it seems to have been assumed that the trust was a person and a resident of both contracting states (hence the tie-breaker issue). The trust was not an individual, so the tie-breaker for persons other than individuals - equivalent to Art. 4(3) of the OECD Model – was applied.

[44] "The Treatment of Trusts under the OECD Model Convention" [1989] B.T.R. 41-60 and 65-102, a version of which is also published in (1989) E.T., Issue 12 (special issue). There is also a short chapter by Ineke Koele; "Trusts and the Application of the OECD Model Convention", in *The Trust - Bridge or Abyss between Common and Civil Law Jurisdictions?* (Kluwer: Deventer, 1992) which is in part a summary of the Avery Jones article. See also J. Prebble, "Accumulation Trusts and Double Tax Conventions" [2001] B.T.R. 69-82 which considers whether trusts are residents of a contracting state and also the application of the beneficial ownership limitation to trusts.

[45] JFAJ "Trusts" distinguishes between life interest trusts, discretionary trusts and accumulation trusts.

[46] See, for example, JFAJ "Trusts", pp. 65-66. See, however, the Canadian Customs and Revenue Authority Technical Interpretation 2001-0108517 to the effect that a trust is not an individual.

[47] The trust being "a person other than an individual". This point is confirmed by the decision in *Wensleydale's Settlement Trustees v. IRC* [1996] STC (SCD) 241.

[48] This issue is discussed in John Avery-Jones (supra.) at pages 84 to 89.

[49] Whether or not a trust is an "enterprise" is also relevant for Article 8 (Shipping etc.), Article 9 (Associated Enterprises) and for Article 13(3) (gains from the alienation of ships etc.).

[50] See Goldberg and Shajnfeld; "Attribution of a Trust's Permanent Establishment to its Beneficiaries" (1986) 34 Canadian Tax Journal 661.

[51] See the notes to Art. 10.

[52] Assume a triangular situation where an asset situated in State S is disposed of by the trustee who is a resident of State T for the benefit of a beneficiary who is a resident of State B. Assuming treaties between the three States based upon the OECD Model; if the alienator is the

trustee, the gain is taxable only in State T. If, however, the beneficiary is the alienator, then the gain should be taxable, under all three treaties, only in the state of residence of the beneficiary.

[53] See, for example, the Canada-Barbados Convention of 1980, Art. 14(3)(b).

[54] And is certainly supported by the Reservation made by the United Kingdom and Ireland to Art. 21. Canada also provides in the "other income" Article of several of its treaties that payments from a trust may be taxed in Canada, but only to a maximum level (generally 15%). This is a helpful and sensible way of dealing with the issue.

[55] On which see Art. 11(b) of the Hague Convention on the Law Applicable to Trusts and on their Recognition:

> "recognition shall imply in particular -
>
> (b) that the trust assets shall not form part of the trustee's estate upon his insolvency or bankruptcy;"

[56] JFAJ "Trusts", p. 101.

[57] The application of double taxation conventions to non-corporate entities is discussed in R. Tremblay and K. Wharram, "Partnerships, Trusts and other Entities: Treaty Benefits" in B. Arnold and J. Sasseville (eds.) *Special Seminar on Canadian Tax Treaties: Policy and Practice* (Canadian Tax Foundation, 2000) at pages 14:67 et seq.; in A.Eason, "Entity Entitlement to Treaty Benefits: A Conceptual Approach to some Practical Problems", ibid., pages 12:11 et seq.; and in P. Lessard, C.Kyres and C. Gagnon, "Treaty Benefit Entitlements of Trusts, Partnerships and Hybrid Entities" (1997) 49 Tax Conference of the Canadian Tax Foundation, at pages 33:23 et seq. See also Vogel, Art.1 para.30c.

[58] For an example of the application of a convention to an economic interest grouping, see the *Kingroup* decision discussed under Partnerships above.

[59] Lessard, Kyres and Gagnon, op. cit., discuss the application of double taxation conventions to: Nova Scotia unlimited liability companies, US limited liability companies (LLC's), S corporations, and US associations. Tremblay and Wharram, op.cit., discuss the application of double taxation conventions to LLC's, S corporations, unlimited liability companies, limitadas and sociétés en nom collectif. With respect to US LLC's, the Inland Revenue has expressed the view that they cannot be a resident of the US but that

treaty relief will be given to the extent that the income in question is subject to US tax in the hands of the members of the LLC resident in the US – see Inland Revenue Tax Bulletin, No.29, pages 440 to 441 and [1997] BTR 320 to 323.

[60] On this, see especially A. Eason, op.cit., page 12: 11 et seq.

[61] See paragraph 37 of the Partnerships Report.

[62] Much of the discussion in this section is derived from an unpublished paper delivered by the author to the International Tax Planning Association in 1996.

[63] A-F Coustel and P. Coudin term this "translucent" – see (1997) ET 463 at 464.

[64] This is the case for the income of partnerships in the UK, for example. The entity may also, aside from the obligation of reporting income, have a duty to withhold and account for tax on behalf of its participators.

[65] This is understood to be the case for a number of entities in France where certain entities – the société en participation, for example – are prima facie taxed as corporations but can elect for transparency, while others – for example, the société en nom collectif – are prima facie transparent but can elect to be treated for tax purposes as corporations. This is also the case for US S corporations and under the US "check-the-box" regulations.

[66] This is understood to be the case for the French société en commandite simple, where the société is taxed on the share of the limited partners, but the general partners are taxed under transparency. This is also understood to be the case in the Netherlands for the open commanditaire vennootschap, which is a taxable entity but the share of the general partners is deductible and taxed directly in their hands.

[67] Because liability is determined with reference to the characteristics of the participators.

[68] Or which have the option to elect against transparency but do not exercise that option.

[69] See the Regulations under the Internal Revenue Code s.894(c).

[70] See also Article 1(8) of the UK-US Double Taxation Convention of 24th July 2001.

THE LEGAL ADVISER'S RESPONSIBILITY

David Goldberg

I once met a man on a boat in Amsterdam - though where I met him is really irrelevant to the story - who told me that he was an American lawyer who advised on SEC law. He said that was a good area to advise on because there were only two types of advice you ever had to give. If the client came through the door and said "I've done so and so" you said "Uh huh, you've just committed a felony" and if the client came through the door and said "We want to do so and so" you said "Well, this is a grey area but, basically, there are four things you can do, A, B, C - and D, which is none of the above".

Tax law is not like that: clients tend to think that it is a science and not an art and they want answers; sometimes they want to be told what to do, and sometimes they want reassurance. I suppose any lawyer's work will fall into a tremendously broad category which it will be difficult to characterise too precisely, but tax lawyers generally deal with three types of situation. First, they will be asked to advise on transactions carried out wholly in a commercial context. For example, the client may wish to sell a business or make a takeover bid or just rationalise his group. Secondly, the client may have been presented with a proposal to mitigate his tax and this type of situation can arise in the context of companies and in the context of individuals. Here the client will want to be told what to do. He wants to know the answer to the question: "should I do this scheme?" Thirdly the client may have carried out a commercial transaction or a tax mitigation scheme and is now in dispute with the revenue about the consequences. Here the client wants reassurance. He wants to hear the lawyer say "Maybe I can get you out of this". I concentrate here on the second and third situations. I should, however, mention a few points about the first situation. Quite often, when a transaction is carried out in a commercial context, clearances will be sought and obtained for the transaction and the legal adviser will be asked to draft or to settle the applications for the clearances. Here, the legal adviser's responsibility will consist principally of ensuring that the clearance applications are drafted in a clear and full fashion. Clarity is essential because confusion may lead to difficulty for the Revenue official considering the application and so to an unnecessary refusal. One particular point here is to get the names of the parties right. Sometimes, applications are drafted using code names. The code names are, in a later draft, imperfectly changed to the real names and the final version of the application is sent to the Revenue with an incoherent mix of names that makes it impossible to tell who is who. A lawyer should see that this type of confusion – which happens surprisingly often in the real world – is avoided.

