TREATY-SHOPPING THROUGH LIFE ASSURANCE[1]

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Tax treaties are not made in order to provide advantages for taxpayers. This is one of those truths which are universally acknowledged. Tax treaties are entered into in order to divide the tax take between the two governments who are signatories to the agreement. And this is done on the basic principle that if the income is taxed *here* the taxpayer can have a credit *there*, or – and this can be more interesting to the taxpayer – if income is free of tax *here*, you can expect it to be liable to tax *there*. Expect, yes, but that is not always the case. There are anomalies, and here is an interesting anomaly. Mr. H is resident in Hong Kong. He has it mind to make a substantial investment in a company which is to be established in Silicone Valley and which is to be listed on the NASDAQ Exchange. In the first scenario, he takes up 40% of the shares, the company does well and he receives substantial dividends for a number of years. He suffers US withholding tax at 30% on these dividends. Now let us look at the alternative scenario. Mr. H takes out a policy with a UK insurance company. He pays a premium to the insurance company and the insurance company subscribes for the shares in the US company. The US company prospers and pays dividends, but this time to the UK insurance company. Under the terms of the tax treaty between the United Kingdom and the United States, dividends paid by a US corporation to a UK resident carry a much lower rate of withholding tax, and in some cases are free of withholding tax altogether. Is the UK insurance company entitled to the benefit of the treaty? This is a question which is really a series of questions. The first one in the series is, is the UK company a "resident of the United Kingdom"? The residence article – Article 4 – is in the usual form: *resident ... means ... any person who, under the laws of [the United Kingdom], is liable to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criteria of a similar nature.* The insurance company we are talking about is incorporated in the United Kingdom and companies incorporated in the United Kingdom are liable to tax there, so the answer to this question is a simple "yes". The next question is, whether the UK company is entitled to a lower rate of withholding tax on dividends received from the US company. This is a question of American law, but my reading of Article 10 is that the US withholding tax is reduced from 30% to 5%. However, we are not yet quite out of the wood. Article 24 is the notorious "limitation on benefits" Article. It restricts the benefit of the treaty to persons who are what it calls "qualified persons". This should not bother us in the present case, because a regular quoted company falls into one of the categories of "qualified person". Much more worrying is paragraph 9 in Article 10, which says, laconically, *The provisions of this Article shall not apply in respect of any dividend paid under, or as part of, a conduit arrangement.* The expression sounds rather vague, but, fortunately, there is a definition in sub-paragraph (n) of paragraph (1) in Article 3. If the transaction or series of transactions is to be treated as a conduit arrangement, it needs to be structured in such a way that the UK company receives the US dividend but pays it – directly or indirectly, and at any time or in any form – to someone who is not entitled to a treaty benefit, and that the transaction or series has as its main purpose, or one of its main purposes, obtaining treaty benefit. Whether the policy in question satisfies the "main purpose" test will, I suppose, depend upon the facts of a particular case. But I should like to focus on the first test. We can see that this requires the UK insurance company to make a payment which – to put it into layman's language – represents the US dividend. In our case, the only payment which the insurance company is going to make is when the policy matures or is surrendered. That may be twenty years down the road. And it may or may not represent the twenty year-old dividend receipt: that dividend may have been swallowed up, in the meanwhile, in some less successful investment. But even if that does not happen, does it make sense to say that the insurance company is entitled to the treaty benefit this year, but that entitlement is withdrawn in twenty years' time? It seems to me that the "conduit arrangement" provision is not aimed at insurance policies at all. The kind of transaction it is, I believe, aimed at is one which uses a treaty country as a stepping-stone on the way to a zero-tax jurisdiction. Typically, a copyright is settled on some offshore trustees, who license it to a Dutch company, which licenses it an American publisher: the US royalties are intended to pass to the Dutch company free of withholding tax under the US/Netherlands tax treaty; the ongoing royalties are deductible in computing the profits of the Dutch company, and the Netherlands does not impose any withholding tax on outgoing dividends. So the upshot is that the offshore trustees are intended to receive their American royalties free of tax, though subject to a small "turn" in Holland. The "conduit arrangement provisions" are there to prevent US withholding taxes being avoided in this way.

