HOME THOUGHTS FROM ABROAD[1]

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Practitioners in the United Kingdom are, not unnaturally, accustomed to look at the UK tax system from within: the landscape is familiar, and harsh. But when we look at the regime from the outside, the landscape is altogether more benign. Indeed, some aspects of it appear to have been expressly designed to replicate offshore facilities, ring-fenced for the benefit of non-residents. These facilities appear to have been, in the past, largely of academic interest – though undoubtedly valued in the world of the London trust companies and their international clientele. But over the last few years, they have acquired a new importance – as have other provisions in the UK tax code which facilitate the use of the United Kingdom as a kind of "stepping-stone" for non-resident investors investing abroad.

Why should non-resident investors start to prefer a UK *stepping-stone* to a simple tax haven vehicle? The answer lies, not in any changes which have occurred in the United Kingdom, but in changes which have occurred elsewhere. Many countries nowadays have some form of blacklist[2] and tax authorities everywhere have heard about *harmful features* and *harmful competition*[3]. Practitioners who might in the past have advised a client to conduct a transaction through a company incorporated in, say, the Cayman Islands, are now looking for the jurisdiction which is on nobody's blacklist and does not feature in the OECD or Primarolo lists – one where a company can show its face to a

French tax inspector and one which carries no aura of tax planning. The jurisdiction which eminently fits the bill is, of course, the United Kingdom.

Non-resident Company

Many readers will remember when the zero-tax non-resident English company was a popular offshore vehicle. Those happy days came to an end on the 15th March 1988[4], but the old non-resident company was effectively re-invented in 1994, in consequence of the coming into force of sections 249 – 251 of that year's Finance Act: under these provisions, a company incorporated in the United Kingdom, but qualifying as a resident of some other country for the purposes of a tax treaty, is to be treated for domestic purposes as not resident in the United Kingdom. At first blush, it does not look like a very interesting provision. Who would want to avoid tax in the United Kingdom in order to have the pleasure of paying tax in some other country? But that line of thought does not take into account the fact that some countries tax certain income very lightly, or not at all, and the United Kingdom has treaties with several of them. A company incorporated in the United Kingdom but resident in Mauritius may have a tax rate as low as 1.5%. One resident in Singapore will pay no tax on any of its foreign income, and most kinds of foreign income are similarly exempt in Malaysia. And if the company is resident in Barbados, it will pay local tax on its foreign income only if it remits such income to Barbados, which it is not obliged to do. None of these countries levies any tax on capital gains. One has to

remember, of course, that shares in all UK-incorporated companies – whether they are resident or not – are subject to UK inheritance tax. If that is a problem, the UK company can have a parent company, incorporated elsewhere.

Corporate Partner

Another way of using a UK company is as the managing partner in a limited partnership formed under the 1907 Act, or a limited liability partnership, formed under the Act of 2000. Partnerships are transparent for tax purposes[5]: where a partner is non-resident and the partnership income has a non-UK source, the partner has no UK tax liability. Typically, the UK company will have only a tiny share, the bulk of the income going to one or more partners offshore. Customers, however, deal with the UK partner, and may by so doing be able to circumvent blacklist and similar problems.

One aspect of the transparency of the partnership is that – unlike a company – the tax liability is not affected by the "management and control" of the business. If the partners want to have partnership meetings in London and take decisions there about the management and control of the partnership business, they can feel free to do so. But if in the United Kingdom they do business with customers, their profits will have a UK source and be taxable accordingly. So if, for example, the partnership is in the business of buying refrigerators in Nigeria and selling them in Iceland, it needs to find somewhere outside the United Kingdom to negotiate with the customers and sign the contracts.