Next, the clearance application must give all material information, so that a clearance given in response to the application cannot be withdrawn, and in this connection the disclosure needs to be extremely full so as to satisfy the requirements of the Matrix case: it may, indeed, even be necessary to mention arguments that the Revenue might want to raise, even though the adviser himself believes them to be wrong. Of course, in the first situation, the legal adviser may very well have some input as to how the transaction will be structured, the aim of the tax lawyer being to mitigate tax. But in this type of situation there will always be a real transaction carried out for commercial purposes, and cases of that sort tend not to raise the sorts of issue which arise where transactions are carried out solely for the purposes of tax mitigation. This is not, however, a hard and fast rule. As has been shown by the *Barclays Bank v. Mawson* case – a case I refer to in more detail below – a commercial transaction can have aspects that raise the sort of issue that arises with the second type of case, but I can comment on this adequately in dealing with the second situation.

The second situation – the case where a client comes through the door and says that he has been presented with a proposal to mitigate his tax – can arise both for individuals (particularly in the field of inheritance tax planning) and companies. I concentrate here on the situation with a company. Once upon a time, when I started advising on tax, there were basically only two "outfits" which sold tax avoidance schemes. But, nowadays, every corner merchant bank – and even firms of accountants – spend a great deal of time thinking up tax avoidance or tax mitigation schemes which they try to sell to clients. And the clients, having been presented with the scheme, will quite often seek advice on these schemes from their lawyers. Counsel is often consulted by the promoters of a scheme at the time it is being put together *and* by the potential user of the scheme after he has been presented with it. In some quarters it is believed that the recent Westmoreland case has so liberalised the environment that tax avoidance has again become acceptable. In my view, for reasons which I shall explain in a moment, this is a dangerous conceit.

When I am presented with a tax mitigation scheme, I adopt a three stage approach to the analysis. First, I read the papers to find out what the scheme is about and to get an initial and very general impression of whether the scheme is good or bad. To me, a scheme is good if it is elegant, by which I mean it is simple and easy to understand. In my experience, clients usually prefer schemes that are more complicated to schemes which are simple, but that is an error: complications require intense analysis and the more analysis that has to be done on a scheme, the more likely it is to go wrong. The simpler a scheme is, the better it is. Having got my initial impression I then try to put that to the back of my mind and analyse the proposals step by step to discover whether there is a weakness on the detailed wording of the applicable legislation. In some cases, Counsel will be presented with proposals and no analysis. In other cases, he will be presented with a detailed analysis prepared by somebody else. Where that happens he needs not only to consider the analysis given to him to see whether he agrees with it, but also to make sure that no relevant provisions of the legislation have been omitted from the analysis. Where he is not given an analysis he needs to ascertain for himself what the relevant provisions are and consider their meaning afresh for himself.

At this stage of the analysis one quite often finds a relevant provision which will apply adversely if the main purpose or one of the main purposes of the transaction is tax avoidance. ICTA 1988 s.703 is one of those provisions, as is FA 1996 Schedule 9, paragraph 13, which relates to debits arising from loan relationships, is another. Paragraph 13 is of considerable current interest, partly because many of the tax mitigation schemes presently around raise the issue as to whether it applies adversely and partly because the Revenue seem surprisingly keen to litigate the meaning of this provision.

A number of points are relevant here. First a provision which refers to the main object or main purposes of a transaction usually imposes a subjective test. The provision asks, "What was the taxpayer's purpose? What was the taxpayer trying to achieve?" And to answer this sort of question it is necessary to discover what was in the taxpayer's mind. A provision of this sort does not require an objective determination of what a hypothetical observer might expect the position to be, but an enquiry into the taxpayer's state of mind. This does not, however, mean that a taxpayer can simply say, "Well I did not intend to get the tax relief and therefore that was not my purpose". What the taxpayer says must be credible in the context of what he did; and if there is no explanation for what he did other than that he wanted tax relief, then he cannot talk himself out of the provision. In such a case it may be found that the taxpayer has a subconscious purpose of which he was unaware. In a dispute as to what the taxpayer's purpose was, the matter is determined by the Commissioners as a matter of fact, so that the evidence given before the Commissioners will be of critical importance to the outcome of the case. I return below to this aspect of the lawyer's job.

Secondly, a purpose needs to be distinguished from a consequence or incident. Just because a transaction has a certain consequence, it does not automatically follow that it had that purpose. For example, if a company borrows money and pays interest, the paying of that interest will, subject to paragraph 13, attract interest relief. But this does not mean that the *purpose* of the borrowing is to obtain interest relief: the purpose of the borrowing can only be discovered by hearing the taxpayer's explanation for it and evaluating that explanation against what has been done with the borrowed money. If something highly artificial has been done with the borrowed money, then it may appear, despite any explanation to the contrary from the taxpayer, that the purpose of the borrowing was to obtain relief for the interest. But if something commercial has been done with the borrowed money, then relief for the interest is plainly an incident of the transaction and not its purpose or one of its purposes.

Thirdly, a transaction may have a tax avoidance purpose which is, nonetheless, not a main purpose. For example, if a person needs money of a certain amount to carry out a commercial transaction, such as a purchase of an income-yielding asset or a business, and he can only get the money by carrying out some form of arrangement which produces non-taxable receipts, his main purpose may be to get the money, and the tax avoidance may only be something that happens in the course of getting the money rather than the purpose of the transaction. This was the position in the highly helpful case of *Brebner* and in *Clarke v. IRC*. In *Brebner*, Lord Upjohn says this at 43 TC 718H to 719A:

> "My Lords, I would only conclude my judgment by saying, when the question of carrying out a genuine commercial transaction, as this was, is considered, the fact that there are two ways of carrying it out – one by paying the maximum amount of tax, the other by paying no, or much less, tax – it would be quite wrong as a *necessary* consequence to draw the inference that in adopting the latter course one of the main objects is, for the purposes of the section, avoidance of tax. No commercial man in his senses is going to carry out commercial transactions except upon the footing of paying the smallest amount of tax involved. The question whether in fact one of the main objects was to avoid tax is one for the Special Commissioners to decide upon a consideration of all the relevant facts before them and the proper inferences to be drawn from that evidence."

Lastly, a particular issue of law arises in relation to paragraph 13 which is this: "Suppose that a borrowing does have an unallowable purpose, how much of the interest payable by the taxpayer is disallowed under paragraph 13?" Paragraph 13 itself stipulates that the amount not allowable is so much of the debit as, on a just and reasonable apportionment, is attributable to the unallowable purpose. In our context the question posed is "How much of the interest payable by the company is attributable to a tax avoidance purpose?" There are two schools of thought here: one is that if a borrowing is made for a tax avoidance purpose *all* of the interest is unallowable; and the other is that only that part of the interest payable in order to secure the tax avoidance is unallowable. I favour the second view, but litigation as to which view is right seems imminent.

I might add that a different kind of anti-avoidance provision is to be found in the intellectual property provisions of FA 2002 Schedule 29. Paragraph 111 directs that "tax avoidance arrangements" are to be disregarded and tax avoidance arrangements are defined in terms of arrangements which enable certain types of debit to be obtained. This is different from other UK anti-avoidance provisions because it directs that the arrangements are to be disregarded and other provisions do not do that. It is also different because the provision does not apply only where the relevant arrangement produces a tax benefit but also where it enables the tax benefit to be obtained, so this provision is quite a lot wider than our existing provisions and may be a precursor of a new form of anti-avoidance clause.

