OFFSHORE TAX PLANNING ISSUES

Rory Mullan[1]

A territorial approach to taxation generally sees a state tax on the basis of residence and source. That is to say that a state will tax:

a) residents on their worldwide income and gains; and

b) residents and non-residents on income and gains having a source within the state.

Under UK law the territorial principle of taxation has in many instances been expressly overridden by a series of anti-avoidance provisions which reverse tax-savings by the use of offshore entities. These impose charges on the potential or actual beneficiaries of the planning.

Significantly, however, in recent years the The European Court of Justice (CJEU) has developed a coherent body of case law as to how the EU treaties and in particular the freedoms of movement interact with Member States tax systems. As EU law now stands, deviations from the territoriality principle, that is to say taxation on a basis other than residence or source, are becoming increasingly difficult for states to enforce leaving the scope and enforceability of a number of UK anti-avoidance provisions uncertain.

In addition, while there are a number of provisions in the UK tax code which are unenforceable as a matter of EU law, the UK does not in every instance tax to the fullest extent permitted by EU law. Obvious examples of this are the taxation of foreign domiciliaries and the treatment of capital gains accruing to non-residents.
Two particular instances where issues arise in this respect are the Transfer of Assets Abroad provisions and section 13 TCGA 1992. The European Commission has begun infringement proceedings in relation to these provisions and in response the UK has issued a consultation with proposed amendments. The draft legislation for the Finance Bill 2013 was published on 11 December 2012. Whether these amendments are enough is open to question, as discussed below.

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EU LAW CONSIDERATIONS[2]

Although direct taxation falls within the individual competence of each Member State of the EU, that competence must be exercised in compliance with EU law and in particular with the freedoms of movement laid down in the EU treaties[3].

The freedoms of movement prohibit a Member State from discriminating against taxpayers on grounds of nationality or otherwise restricting their exercise of the freedoms of movement. Where a tax provision prohibits, impedes or renders less attractive the exercise of a freedom of movement will be unenforceable as against a tax payer exercising EU law rights[4], unless that provision

a) can be justified as pursuing a legitimate objective compatible with the EU treaties or is otherwise justifiable by overriding reasons in the public interest[5] and

b) it can be shown that the provision is a proportionate means of achieving the justification in a), in that it is both appropriate to achieving its aim and that it does not go further than necessary in so doing[6].

Maintaining tax revenues is neither among the objectives stated in the Treaty nor an overriding reason in the public interest capable of justifying a restriction on a freedom instituted by the Treaty[7]. As such restrictive tax measure cannot be justified on the ground that a Member State's tax revenue would be reduced, unless it can be shown that the purpose and effect of the provision is to prevent activities carried out in the Member State escaping the charge to tax (in which case the measure will still need to be proportionate).

The right of establishment and free movement of capital

The freedoms of movement which tend to be in point in the context of offshore tax issues are:

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2 For a fuller and more comprehensive analysis of the issues involved please see *The Interaction of EU Treaty Freedoms and the UK TAX Code,* Rory Mullan and Harriet Brown (2011)

3 C-337/08 *X Holding BV v Staatssecretaris van Financien* [2010] STC 941 at paragraph 16

4 C 311/08 *Société de Gestion Industrielle (SGI) v État belge* at paragraph 50 and 51

5 C 318/07 *Persche v Finanzamt Lüdenscheid* [2009] STC 586 at paragraph 41

6 C 524/04 *Test Claimants in the Thin Cap Group Litigation v IRC* [2007] STC 906 at paragraphs 82 and 83

7 C 318/07 *Persche v Finanzamt Lüdenscheid* [2009] STC 586 at paragraph 36

The right of establishment. This right is contained in article 49 TFEU and confers on both individuals and companies the right to participate on a stable and continuing basis in the economic life of another Member State[8].

Free movement of capital. This freedom is contained in article 63 TFEU. It prohibits restrictions on movements of capital both within the EU and between Member States and third countries. Movement of capital is widely defined[9].

Although the provisions concerning free movement of capital are said to apply to third countries in the same way as they apply to Member States[10], that is subject to two important caveats:

1) The legal relations between Member States and third countries is likely to be different to that which exists between Member States, and this can accordingly allow a Member State to justify a measure as against a third country which it could not justify as against an Member State[11].

2) Measures in place on 31 December 1993 will not be disapplied to the extent that they restrict movements of capital with third countries involving direct investment[12]. This will not apply where the measure has been changed to create a new restriction[13].

There can be an overlap between the right of establishment and the free movement of capital. For example investment in the share capital of a company can involve the exercise of both treaty freedoms, although typically the right of establishment will only be engaged if the shareholding gives a level of influence in the running of the company (likely to be at least 25%).