Corporate Trustee

A third use of the UK company is as a trustee. A trustee can carry on a trade, if it has power in its trust instrument to do so, and it can of course buy and sell assets and realise and re-invest gains. The UK tax system is very generous to UK-resident trustees of settlements made by non-resident and non-domiciled settlors. Moreover, the United Kingdom, unlike the offshore jurisdictions, does not require a company to have a licence to act as a trustee, nor does it require a trust company to have a name which suggests that it has anything to do with trusts. When the capital gains tax was introduced, in 1965, a tax-free regime was carved out for trusts established by non-residents. This was deliberately done, to protect the business of the established trust companies. A lot of tax planning involves taking advantage of loopholes the legislature never intended. But this is quite the opposite: Parliament has expressly provided a capital gains tax regime for the trust company incorporated in the United Kingdom, or managed and controlled there, which manages trusts as a business and acts as trustee of a settlement made by a settlor not domiciled, resident or ordinarily resident in the United Kingdom. While being fully taxable on the gains that it makes for itself, it is treated, in its capacity as trustee, as non-resident and is therefore not subject to capital gains tax on gains it makes in that capacity[6]. If there is a beneficiary who is absolutely entitled to the income, the trust will be "transparent" for income tax, just as a limited partnership is, with the result that non-UK income can pass through the trust to a non-resident

beneficiary, without attracting any UK tax[7]. A "thin" trust – in which the non-resident settlor reserves to himself a life interest – is a simple, and cosmetically attractive, zero-tax vehicle. It has freedom from capital gains tax and freedom from income tax on its non-UK income.

Tax Treaties

Does the UK trust have a treaty-shopping aspect? The archetypal case is that of the Kuwaiti investor who plans to acquire a major share in a Spanish company. For any one or more of a variety of reasons, he may decide to establish a "thin" trust, appointing as trustee a company resident in the United Kingdom and inviting the trustee to make the investment. He is advised that if he were to make the investment himself, he would be liable to capital gains tax in Spain if he ultimately disposed of the shares at a profit. But what happens if the investments is made not by him but by the trust company? Article 13 of the tax treaty between the United Kingdom and Spain exempts a resident of the United Kingdom from Spanish tax on such a gain. At first sight, it seems illogical that the trust company can be non-resident by virtue of section 69(2) but at the same time resident for the purposes of the treaty. But that, it is submitted, states the position too simply. The use of the word "treated" in section 69, tells us that we are moving from the world of reality to the world of make-believe[8]. The section contains two statutory fictions. By subsection (1) the trust company is to be *treated* as a "single and continuing body of persons" (which it may or may not

be), and the residence of that "body" is to be determined partly by reference to the residence of the trustees or a majority of them. By subsection (2) the trust company is to be *treated* (in the circumstances contemplated) as non-resident, which is the very opposite of the fact. These statutory fictions are not imported into the Income and Corporation Taxes Act: a resident trustee is liable to income tax on trust income without reference to income accruing to his predecessor or successor, and whether or not he is treated as non-resident for capital gains tax. Nor is there anything in the language of any of the tax treaties which suggests that these fictions are to be imported into them: the "alienator" entitled to the benefit of the treaty is the trust company; it is "liable to taxation" in the United Kingdom, by reason of its "domicile, residence, place of management or other criterion of a similar nature", as may be evidenced by its liability to corporation tax on its trust fees[9].

The "thin" trust does not offer any treaty relief on the *income* flowing into the trust. It is not every country which taxes gains arising from foreign investment, but countries as a rule do tax outgoing dividends, interest and royalties. Is there a UK trust appropriate to these? If there is no beneficiary with an interest in possession in the trust income, but the trustees are to accumulate the income or to distribute it at their discretion, the trust is not transparent: the income is that of the trustee, and the trustee is in principle liable to income tax on it. But if the UK trust company is only one of two or more trustees, and the other trustee or trustees are resident outside the United Kingdom, then, so long as the settlor is resident,

ordinarily resident and domiciled outside the United Kingdom, the UK trust company will be treated for domestic purposes as non-resident (Finance Act 1989, s110), and the income may therefore be accumulated free of tax. It is submitted that income paid to the trust company is income of a resident of the United Kingdom for treaty purposes[10], although it is not "subject to tax" – a circumstance which is sometimes[11], but not by any means always, a condition of relief.