If the detailed analysis of a proposal reveals weaknesses there is, of course, no need to go any further: the client should not implement the proposal. But if the proposal is sound in its details there is a need to embark on a third stage of analysis. It is necessary to stand back from the detail of the proposal and look at the matter as a whole, and to ask whether, if challenged in court, it will succeed in its object. The terminology at this stage of the process has been changing lately. Originally – in early *Ramsay* and *Furniss* days – the question considered was whether the transaction in issue was "real", as distinct from, I suppose, unreal. This was the sort of terminology favoured by Lord Wilberforce in *Ramsay*. At a slightly later stage, a distinction was made between unacceptable tax avoidance and acceptable tax mitigation. This was the terminology favoured by Lord Templeman. Another way of approaching the matter – the way currently favoured by the Courts – is to focus on the purpose of the provisions which are in issue and to construe them in the light of that purpose. As demonstrated by *Westmoreland* and perhaps highlighted even more starkly by the *Barclays Bank v. Mawson* case, in analysing any transaction for tax purposes it is first necessary to identify the statutory provisions which are relevant and then to determine precisely what question those provisions are raising. In the determination of the statutory question, the purpose of the legislation has now been given a paramount role and this will have a huge impact on the approach of the Courts to a transaction. In the *Westmoreland* case the statutory question was "had the interest there in issue been paid as a matter of law?" But the key point to note about *Westmoreland* is *not* the question in that case itself, but the point the case makes that each statutory provision raises its own particular question, which will not necessarily respond to the same sort of analysis as has been adopted in previous cases. Each issue may – indeed, will – require separate analysis. And this is why I think it is a dangerous conceit to believe that *Westmoreland* has liberalised the attitude of the Courts to tax planning. In fact it has created a very flexible analytical tool which enables the Court to give a profound role to the underlying purpose of the legislation. The points I am making are neatly summarised by what Lords Hope and Nicholls say in *Westmoreland*, and I think if I run what they say together the point becomes very clear. Lord Hope says

> "The only relevant questions here are: (1) the question of law: what is the meaning of the words used by the statute? And (2) the question of fact: does the transaction stripped of any steps that are artificial and should be ignored fall within the meaning of those words?"

And Lord Nicholls says

> "When searching for the meaning with which Parliament has used the statutory language in question, Courts have regard to the underlying purpose that the statutory language is seeking to achieve."

A striking application of these principles is found in the *Barclays Bank v. Mawson* case. In that case a finance leasing transaction was carried out which, it might be thought fell within the wording of the statute but did not attract allowances because it did not fulfil the purpose of the Capital Allowances legislation – see, in particular, paragraph 51h to j of Mr Justice Park's judgement at [2002] STC 1100.

> "In my opinion it is legitimate to have in mind the points which I have made in the last few paragraphs in considering whether the requirements of s.24 have been met by BZW's scheme. In *Westmoreland*

> [2001] STC 23 at [6], [2001] WLR 377 Lord Nicholls said:
>
> 'When searching for the meaning with which Parliament has used the statutory language in question, courts have regard to the underlying purpose that the statutory language is seeking to achieve … weight is given to the purpose and spirit of the legislation'
>
> As regards finance leasing the underlying purpose of Parliament, in my view, is to enable capital allowances to be used so as to provide to lessees at attractive rates finance for them to use and to develop their real business activities. The underlying purpose of Parliament is not to enable cash payments to be made annually to third parties who are able to provide a major item of machinery or plant which satisfies one of the conditions for a finance lessor to claim the allowances. Nor is that in accordance with 'the purpose and spirit of the legislation'."

I note, in passing, that how the purpose of the legislation is found is not explained in the cases. Some statutes do clearly have a particular purpose. The purpose of other statutes is less clear; and some statutes have a penumbral spirit, the result of which is that the limits of the apparent purpose are not rigidly defined. In the case of finance leasing, for example, the underlying purpose of Parliament might extend to enabling capital allowances to be used to provide finance *or* (this was not mentioned by the judge) *other business benefits* to lessees; and, if the purpose went that far, the transaction in *Barclays Bank* might properly have attracted allowances. Indeed, there is an issue as to why the purpose of the capital allowances legislation does not go that far. What difference is there between finance and other business benefits? The question of purpose can be very hard to determine.

Nonetheless, no matter how hard it is to determine, there is now a need to ascertain the underlying purpose of any relevant legislation. So I think one of the functions of the legal adviser, when advising on a tax mitigation proposal, is to consider the purpose of the legislation in an endeavour to see whether the proposal fulfils that purpose. I try to ask myself "Does this proposal use the legislation as it was intended to be used, or does it abuse the legislation?" And I think that there may be a third category, distinct from use and abuse, which is skilful navigation – not definitely fulfilling the purpose of the legislation but not abusing it either. I do not pretend that this task of deciding whether a proposal uses, abuses or skilfully navigates the legislation is an easy one. In some cases views as to what the purpose of legislation is can differ. As I have indicated, we might not all agree with Park J's statement as to the purpose of the capital allowances legislation. But on other occasions, the point can be clear and, where it is clear, I think it is the legal adviser's responsibility to say so and to discourage his clients from implementing proposals which are an abuse of the legislation.

There is a great deal of pressure put on people to do tax schemes and put on advisers to say that they work; and it takes some courage to say that they don't. But it is a job that should not be shirked, especially given the approach of the Courts demonstrated by

Westmoreland and, as I say, highlighted by the *Barclays Bank* case. However, where a proposal uses the legislation properly, or skilfully navigates around its pitfalls then I think the legal adviser can approve of the proposal, and it is in this sort of area that the future of tax mitigation lies.

Before leaving this second situation – the tax mitigation proposal – there is one other point I should make. Many of the currently available tax mitigation proposals seek to rely on Revenue practice statements, such as SPD 12 in the context of partnerships. The view often put to Counsel is that these statements are binding on the Revenue and so can be relied upon by the taxpayer. For my own part, I think this is very doubtful: there is no reported case in which the revenue have been held bound by a substantive statement of the law which the Court considers to be wrong. There are, of course, statements in the cases by eminent judges that the Revenue may be bound by such statements – but, in the end, the Revenue have not been held bound on any substantive (as distinct from procedural matter) even where they have entered into a specific agreement. So I think the view that the Revenue are bound by practice statements is highly optimistic, and I try to discourage clients from relying on them where it seems to me that they do not accord with the law.

If a client, who has been told not to by his legal adviser, implements a proposal, it is almost inevitable that the third situation I envisaged at the beginning of this talk will arise: the client will come back to say that he is involved in a dispute with the Revenue. I should, of course, add that this is possible even where the adviser has said that it is sensible to implement the scheme: any tax mitigation transaction carries with it the risk of dispute which cannot be ignored. At the dispute stage the legal adviser has two functions. First, he must guide the correspondence with the Revenue and second, he must advise on the preparations for a contested hearing. During the dispute stage the Revenue will very often ask for information, particularly in relation to the purposes with which a transaction was carried out, and the Revenue will seek documents. One question which a legal adviser is frequently asked is what documents should be provided to the Revenue. My own answer is always that every document should be provided to the Revenue.

In this connection, however, it must be remembered that the s.20 powers of the Revenue are subject to three limitations in relation to documents which attract legal professional privilege or some other similar form of protection. First the Revenue cannot obtain documents which are the subject of legal professional privilege. They cannot obtain these documents either from the taxpayer himself or from his adviser, unless the taxpayer is willing to provide them. This has been made clear by the *Morgan Grenfell* case in the House of Lords. It should be noted, however, that legal professional privilege is not as wide as is sometimes thought. In general terms it extends to all communications between the client and his legal adviser (or vice versa) for the purpose of obtaining or giving advice, and it certainly extends to the advice itself. It does not cover original documents implementing a proposal nor, unless they can be characterised as advice, drafts of those documents or copies of them. Secondly s.20B(2) creates a limited form of litigation privilege so that a party to an appeal does not have to produce documents relating to the conduct of the appeal. It should be noted that this protection only applies where a s.20 notice is given by an Inspector and not where it is given by the Board. Thirdly, under s.20B(9) a tax adviser does not have to deliver or make available documents which are his property and which contain advice about tax. This protection is subject to the limitations in s.20B(11) and (12) so that advice explaining a tax return can be obtained from a tax adviser, but the Revenue have given certain assurances as to the way in which they will use these powers in paragraphs 10 and 11 of SP5/90, which read as follows:

> "10 Accountants' working papers will not be called for on a routine basis. The Revenue will normally do so in connection with enquiries into a client's tax affairs only where they have been unable to satisfy themselves otherwise that the client's accounts or returns are complete and correct. Although the new provisions give the Revenue formal powers to require access to accountants' working papers, this has been given in the past on a voluntary basis where appropriate. The Revenue will continue their general policy of seeking access on a voluntary basis and will use their formal powers only where they consider it absolutely necessary.
>
> 11 Requests will be limited as far as possible to information explaining specific entries. But there

> may be occasions when the Revenue will wish to examine the whole or a particular part of the working papers. The Revenue will usually be willing to visit the accountant's office or the client's premises to examine the papers and to take copies or extracts."