Where a provision can apply to either treaty freedom, both will be in point. Where, however, a provision is aimed primarily at the right of establishment, for example because it targets persons engaged in the influence and running of a company, it may be that free movement of capital will be excluded[14]. This will typically cause a problem in situations involving a third country.

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8 C 55/94 *Gebhard* at paragraph 25

9 The Nomenclature contained in Annex I to Directive 88/361 gives an indication of the type of transaction which comes within the meaning of movement of capital, although it is not exhaustive (C 510.08 *Mattner* at paragraph 19).

10 C 101/05 *A* at paragraph 31

11 C 72.09 *Rimbaud*

12 Article 64 TFEU and C 436/08 *Haribo*

13 C 446/04 *FII* at paragraph 194

14 C 31/11 *Scheunemann v Finanzamt Bremerhaven*

TRANSFER OF ASSETS ABROAD

These are a complicated and technical series of provisions contained in Chapter 2, Part 13 ITA 2007 but which date back to FA 1936. The following is purely a broad outline.

The provisions apply where there has been a *relevant transfer*. There is a *relevant transfer* if:

a) there is a transfer of assets and

b) as a result of either

  i) that transfer,

  ii) one or more associated operations or

  iii) the transfer and one or more associated operations

  income becomes payable to a person abroad (section 716 ITA 2007).

It is, however, to be noted that a *transfer* is expanded to include the creation of rights (section 716(2) ITA 2007), *assets* includes property or rights of any kind (Section 717 ITA 2007) and that a *person abroad* can include persons are in fact UK resident (non-UK domiciled persons and non-UK incorporated companies).

An *associated operation* is an operation of any kind effected by any person in relation to (i) any of assets transferred or (ii) any assets directly or indirectly representing the assets transferred, or (iii) income from (i) or (ii or (iv) assets representing accumulations of income from (i) or (ii) (section 719 ITA 2007).

The legislation also refers to *relevant transactions* which is a transaction which is either a relevant transfer or an associated operation.

There are four potential charges under the provisions. These charges currently apply to persons who are ordinarily resident in the UK, although presumably with the abolition of ordinary residence this will be changed to UK residents:

(i) *The power to enjoy charge:* a person who has sought to avoid liability to UK tax by means of a relevant transfer (a transferor) will have the income of the person abroad treated as arising to him if he has power to enjoy that income as a result of the relevant transfer and/or associated operations (section 720(2) and 721 ITA 2007).

(ii) *The transferor's benefit charge:* a transferor who has power to enjoy by reason of receiving a benefit out of the income of the person abroad is liable to income tax on the whole of the amount or value of that benefit save to the extent that he has already been subject to tax on income from which the benefit derives (section 720(2) and 724 ITA 2007).

(iii) *The capital receipt charge:* a transferor who receives a capital sum (which includes a loan, a repayment of a loan and other sum which is not income and not paid for full consideration) in connection with a relevant transfer or an associated operation is deemed to have income of the person abroad arising to him (section 727 ITA 2007).

(iv) *The non-transferor's benefit charge:* a non-transferor who receives a benefit out of assets which are available as a result of a relevant transfer will be treated as receiving income of a person abroad if that income has not been subject to charge under (i) to (iii) (section 732 ITA 2007).

The motive defence

There is a defence to the transfer of assets charge where either of the following is satisfied in relation to *all* relevant transactions (that is to say both the relevant transfer and also any associated operations) (section 737 ITA 2007):

> *"... it would not be reasonable to draw the conclusion, from all the circumstances of the case, that the purpose of avoiding liability to taxation was the purpose, or one of the purposes, for which the relevant transactions or any of them were effected".*

or

> *"(a) all the relevant transactions were genuine commercial transactions (see section 738), and*
>
> *(b) it would not be reasonable to draw the conclusion, from all the circumstances of the case, that any one or more of those transactions was more than incidentally designed for the purpose of avoiding liability to taxation".*

Commercial transaction is narrowly defined. A transaction will not be a commercial transaction unless it is effected in the course (or with a view to setting up) a trade or business and for its purposes. Furthermore it must be on arm's length terms. Making or managing investments is only a business if done by a person unconnected with the person for who it is done and on arm's length terms (section 738 ITA 2007).

The above motive defence applies to transactions made after 5 December 2005. For transactions before that date a wider motive defence was available if:

> *"... the purpose of avoiding liability to taxation was not the purpose, or one of the purposes, for which the relevant transactions or any of them*

were effected".

or

"... the transfer and any associated operations-

(a) were genuine commercial transactions, and

(b) were not designed for the purpose of avoiding liability to taxation".