That has been a rather long-winded excursion, but the short point is, that so long as we are outside the "conduit arrangement" provisions, the US withholding tax on the dividends in this example is going to be only 5%, as opposed to 30%. There is one little UK problem Mr. H needs to bear in mind, and that is that assets situated in the United Kingdom are subject to inheritance tax, and this tax is payable on the death of the owner, even though he is not resident or domiciled in the United Kingdom. The rule is that a policy issued by a UK-resident company is an asset situated in the United Kingdom. The way the insurance industry deals with this in practice is that the policy document takes the form of a deed – what we used to call a document "under seal" – kept outside the United Kingdom. It is issued by a foreign branch of the UK insurer and provides that the proceeds are payable at that branch. But these are technical details. The main point is that by using an insurance "wrapper" Mr. H indirectly benefits from a tax treaty he cannot benefit from directly.

The "limitation on benefits" Article is only to be found – so far at least – in treaties with the United States, and I take the example of an investment in the United

States for the very reason that treaty-shopping into the United States is so difficult as to be generally impossible. But the United Kingdom is party to ninety-eight other tax treaties, so there has to be scope for using UK insurance policies for treaty-shopping in all those countries too. It is also worth remembering that while tax treaties generally provide for a reduced rate of withholding tax on dividends, the European Union Directive provides for dividends to be paid from one EU country to another free of all withholding tax. This opens up the possibility of using a UK insurance policy for what I suppose must be called “directive-shopping”. For instance, if Mr. H’s investment is to be in Spain, the tax treaty would not reduce withholding tax on the dividends below 10%, but the Directive would eliminate it altogether. That is an important saving. But Spain’s withholding tax on dividends is quite low by European Union standards. In Germany the withholding tax is 21%, and in France, the Netherlands, Austria and Denmark 25%.

Treaty-shopping can not only reduce or eliminate taxes on income, it can also reduce or eliminate taxes on capital gains. Going back to the Spanish example, my understanding is that the sale of a substantial interest in a Spanish company gives rise to capital gains tax liability in Spain, whether the investor making the sale is resident in Spain or not. Article 13 of the tax treaty between Spain and the United Kingdom, however, exempts the UK resident from tax on such a sale, and it follows that Mr. H might want to make his Spanish investment through a UK policy, not only for the purpose of receiving his dividend tax-free but also for the purpose of avoiding Spanish tax on the gain he makes when the investment is ultimately sold.

The real problem with this transaction is not in advising whether it works or not. There seems to be little doubt about that. The difficulty lies in finding an insurance company that will do it for you. You can go to the Isle of Man or the Cayman Islands, and get a Manx or Caymanian insurance company to invest in shares in a company that they have never heard of. If that is what the policyholder wants them to do, then so long as the value of the policy is linked to the value of the investments – so that if the investments are a success this increases the value of the policy, and if the investments are a failure this does not cost the insurance company anything, they will be happy to do it, and why not? But these offshore jurisdictions do not have any tax treaties – except, in the case of the Isle of Man, a very old one with the United Kingdom, so an offshore policy cannot give us the treaty-shopping result. Onshore jurisdictions tend to have regulations limiting the kind of investment the insurance company can make to regular portfolio investments, like government bonds and shares traded on a recognised stock exchange. And there are generally regulations requiring the company to diversify its investment portfolio. All this is understandable in the context of the regular insurance policy sold in the retail market: there it works for the benefit of the policyholder, limiting his exposure to more risky or less tradable investments. But a more risky and less tradable investment is exactly what Mr. H is my example wants to make. And it is exactly in that investment area that treaty protection is most valuable. With a diversified portfolio of quoted securities, the investor is not too concerned about the withholding tax on the dividends. The investments are made with a view to growth – that may be a bit of an illusion nowadays, but it is still what the investor is hoping for. There is never any local tax on portfolio gains, and the yield is not all that significant. But an investment in a new company – in California or in Spain in my examples – is expected to have a high yield, and in many countries is subject to a capital gains tax on disposal. This is where the treaty protection is needed.