It must, however, be noted that advice given by a tax advisor who is not a lawyer is not protected from disclosure by the rules relating to legal professional privilege. Thus, if a taxpayer has in his possession advice given to him by a tax adviser who is not a lawyer, the Revenue can obtain those documents by serving a s.20(1) notice on the taxpayer and this is so notwithstanding the *Morgan Grenfell* decision itself. However it does seem possible that the Courts would strike down an attempt to obtain documents of this sort under Article 8 of the Human Rights Convention. Once the process of Revenue investigation is complete, it may be, and very often is, possible to do a deal with the Revenue without going to Court, but if this is not possible, then the matter will have to go to a hearing and the case will have to be prepared. In my view, the preparation of the case should begin at the same time as the dispute process or, if not then, at least as soon as it seems likely that a settlement will not be reached. Of course, most clients do not want to begin preparing for litigation. There are cost and resource implications, and there is always the hope of settlement, which many fear will somehow recede into a remote galaxy if preparations are begun. But I have a number of reasons for believing that it is best to begin preparing for litigation early. First, litigation is an incremental process. A case looks a bit different each time it is considered.

The sooner one starts thinking about arguing a case, the better the argument presented at trial is likely to be. Secondly, litigation takes time to prepare. There are documents to gather up, and there may be witnesses to interview, and these processes can be lengthy: you do not want to be doing this preparation against the deadline of an incipient hearing date. Thirdly, there is a need to determine what evidence will be needed to prove the case. At the beginning of a tax case, one tends to assume that a lot will be agreed and that the issues on which evidence will be needed will be narrow. But, as the case develops, it may become apparent that there is less common ground than was imagined, and the correct witnesses need to be identified to prove what one might originally have taken for granted. Sometimes it may be necessary to have expert witnesses – and all witnesses should these days provide witness statements which will need to be carefully considered, and all this takes time. But lastly, and most important, the best reason for starting preparation early is this. If you have a good case, or even just a reasonable case in which you believe, an appeal is your right. It is how the taxpayer defends himself against an unjust claim of the Revenue. And by beginning to prepare for litigation – by letting the Revenue know that you have begun – you send the important message that you believe in your case and are willing to fight. And, conversely, if you do not send the message that you are willing to litigate, then, in my view, you send the message that you do not believe in the case. The message that you do believe in your case helps to promote a settlement: the message that you don't has the opposite effect. So the best and strongest reason for beginning preparation early is that it produces the best prospect of not having to litigate.

A lawyer should never too easily encourage litigation. The Courts are not always easy places; the outcome of litigation, however certain it may appear, is always doubtful, and a settlement is usually better than a fight. But it does not pay to be too frightened of litigation either. And in the dispute phase, the lawyer’s role can be to stiffen the sinews and not allow clients too meekly to surrender. If a case does have to be prepared for trial, the lawyer will have valuable input both in the mechanical form of saying what needs to be before the Court and in the more imaginative role of determining just how the case should be put and with what witnesses. And generally it cannot be overstressed that the help of a lawyer – especially counsel – in tax disputes is always beneficial.

DISPOSALS BY COMPANIES WITH SUBSTANTIAL SHAREHOLDINGS

by David Goy

The new exemption regime for substantial shareholdings applies as from 1 April 2002. Its purpose, according to the Government, is to enable "groups wishing to restructure for commercial reasons [to] be able to do so without essential business decisions being constrained by the tax system" Certainly its introduction will have a significant impact as regards tax planning. Historically, tax planners have laboured long and hard on occasions to work out how tax charges on sales of subsidiaries can be minimised. Arrangements involving intra group dividends, asset transfers, the use of loss companies have regularly fallen to be considered. In future, certainly in the context of trading groups, the first question likely to arise is, does the new exemption apply? Companies often have a choice whether to sell business assets or shares. The availability of the new relief may now tip the balance, in certain circumstances, in favour of a share sale.

The major significance of the new exemption is likely to be seen, not merely when sales are being considered but also in planning forms of corporate structure. Offshore holding companies have been used in the past to preclude chargeable gains arising on sales of subsidiaries from being taxed. In future, in the context of trading groups, UK holding companies may be just as good.

One initial point to be made about the relief is that where it operates so as to preclude a gain from being chargeable, it also prevents a loss from being allowable. A curiosity of the new exemption, therefore, is that while it may not always be easy for a transaction to fall within it, if it does, it may be difficult then to arrange matters so that it falls outside it. The aim is not to allow a taxpayer to avoid realising chargeable gains, while at the same time, in like transactions, enabling it to realise allowable losses.

The Relief in General

The new exemption is contained in a new Schedule 7AC TCGA 1992 added by s.44 FA 2002. In brief, what the new relief provides is that a gain on a disposal of shares after 31st March 2002 is not a chargeable gain if a number of conditions are satisfied:-

(i) <u>The disposal must be by a company</u> (see paragraph 1)

The relief is not available to individuals or trustees.

It should be noted that there is no requirement that the company is resident in the UK. While a non-UK resident company is not normally concerned with tax on chargeable gains, the relevance of this point arises in connection with section 13 TCGA 1992 and the attribution of gains made by non-resident companies to UK resident shareholders. Section 13 only apportions "chargeable gains" and hence if the relief applies there is nothing to apportion. Thus where, for example, a structure has been set up, possibly to obtain the benefit of a double tax treaty, under which an offshore holding company holds an investment in a subsidiary trading company, there should be no need to move that investment into a UK company in order to obtain relief.

The only circumstance in which the residence of a company is directly relevant is where it is sought to obtain the benefit of paragraph 3. This is a provision referred to below, but in broad terms it gives relief where the conditions otherwise necessary to be satisfied in order to obtain the relief are not satisfied but would have been satisfied had the disposal been made at some time in the previous two years. In such a case the company making the disposal must either be resident in the UK or a gain accruing must be within the charge to corporation tax (see paragraph 3(2)(c)). This requirement may have relevance in a case where a non-resident company has gains apportionable under section 13 TCGA 1992 and wishes to realise losses to reduce the charge to tax on its shareholders. As we will see, if the company has a loss-making subsidiary, it might deliberately try to fail the conditions required to be satisfied in order to obtain the relief, with a view to realising an allowable loss on the disposal of shares. Such a course might be possible for the non-resident unaffected by paragraph 3, when it would not be possible for a resident company. Save as regards paragraph 3, the Schedule is generally unconcerned with the residence of companies. Thus it is immaterial where the company in which shares are disposed of is resident.

Likewise, when groups are looked at in the Schedule, the reference is to worldwide not UK groups.

(ii) The disposal is of shares in a company in which the company making the disposal has a substantial shareholding (see paragraph 7)

The particular point to note here is that the relief is not a relief for disposals of substantial shareholdings, but is a relief for disposals, where the company making the disposal has or has had a substantial shareholding. The requirement is that a company must have had a 10%+ holding for at least 12 months in the two years preceding the disposal. So by way of illustration, if a shareholder has 11% now and sells 5%, he can obtain relief on the sale of his remaining 6% so long as he sells it within 12 months of the first sale.

(iii) The relief is a relief for disposals of interests in trading companies

Both the vendor company and the company in which the shares are sold must satisfy a trading requirement throughout the period commencing at the beginning of the latest twelve-month period by reference to which the substantial shareholding requirement is met, and ending at the time of the disposal. They must also satisfy a like requirement immediately after the disposal (see paragraphs 18 and 19). The trading requirement is broadly that the company is a sole trading company or member of a trading group. The reference to groups in this context is to the capital gains tax definition, save for the substitution of the 51% test for the 75% test (see paragraph 26). As already mentioned, this will mean that international groups will have to be looked at as one, in order to see whether the exemption is available. Concentration on UK resident companies will not determine the issue. While there are quite complex provisions to be applied to determine whether the trading requirement is met, there are no provisions like those which feature in other legislation under which certain sorts of trades do not qualify (e.g. IHT business property relief, which excludes share dealing and land trading).