Stepping Stone

The "stepping-stone" concept is not new. Treaty shopping by interposing a Netherlands company between a copyright owner in a (say) the Bahamas and a user in a country with which the Netherlands has a tax treaty has been going on for many years. The Netherlands has tax treaties with a large number of countries and does not impose any tax on outgoing royalties. Tax authorities in some countries, however, have become intolerant of this royalty route, and practitioners looking for an alternative route have found the United Kingdom offers similar advantages without necessarily suggesting a tax avoidance motive. Outgoing copyright royalties (not in respect of a UK copyright) suffer no UK tax[12], but if the outgoing royalties are for the use of a patent, there is in principle a tax charge[13] – a charge which may not be suffered if the recipient is resident in a country with which the United Kingdom has an appropriate tax treaty. Barbados is attractive in this context: the royalties may be remitted to an international trust and distributed to beneficiaries elsewhere[14].

A UK company may also function as a kind of Stepping-stone for dividends. Suppose an operating company, resident in a high-tax country, is owned by an investor in a zero-tax jurisdiction. By interposing a UK holding company, dividends may be free of withholding tax, or suffer a lower rate of withholding tax than would be suffered if the dividends were paid direct to the investor: the UK holding company benefiting from a tax treaty or from the Parent/Subsidiary Directive. The United Kingdom gives tax relief to incoming dividends in the hands of the holding company, but does so in a different way from that adopted on the Continent. The Continental approach is to exempt the foreign dividend from tax, if the profits out of which the dividend is paid have suffered tax abroad. The British approach is to tax the foreign dividend, but to allow credit for the foreign tax, including tax paid on the operating company's profits[15]. The full rate of corporation tax in the United Kingdom is 30%. So it follows that so long as the operating company's dividend has suffered at least 30% tax abroad, the UK holding company enjoys the same freedom from domestic tax on the incoming dividends as is enjoyed under the Continental systems. Both systems offer an exemption from tax on gains on disposals of foreign direct investments (though the UK regime is new and not very user-friendly). But the United Kingdom does not nowadays levy any tax on outgoing dividends, so the zero-tax investor does not have to think about routing through the Antilles or funny gearing or prolonged liquidations, and it is this feature which has elevated the United Kingdom to the jurisdiction of first choice for this kind of Stepping-stone.

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[1] This article is adapted from parts of a paper prepared for the meeting of the International Tax Planning Association in November 2003. Some of the material was published in the *International Tax Report* of October 2003.
[2] See Marshall Langer, in *ITPA Journal* Vol III No.3.
[3] From the Primarolo Report and the OECD Reports, respectively. See Philip Baker's article in this issue.
[4] Finance Act 1988 s.66.
[5] Income and Corporation Taxes Act 1988, ss.111, 112 and 182A; And see *GITC Review* Vol II No.1 page 67.
[6] See, now, section 69(2) of the Taxation of Chargeable Gains Act 1992, but note the provisions relating to a branch or agency, contained in section 10.
[7] See *Singer v. Williams* [1921] 1 AC 41.
[8] The statement in the text is implicit in the language of the subsection. Take the example, "Ludwig Wittgenstein paid the Germans a lot of money to have his sisters in Vienna treated as non-Jewish". One thing that statement tells us is that they were not actually non-Jewish, for if they had been, their brother would not have needed to pay the money. In abstract terms, "If X is to be treated as having quality Y, X does not actually have quality Y." In the context of section 69(2), the statement that the trustee is to be *treated* as non-resident, predicates that the trustee is not actually non-resident.
[9] The point is explored more fully by the author in a forthcoming issue of the *Offshore and International Taxation Review* (Keyhaven).
[10] The argument follows that outlined above in relation to section 69(2). The UK trust company is *treated* as non-resident as regards the trust income, just as it is as regards the trust capital gains, but it is nevertheless a "resident of the United Kingdom" for the purposes of a tax treaty. It is also "a company of a Member State" for the purposes of the EU Parent/Subsidiary Directive.
[11] e.g. in Article 11 of the treaty with Barbados.
[12] See Income and Corporation Taxes Act 1988, s.537 and *Simon's Taxes* B.819.
[13] Income and Corporation Taxes Act 1992, s.349.
[14] See GITC Review Vol I No 2 at page 23.

[15] Income and Corporation Taxes Act 1992, Part XVIII Ch II.