Is there a solution to this dilemma? I have made enquiries in a number of countries, and I must say it has been a faintly dispiriting experience. I got nowhere in Cyprus, the Netherlands, Singapore, Switzerland or the United Kingdom. In Luxembourg, I struck gold. The Head of Marketing at Lombard International Insurance sent me a message saying this:-

> "In terms of your specific example, we would be able to create a policy which included as an investment the substantial holding in an unquoted US company. You are right to say that Luxembourg would impose no taxes within the policy or on payment of surrender, maturity of death benefit proceeds."

Having been delighted to discover that I was re-inventing the wheel which had already been invented in Luxembourg, I was further delighted to find that it had also been invented in Ireland. My first enquiries in Ireland drew very negative responses. But then my attention was drawn to an Irish company called Irish Life International. Evidently, they can issue policies which are backed by investment in private company shares! As a matter of policy, they will not do business with intending policyholders resident in France or Germany or outside the European Union. Strangely, they are very happy for a policyholder to circumvent this rule by establishing a company or trust in the Isle of Man (which counts as part of the European Union for these purposes, though of course it is not). Ireland and Luxembourg both have an extensive range of tax treaties, and a policy taken out in one of those countries may function as an advantageous vehicle for investment in many parts of the world. These are just two examples which I have been able to unearth, but there may well be other countries where insurance policies work as treaty-shopping vehicles in this way.

The Luxembourg and Irish companies I mention are in business in a big way and are no doubt utterly solvent. But unfortunate things can happen to the biggest companies, and one has to remember that there is one important difference between Mr. H's position as a direct investor in the US company and his position as a policyholder with an insurance company which makes that investment, and that is that if the insurance company goes broke he has no right to the US investment, but must join the queue of creditors of the insurance company to get whatever may be available to creditors generally. Reading the sales literature of the Irish and Luxembourg companies, I discover that local regulations require the company to maintain what in Ireland are called "technical reserves" matching the total value of all liabilities to policyholders, so that in the event of winding up, all assets representing technical reserves are ring-fenced for the absolute benefit of policyholders, subject to expenses. There must of course always be some element of risk that the protective regulations are not complied with, and I do not know how far regulations of this kind extend to other countries, so that there is, even in the best case, always some element of risk in holding an asset through an insurance policy. This is one of the considerations which has led people to think about having an insurance company of their own. Another consideration – and it is not altogether an unimportant one – is that having one's own company could work out a good deal cheaper than using one of the commercial companies – whose charges have to be high enough to pay any introductory commission, and of course to make a profit for their shareholders. A do-it-yourself insurance company may be incorporated in a number of places. Let me take, by way of example, an insurance company incorporated in England. The company does not carry on any business in the United Kingdom. Its directors' meetings may take place in the United Kingdom[2], but the company carries on all its business in Anguilla, where it has a licence and is regulated. What I plan to achieve here is to have a company which is a resident of the United Kingdom for tax purposes but an Anguillan insurer for regulatory purposes. It is resident in the United Kingdom for UK tax purposes, and will be liable to UK tax on its profits – but these do not include income which is allocated to policies held by policyholders resident outside the

United Kingdom. By the same token, it will be a resident "of" the United Kingdom for treaty purposes and entitled to the benefit of tax treaties to which the United Kingdom is party – remembering that if it is to take advantage of the US treaty, it needs to be a "qualified person".

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[1] This article is based on part of a talk given by the author at a meeting of the International Tax Planning Association in Singapore in November of last year. The full text can be found in the ITPA *Journal* Vol V No.2.

[2] I am told that the UK Revenue will not in practice certify the company's UK residence on the basis of its place of incorporation alone.