For completeness one point should be made at this stage. Reference has been made to the relief as a relief available on the disposal of shares. There is a small qualification to this, in that relief may also be available on the disposals of certain "assets related to shares" (e.g. options to acquire shares). This is provided for in paragraph 2, but nothing more is said about it in this article.

What are now considered are a number of more precise points about the relief. No attempt is made in this article to give exhaustive coverage of relevant points, but reference is made to a number of points that have arisen in practice – some simple; some not so.

1. <u>Paragraph 5</u>

As almost a knee-jerk reaction, the Revenue, when introducing a relief, become over-concerned with it being used for tax avoidance. So in Schedule 7AC there is in paragraph 5 an anti-avoidance paragraph, which precludes the relief being available in certain circumstances. Paragraph 5 applies if there are arrangements of a certain sort from which

> "the sole or main benefit that could be expected to arise in that the gain on the disposal is by virtue of the Schedule not a chargeable gains".

This is a bit like section 787 ICTA 1988 regarding interest payments. On the whole it is unlikely to apply save in the rarest of circumstances.

It is not all arrangements that can be caught, but only those of a defined sort. These are arrangements pursuant to which an untaxed gain accrues to the company, and before the accrual of that gain

> the disposing company acquired control of the company (the shares in which are disposed of); or
>
> there was a significant charge in trading activities affecting the company the shares in which are disposed of.

Any structures set up before the proposal to introduce this relief was announced can hardly be said to be arrangements the sole or main benefit from which could be expected to arise is the obtaining of relief under the Schedule. In addition it is doubtful that the paragraph will ever apply to any normal commercial structure. The sole or main benefit requirement will not be met. Sales will occur because of commercial motives. In this connection, the Revenue have given the following illustration of when paragraph 5 may apply:-

> "The provision is intended to counter a situation where what is essentially an investment return is dressed up as an exempt capital gain. An example might involve a package of derivatives designed to produce a guaranteed return being acquired by a company (company B which is controlled by company A). Alternatively, company B could already hold such a package and be acquired by company A. It is claimed the derivatives are assets of a financial trade being carried on by company B – the trade may have commenced only with the arrival of the derivatives package and they may be the only assets of company B. Alternatively, company B may have had a small pre-existing, probably related, trade. The shares in company B would be sold by company A before any return on the package of derivatives is taxed. This may be because any income is not taxed on an accruals basis or because the package produces a return only on exercise or sale and there is nothing that could be taxed before that point. The sale may be back to the provider of the derivatives package, so that any profits and losses match. But for the anti-avoidance rule company A would have obtained what is in effect an investment return on its 'deposit' as an exempt capital gain".

The essential point arising from the above is that the circumstances being referred to are, to put it mildly, unusual.

2. The substantial shareholding requirement

This requires a minimum 10% shareholding throughout a twelve-month period in the last two years preceding the disposal. The 10% shareholding requirement involves

> ownership of not less than 10% of the company's ordinary share capital;
>
> entitlement to not less than 10% of the profits available for distribution to equity holders;
>
> entitlement, on a winding up to not less than 10% of the assets available for distribution to equity holders.

All of these requirements must be met. To illustrate the position, let us suppose Company A is a parent and proposes to sell one of its subsidiaries, Company B. All the requirements for the new relief are satisfied. Company A owns all the shares in Company B. Unfortunately Company A does not want the exemption to apply because it is going to make a loss on the sale of Company B. What can it do? One possibility might be for the share capital of Company B to be re-organised so that a new class of shares is issued to a person (not being another company in the group) which represents more than 90% of the ordinary share capital but which has very limited economic rights, these rights being retained by Company A. Whether this is possible or not will depend upon a whole range of factors including the size of the share capital of Company B. If it has 100 £1 shares, such a course might not be difficult; if it has many millions it may be more difficult.

Note:-

the new shares cannot be held by a group company (because of paragraph 9);

the course would involve degrouping Company B;

even if such a course is feasible there would have to be a twelve-month delay;

such an arrangement would not be affected by paragraph 3 because the requirement in paragraph 3(2)(a) would not be met.

In determining whether the substantial shareholdings requirement is met two particular rules apply:

(i) holdings of group companies are aggregated (paragraph 9);

(ii) the period for which a company has held shares is extended by any period during which the shares were held by a company which disposed of them to the company concerned on a no-gain no-loss disposal e.g. an intra-group disposal under s.171 (see paragraph 10).

The operation of these rules is not always as straightforward as it might seem. Let us take an example. Company A is a non-resident parent of a group. It transfers shares in Company C to Company B, a company resident in the UK. Company B has only recently been formed. All the companies are members of the same group. Shares in Company C have been held by Company A for many years, but Company B only has just acquired the shares when it is decided to sell them. Here:-

(i) Company B, of itself, does not satisfy the substantial shareholding requirement.

(ii) No reliance can be placed on paragraph 10: there is no disposal at no gain or loss, because Company A is non-resident.

(iii) Can there be reliance on paragraph 9?

Company C is treated as holding shares held by another member of its group. Can it apply though in respect of a period when Company B did not exist and was not therefore a member of a group? Two interpretations are possible. First it can be argued that if a company is a member of a group at the time of the disposal in question, it can be treated as holding and as having held any shares held by a company which is at that time a member of a group. The alternative approach is that the deeming only works while companies are members of the same group at the same time. Hence if a company does not exist the paragraph cannot apply. I take the latter view of the position. Typically, if there is a difficulty it is a problem fairly easy to rectify, either by a transfer of the shares to another company in existence throughout the period in question, or by an election under s.171A TCGA that another Company in the group throughout such period should be treated as making the disposal.

3. The trading requirement

The only general point to be made about the trading requirement in paragraph 19 and onwards in the Schedule is that the greatest uncertainty as to the applicability of the relief will arise from this requirement. The requirement is that a company or group concerned must carry on trading activities where its activities do not "include to a substantial extent activities other than trading activities" (see paragraphs 20(1) and (21)(1)). The Revenue have said that the same approach will be adopted, as to what is "substantial" as for taper relief purposes (as to which see the Tax Bulletin June 2001). As to this they say that "substantial" means more than 20%.

One particular point to note is that in considering whether there is a trading group, the activities of the members of the group are treated as one business, with the result that activities are disregarded to the extent that they are intra-group activities (see paragraph 21(5)). In certain circumstances, holdings of shares in joint venture companies are disregarded, and a company is itself treated as carrying on a proportion of the activities of the joint venture company (see paragraph 23). In this situation there is nothing to say that services provided to the joint venture company are to be disregarded. Thus if a group company leases property to the joint venture company, that activity will be non-trading and will be taken account of in determining the trading status of the group, even though, had the joint venture company been a subsidiary, it would have been ignored.

I now revert to the position where a company to be sold will be sold at a loss, where the desire is to fall outside rather than within the relief. I have already mentioned one particular course that might be adopted so as to preclude the substantial shareholding requirement from being satisfied. But as I have said even if that is feasible it will involve a twelve-month delay. As a result of this, it may be thought that if losses will be crystallised there may be more merit in seeking to ensure that the trading requirements are not met.

> Example. Company A owns all the shares in Company B, a trading company. All the conditions for obtaining the relief are satisfied, but because, if the shares are sold, a substantial loss will arise, the effect of the relief is disadvantageous. What is proposed therefore is that the trade of Company B is transferred at market value to a fellow subsidiary, Company C. Company B will then cease to trade and subsequently it will be wound up. Will an allowable loss arise?

The argument is that the relief will not apply, because Company B will not satisfy paragraph 19, in that Company B will not be a trading company immediately after the disposal. A problem arises, however, because of paragraph 3, which provides an exemption broadly where the conditions for relief have been met in the preceding 2 years. This paragraph is as much concerned with preventing allowable losses as giving relief from gains. The following is said as to the effect of paragraph 3 in the Treasury's notes on the Finance Bill:-

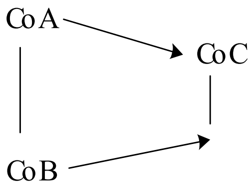
> "Thus, for example, where the company invested in ceases to trade on being placed in liquidation, any gain accruing to the investing company on a disposal of shares in that company in the following two year period is potentially exempt under this paragraph. And where the trade of the company invested in is transferred elsewhere (within a group, for example), any loss on the disposal by the investing company on shares in that company within the two year period after the company invested in ceased to be a trading company is potentially not allowable."

In the example I have given, paragraph 3 would operate to prevent losses being allowable unless there is a two year delay. It would not be the case, however, if Company A did not control Company B (see paragraph 3(2)(e)). The effect of paragraph 3 is important to consider, where a trade ceases, with the company invested in being subsequently disposed of or liquidated. If a gain is to accrue, the aim typically will be to ensure that it is crystallised within 2 years from the termination of the trade. If a loss is to accrue the aim will be to defer the disposal for more than 2 years. For these purposes it should be noted that the time of the disposal is the time of contract, even if the contract is conditional (see paragraph 3(7)). It may be that paragraph 3 can operate to provide relief in somewhat unexpected circumstances. Suppose that Company A is the parent of a large trading group and owns Company B, which carries on a trade from a variety of premises. It is desired to enter into a sale and lease back transaction of these properties. If Company B does this chargeable gains will apply. Let us suppose, however, that Company B's trade is transferred to Company C (intra group) and a lease is granted to Company B of the premises concerned. Company B, at this stage, ceases to be a trader and its shares are sold to the outside investor. Is relief available on the sale? On the face of it no, because of the requirements of paragraph 19 not being met. A trading company is not being sold. But why does paragraph 3 not apply? In this connection it should be noted that shifting value into Company B in order to obtain the benefit of the relief is difficult. If there are intra-group transfers s.179 will apply on a sale of Company B. In this connection gifts into such a company protected from charge by s.165 TCGA 1992 will not enable gains to be protected (albeit losses will still be non-allowable see paragraph 3(5)).

4. The position on share exchanges

Paragraph 4 has the effect that the exemption can apply on transactions which do not normally give rise to disposals (e.g. share reorganisations falling within s.127 TCGA 1992). In such cases chargeable gains will arise on the disposal, and the company concerned will have a new base value for the new shares acquired.

Example



– In the above example relief will be available on Company A's disposal of the shares in Company B. If Company A subsequently disposes of shares in Company C, it will have to wait 12 months to get relief. Likewise Company C will get relief on a sale of Company B only if it waits for 12 months.

The position is more complicated if all the companies are in the same group. In such a case, it is not thought that a disposal will bring the exemption into play. This is because paragraph 4 requires it to be assumed, in seeing whether the exemption applies, that s.127 does not operate. On that assumption, the exemption would not apply, because the disposal would be within s.171, and paragraph 6 says that such a disposal is excluded. On this basis the taxing provisions operate normally and without regard to the Schedule. In these circumstances, on a disposal by Company A of new shares acquired in Company C, periods of ownership before the exchange can be taken account of by virtue of paragraph 14. On a disposal by Company C of Company B, Company C will not be able to take advantage of paragraph 10 (because no s.171 disposal can be taken advantage of). Paragraph 9 will be able to be taken advantage of, but only in respect of periods during which Company C has been a member of the group.

THE LIMITED PARTNERSHIP

A UK vehicle for non-residents with non-UK income

by Milton Grundy and Michael Thomas[1]

The statutory provisions governing the tax liability arising on the income of a partnership – whether general or limited – are to be found in ss.111 and 112 of the Income and Corporation Taxes Act 1988. The partnership is not treated as an entity which is separate and distinct from the partners, and liability to tax only arises if the partners are chargeable to income tax by reference to their share in the partnership income. If therefore the partners are all non-resident and the income does not have a UK source, no liability to tax arises. It is not generally difficult to determine whether or not an item of income has a UK source; in this context, one has to remember that income arising from the carrying on of a trade in the United Kingdom has a UK source even if all the customers are overseas. Whether or not a trade has been carried on in the United Kingdom is – in that unhelpful phrase of which lawyers are so fond – a question of fact in each case. The test is, "Where do the profits really arise?" and an important fact is where the contracts are made: in the circumstances contemplated, the partnership should be prepared to offer evidence that the contracts it makes are made outside the United Kingdom. Strictly, there would be no harm in one or more partners seeing a customer in the United Kingdom, but since such a meeting might be taken – in the event of a disputed claim – to be evidence of the carrying on some part of the trade in the United Kingdom, this is something to be avoided. Partnerships have a similar transparency for inheritance tax purposes, so that if the partnership assets are situated outside the United Kingdom and an individual partner is not domiciled in the United Kingdom, no charge to inheritance tax arises on his death. Partnerships are also transparent for capital gains tax purposes (Taxation of Chargeable Gains Act 1992, s.59), so that provided the partners are all non-resident and no trade is carried on through a branch or agency in the United Kingdom, the use of a limited partnership would not give rise to any charge to capital gains tax. Although non-residents are not (in general) liable to capital gains tax on the disposal of assets situated in the United Kingdom, they are subject to income tax on income which arises in the United Kingdom, so that if the limited partnership had UK-source income, each of the partners would be taxable on his share of it. It follows from this general fiscal transparency that distributions to partners are immaterial. An initially surprising result of the fiscal transparency of partnerships is that the concept of "management and control" has no relevance to partnerships, and, so long as all the partners are non-resident and the partnership does not have any UK-source income, it makes no difference whether or not the partners hold meetings in the United Kingdom.

The statutory provisions affecting all partnerships – limited as well as general – are to be found in the Partnership Act 1890. The Act is merely declaratory, and, except insofar as they are inconsistent with the express provisions of the Act, the rules of equity and of common law applicable to a partnership are still in force. A limited partnership is also governed by the Limited Partnerships Act 1907. A limited partnership requires to be registered with the Registrar of Companies. There are separate registries in England, Scotland and Northern Ireland, and the appropriate one is in that part of the United Kingdom in which the principal place of business of the limited partnership is situated or proposed to be situated. There is a trifling registration fee and there are no annual fees. The partners send a signed statement to the Registrar, which includes particulars of the sums contributed by each of the limited partners, and whether paid in cash or how otherwise. This is open to public inspection, on payment of a small fee. A limited partnership does not have legal personality, except in Scotland – see Partnership Act 1890, s.4(2). It is not unlawful for the limited partners to participate in the management of a limited partnership, but if they do so they lose their limited liability. A general or limited partner can be any individual, wherever resident, or any company, wherever incorporated. The signed statement filed with the Registrar must contain particulars of the principal place of business of the limited partnership, in England, Scotland or Northern Ireland, as the case may be. The draftsman does not appear to have contemplated that a limited partnership would in practice carry on all its business outside the United Kingdom, but nothing in the Limited Partnership Act prohibits it from doing so. It is considered, therefore, that the principal place of business specified in the statement lodged with the Registrar is the place at which, if any business were to be carried on in the jurisdiction, such business would be carried on. This is, of course, an important point, because – as appears from what is said above about the tax position – if a limited partnership if it were to carry on a trade in any part of the United Kingdom, a liability to UK tax would arise.

The essence of the partnership – whether general or limited – is a contract between the partners to engage in a business with a view to profit. Mere co-ownership of property does not, of itself, give rise to a partnership between the co-owners, whether or not they share any profits made by the use of it. The decided cases are replete with examples of facts which fall just on one side of the border or the other, but in practice the distinction between an active business and passive investment is plain. Confusingly, a limited partnership is a "collective investment scheme" for the purposes of the Financial Services Act, but this simply means that interests in the limited partnership cannot be offered for sale to the public without the compliance with the provisions of the Act, and does not bear on the question, whether there is a true partnership or a mere co-ownership of assets. Mutual funds are not established as limited partnerships but either as unit trusts or as companies.

It is unlawful for a person who has a place of business in Great Britain and carries on business there to do so (without Government approval) under a name which would be likely to give the impression that the business is connected with Her Majesty's Government, any part of the Scottish Administration or any local authority (Business Names Act, 1985). These provisions do not of course apply in the circumstances contemplated, but it is considered that the Registrar would not register a limited partnership whose name would be prohibited by the Act. Only a limited company can include “Ltd” or “PLC” (or their full versions) in its name (Companies Act 1985. ss.33 and 34). Otherwise, a limited partnership can carry on business under whatever name it pleases. If all the partners are companies, the limited partnership must have audited accounts and these are open to public inspection (Partnerships and Unlimited Companies (Accounts) Regulations, SI 1993/1820, implementing EC Directive 90/605. Subject to some exceptions, which are not material here, the number of partners in any partnership – whether general or limited – cannot exceed twenty.

Some practitioners outside the European Union have been concerned that the use of a limited partnership formed in accordance with the Limited Partnership Act for the supply of services may expose the partners to value added tax on the grounds that the partnership “belongs” in the United Kingdom – Value Added Tax Act 1994, s.7(10). But for a partnership to be treated as belonging in the United Kingdom it must have a business establishment or some other fixed establishment in the United Kingdom – see Value Added Tax Act 1994, s.9(2), and this will not be the case in the circumstances contemplated.

A UK limited partnership is registered in the United Kingdom. It has a UK address and a registration number. As a tax-transparent vehicle, it has particular appeal to trusts and companies established in offshore jurisdictions. In some onshore jurisdictions, a payment to a "tax haven" company is disallowed as a deduction. In others, it is the occasion for an investigation. But even where the consequences are less specific, one can find that one or more parties to a transaction simply do not want to participate, if an offshore company is involved. Such considerations have stimulated the search for cosmetic alternatives to the offshore company – a vehicle which attracts little attention and is on nobody's blacklist. And it is here that the fiscal transparency of the UK limited partnership is particularly advantageous.

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[1] An earlier version of this article appeared in *The Limited Partnership*, edited by Milton Grundy (International Tax Planning Association, 2001).

IHT PLANNING – THE GIFT WITH REVERSION APPROACH

Patrick Soares

A taxpayer may have valuable assets (e.g. a portfolio of shares) with respect to which no business property relief or any other inheritance tax relief is available. If he holds on to the shares then the capital gains inherent in the shares would be "washed" on death but an inheritance tax charge may arise because, for example, he has no spouse to leave the property to in his will.

The taxpayer is therefore in a quandary. He cannot give the shares away without paying capital gains tax; on the other hand if he holds onto the shares he will pay inheritance tax.

Under the gift with reversion approach, to overcome the quandary, the taxpayer would carry out the following steps:-

1. He would set up a discretionary trust under which at the end of, say, a year the trust assets would revert back to him. The members of the discretionary class could include himself. The discretionary class could receive income in the trustees' discretion. For reasons mentioned below the discretionary class would not include beneficiaries who he may want to give the shares to ultimately.

2. Whilst the trust is discretionary, i.e. before the reversionary interest has fallen in, he could give the reversionary interest to an interest in possession trust for the benefit of, say, his children. His children would not be amongst the class of discretionary beneficiaries under the discretionary trust. The intention is the taxpayer would survive the gifts by seven years having not retained any benefit under the new interest in possession trust.

3. At the end of the year the funds (the shares) would go out of the discretionary trust, suffering a small inheritance tax charge, with the capital gains tax holdover election being made.

The transactions are now looked at in more detail.

Transfer of Portfolio of Shares to Discretionary Settlement

For inheritance tax purposes there will have been a chargeable transfer but hopefully the nil rate band would take care of any actual charge to tax. The reduction in value of the estate of the settlor should not be too great because one would take into account the fact that at the end of the year the shares must come back to the settlor. The reversionary interest is not excluded property for inheritance tax purposes. The capital gains tax charge on the gift into the settlement can be held over under TCGA

1992 s.260. There should be no stamp duty or income tax consequences arising from that transaction.

Gift of the Reversionary Interest by the Settlor

This would be a PET within IHTA 1984 s.3A because none of the members of the discretionary class will be the recipients of the gift of the reversionary interest (namely the children who have interests in possession under the new settlement). The pernicious IHTA 1984 s.55 will not apply. That provision provides that if a person receives a reversionary interest and that person already has an interest under the settlement then the reversionary interest is not comprised within his estate; the effect of that would be there would be no PET and there would thus be a chargeable transfer. Oh horror! (if that were the case). By ensuring that the children are not members of the discretionary class it is clear that the gift of the reversionary interest would be a PET. There will be no charge to capital gains tax on the gift of the reversionary interest as it is a gift of an interest under a settlement (TCGA 1992 s.76(1)). There should be no relevant stamp duty or income tax consequences arising from that transaction.

Vesting of Shares in New Trustees of the Interest in Possession Settlement at the End of a Year

Under IHTA 1984 s.65 there would be a small charge to inheritance tax but that would enable any charges to capital gains tax to be held over (TCGA 1992 s.71(1), s.260(1), SDTS C.4.208, CG 33551 and CG 67041 and TCGA 1992, s.77).

The *Ramsay* Approach

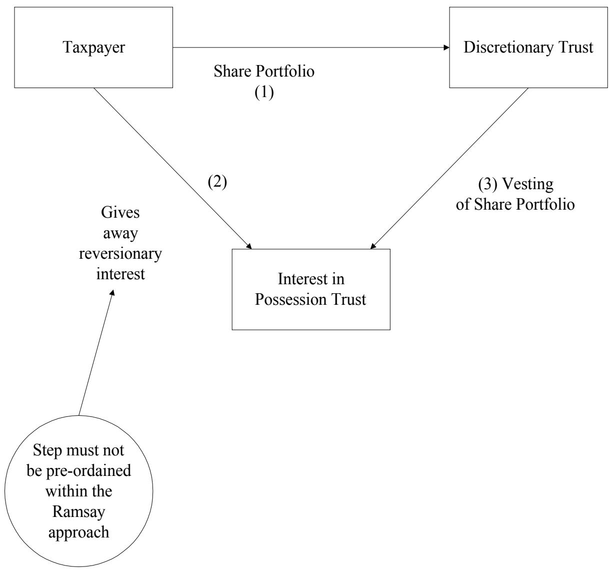
It is not felt that the *Ramsay* approach would have any application provided the taxpayer had not determined in advance what was to happen with the reversionary interest. The necessary element of pre-ordination would not be present. The taxpayer may die; he may decide to have the share portfolio back; he may decide to give it absolutely to his children or in trust. Each case, of course, must be examined on its own facts. Almost by definition one cannot have tailor-made schemes which overcome the *Ramsay* approach! It is arguable that *Ramsay* should not apply in any event in such circumstances as only “pure legal” concepts are involved but it may be precarious to rely on such arguments (*MacNiven v. Westmoreland* [2001] STC 237).

Associated Operations

It is felt that all the transactions would be associated operations within IHTA 1984 s.268(1). The disposition, namely the ultimate gift of the shares, carried out by two transfers of value, namely the gift into the discretionary trust and the gift of the reversionary interest, would be treated as having been carried out at the time of the last operation, namely, when the shares vest in the trustees of the interest in possession trust. One therefore has associated operations and these are what may be termed “relevant” associated operations (*MacPherson v. IRC* [1988] STC 262 and *Reynaud v. IRC* [1999] STC (SCD) 185). However, the most that can be accomplished by those provisions applying is that there is a PET made by the taxpayer at the time when the shares vest in the trustees of the interest in possession trust; however credit is available for the earlier transfer of value when the shares were put into the discretionary trust; it is thus not felt that the associated operations have any relevant consequences.

Conclusion

Overall the arrangement has its attraction but one must ensure that the subsequent gift of the reversionary interest is not part of a pre-ordained scheme within the *Ramsay* approach; bearing in mind, of course, that the settlor may die before the gift is made, and he has a year in which to make the gift if he makes the gift at all, that should not be too difficult, one hopes, to achieve.



MODERNISING STAMP DUTY ON LAND AND BUILDINGS IN THE UNITED KINGDOM

Patrick Way

Background

The Inland Revenue issued a consultative document in April 2002 on the subject of modernising stamp duty on land and buildings in the UK. Various indications of the future for stamp duty can be gleaned from this document and the subsequent discussion process.

Towards the end of 2003, or the beginning of 2004, it will no longer be necessary to send in documents to the Stamp Office in the present way. Instead, there will a standard form for notification which will be available electronically. Payment will be accepted by cheque, cash, BACs, CHAPs, as at present. Other electronic means of accepting payment are already being explored. Methods will be introduced to ensure that land registries can check that payment has been made in advance of registration. In due course, as a second part of this process, the land registries themselves will introduce electronic systems for conveyancing and other registration procedures. The aim is that these systems should replace the need to notify the Inland Revenue separately of a chargeable transaction.

Scope

A key feature of the changes overall is a new form of stamp duty transactions involving land and buildings in the United Kingdom. It should extend to transfers of substantial interests in entities (such as companies) owning mainly UK land. More particularly, in the consultative paper the Stamp Office suggest that the new rules would be likely to apply to:-

- the transfer of *substantial* interests (for example acquisitions of shareholdings of 30% or more), in

- certain *qualifying entities* including companies, partnerships, and other (possibly non-UK) vehicles,

- whose *major activity* involves the ownership or exploitation of UK land and buildings, and

- whose assets consist *primarily* of interests in UK land and buildings (for example at least 70% of gross assets).

Stamp tax, because that is what it will become, will be a modern purchase tax paid by a purchaser or a lessee. (At the moment there is no person responsible for the payment of stamp duty, because it is a tax on documents, and therefore, in practice, the person who seeks to rely on the document in question would typically seek to have the document taxed. But that is a matter of commercial expedience, not law.)

The consultation process has now been underway since April 2002, and the intentions of the Revenue are clearer. They want the new stamp tax to be a global tax. This means that they want it to be payable by the purchaser or the lessee wherever such a person may be resident, if the transaction relates to UK land. In other words, they are aware of techniques by which entities based in locations such as Ireland or the Channel Islands are set up to acquire UK property in circumstances where stamp duty is avoided and the "knock out" provisions of s.14(4) Stamp Act 1891 are irrelevant because the structures involve no UK nexus. As stated, the new stamp tax is to be on "substantial interests". This means that whether land is held through a company, a unit trust, a partnership or however, stamp tax will arise on the acquisition of a substantial interest. It is not clear whether the Inland Revenue are fully focused on the meaning of the word "acquisition" in these circumstances. After all, in Australia, where a stamp tax has been in existence for some time, the relevant legislation appears to be wider than that proposed by the UK Revenue. For example, it is not clear that if a structure were created involving a series of companies, a land transaction would automatically be caught by the new rules: there may not be sufficient "tracing" down to the company that holds the land interest to produce a charge in these circumstances.

The 2003 Budget is likely to describe in more detail the changes which will probably come into effect by the end of October 2003 or perhaps some time in February 2004. The Law Society have asked for a transitional period to be introduced which would allow property practitioners to become used to the new forms that will be used initially. The general feeling is that it is unlikely that there will be a consolidated Stamp Tax Act, but if this were to be the case, after all, then this would not be enacted until some time in 2004 at the earliest.

The new rule will be that the trigger point for the tax will be either the payment for the transaction (with an exemption for deposits) or else will be the time of substantial performance. On the face of it, therefore, all current stamp duty planning is likely to need sufficient rethinking, since the new tax will impact on any transaction involving land by reference to the cash paid or by reference to the transaction occurring: we shall all need to start afresh with what is in essence an entirely new tax.

What is left in the meantime?

Before the new stamp tax takes effect, there remain some planning ideas.

Resting on contract

Section 115 Finance Act 2002 brings to an end schemes involving resting on contract (exchanging but not completing), but only where there is a contract or agreement for the sale of an estate or interest in land and the amount of the consideration exceeds £10m. or is part of a larger transaction where the consideration exceeds £10m. Consequently, the position remains that contracts may be exchanged without stamp duty where the consideration is £10m. or less. In certain circumstances this is enough. The vendor and the purchaser simply agree to exchange contracts, the equitable interest passes by operation of law and with care (and subject to the circumstances) the purchaser has all that it needs.

Split title

If one wants to take this resting on contract technique a step further, then one can use the so-called "split title" arrangements involving a lease. The vendor would grant a long lease to a nominee for itself. Provided the nominee was not connected with it no *ad valorem* stamp duty would arise. There would then be a contract for the assignment of the long lease to a purchaser, and the relevant contract would not be completed. Assuming that the consideration did not exceed £10m, no *ad valorem* stamp duty would arise. In due course, the freehold reversion could be passed over to the purchaser or a subsidiary of the purchaser. The Stamp Office seem resigned to the fact that this technique avoids stamp duty and is not caught by s.90 Finance Act 1965 (contemplation of sale). Their resignation is probably tempered by the fact that this planning cannot survive the introduction of the new stamp tax: the payment of the consideration would, in effect, produce a stamp tax charge in the new regime.

Variation of the split title scheme

A slightly more provocative version of the split title scheme involves, again, the creation of a long lease in favour of a nominee. The long lease would be, say, for a peppercorn. This would drive down the value of the freehold reversion. The freehold reversion would then be sold to the purchaser for its market value (next to nothing). In due course, the purchaser might then make a substantial payment to the vendor in consideration of the vendor (in its capacity as lessee) agreeing to a cancellation of its lease for the consideration in question. This arrangement should not involve a conveyance on sale (it is merely a cancellation), and consequently ad valorem stamp duty is avoided. This technique is aggressive but probably effective.

Reducing rent with a stamp duty-free payment

Another clever idea takes advantage of the ability to make a payment to reduce rent in circumstances where the payment does not give rise to stamp duty. Accordingly, the vendor would grant a long lease to a subsidiary and perhaps it would be agreed that a considerable rent (say £30m.) would be paid in the first year with, say, 12% rental increases over a period of time and then a peppercorn rent in due course. In these circumstances that lease might then be sold to the purchaser for, say, £500,000. The scheme would then unravel by the purchaser of the lease paying a large sum of money, say, £30m., to reduce the rent. The payment is entirely free of stamp duty: it does not fall within the charging provisions of the legislation. The reduction might be to reduce the rent (as stated) from £30m. in Year 1 to a small rent of, say, £100,000 per year. Anything less than this might lead to the conclusion that there had in effect been a chargeable surrender and regrant after all. In due course a subsidiary of the purchaser could then acquire the freehold interest. In these circumstances £30m. is moved to the vendors free of stamp duty.

Foreign Partnerships

One fairly straightforward technique for avoiding duty used to be to transfer land into a company and then to sell shares in that company at a rate of ½% (or nil if the company were foreign). Section 119 Finance Act 2000 put an end to this. However, it may be possible to "re-invent" this idea by utilising a foreign partnership instead of a foreign company. The vendor contributes property to the partnership. The Stamp Office generally accepts that this is stamp duty-free on the basis, for example, that s.241 Finance Act 1994 (exchanges) has no relevance. There is then a sale of the relevant partnership interest in circumstances where s.14(4) Stamp Act 1891 does not apply. In due course the partnership may be dissolved in circumstances where no stamp duty arises having regard to the ratio of the case of *IRC v. Macleod* (pure winding up – no consideration). Care needs to be taken in relation to this arrangement if interest relief is needed in the hands of a foreign purchaser, as it will be necessary to take additional steps in these circumstances.

Finance Act 2002

The Finance Act 2002 introduced a number of anti-avoidance provisions. These included a prohibition on group relief on intra-group transfers under s.42 Finance Act 1930 where there is a transfer of land and buildings followed by an onward sale of the transferee company within two years if it retains the land. The legislation is very poorly drafted, and there seems nothing to prevent a transfer of land down two or more tiers of companies in circumstances where the transferee company that leaves the group will not own the land directly. In relation to moving assets up the chain (in a reconstruction and "s.110 liquidation") it is clear that there should be no new clawback rules under the new anti-s.76 provisions introduced by FA 2002, if the land which is being transferred up the chain leaves the holding company pursuant to relief under ss.75 or 76 FA 1986. But the Stamp Office seem to take the view that where there is a direct distribution then the clawback provisions in s.113 Finance Act 2002 may apply after all.

Conclusion

Stamp duty (or stamp tax) is undergoing a significant change and all of us involved in this area need to keep an eye on matters in anticipation of significant new legislation towards the end of 2003 or the beginning of 2004.

Caveat

The ideas in this article are intended to stimulate thinking: they should be implemented with great care.

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