EU law issues

In C-196/04 *Cadbury Schweppes plc v IRC* [2006] STC 1908 the CJEU explained (at paragraph 45), that where a national code of one state seeks to charge its residents on the profits of an entity in circumstances where there would be no charge if an entity were established in that state there is a tax disadvantage which gives rise to a prohibited restriction on the right freedom of establishment. It made clear that the overall tax take was not the point. If a disadvantage is placed on the person exercising the right of establishment that would *prima facie* be contrary to the right to establishment. In particular, there was a prohibited restriction on the right of establishment where there is a greater tax liability on a person as a result of exercising that right.

This reasoning would seem to apply equally to each of the power to enjoy charge, the transferor's benefit charge and the capital receipt charge, all of which would seem to be contrary to both the right to establishment and the right to free movement of capital. It is difficult to see what justification recognised by the CJEU could possibly be in point.

As regards third countries, it would seem to be the case that free movement of capital will be in point. The UK government would appear to have lost the benefit of the standstill in Article 64 once it reduced the scope of the motive defence in December 2005. Furthermore, it would not seem to be the case that the provisions are aimed at restricting the right of establishment.

An argument might be made that the exercise of the EU law rights expressly conferred by Parliament cannot properly be considered tax avoidance, so that the motive defence properly deals with all EU law issues. Such an argument would, however, represent a novel approach and is not consistent with the current approach applied by the Courts[15].

In any event it seems that the charge on transferors under the transfer of assets

15 For a fuller discussion see *The Relevance of EU Law to the Motive Defence*, Rory Mullan (2011) OITR, Issue 15

abroad legislation will be unenforceable in any case where there has been an exercise of rights protected under EU law. Where a taxpayer has in fact paid tax under these provisions, consideration should be given to reclaiming it as discussed below.

SECTION 13 TCGA 1992

This section imposes a charge by attributing gains of a non-resident company which would be a close company if resident in the UK to UK resident participators.

The gain is attributed in proportion to the interest of the participator in the company, although there will be no attribution of the participator and connected persons would not have more than 10% of the gain apportioned to them.

There is an exclusion for assets used for the purposes of a trade or for which the company would otherwise be chargeable by reason of A UK permanent establishment.

The effect of the section is to restrict the exemption from capital gains of non-resident persons by attributing those gains to UK resident participators. It operates to prevent individuals from sheltering gains by transferring them to a non-resident company.

EU law issues

The section has the effect that shareholders of a non-resident company are faced with capital gains tax charges at the higher rates applying to individuals, whereas shareholders of a UK resident company would benefit from (i) not having any liability and (ii) that liability being at lower corporation tax rates. That would seem to be a clear disincentive to the exercise of treaty freedoms and as such, would amount to a *prima facie* breach of the UK's obligations under EU law.

Application to third countries

This is clearly a restriction on the right of establishment (where the shareholder has a definite influence in the company and the company is exercising a right of establishment) and on the right to free movement of capital. The provision would seem to be aimed at restricting both freedoms and both will be in point.

As regards the 31 December 1993 standstill in Article 64 of the Treaty on the Functioning of the European Union, a number of changes have been made since that time (for the full amended text see the Appendix to these notes). The section has been altered in number of ways.

a) It now applies in respect of participators rather than merely shareholders. The extension to loan creditors operates to restrict movements of capital by way of loans.

b) Where a gain is used to repay a creditor within two years, there is no longer relief against the charge which would otherwise arise. Once again this operates to restrict movements of capital by way of loan.

c) There was previously no charge where there was a distribution within 2 years. Now, there is only a credit against the tax incurred on the distribution. This means that rather than having all of the tax relieved when a distribution is made within two years, only a portion of such tax may be relieved.

d) Another alteration is in subsection (11A) which provides that gains are to be calculated as if they accrue to a company within the charge to corporation tax. This change was introduced in line with the introduction of taper relief for individuals. As such, it does not appear to have changed the situation which had previously existed.

Having regard to the changes, although it is not unarguable that the legal substance is broadly unchanged, regard being had in particular to the approach of the UK courts in *FII*, it would appear that new restrictions have been introduced and that this should allow the reliance on Article 63 of the Treaty as a defence to a charge under this section in a third country context.

It is, however, noted that this assumes that there has been a 'direct investment' which may not necessarily be the case. If there is no direct investment, the standstill provision of Article 64 of the Treaty is not in point.

Justifications

It is difficult to see what justifications the UK could raise for the charge. While an argument might be made that the UK is entitled to tax gains from UK situate property, it is not proportionate to charge shareholders rather than the company itself. Furthermore, the charge applies to worldwide assets of the non-resident company.

In the circumstances, it seems clear that section 13 TCGA 1992 is incompatible with EU law and will be unenforceable in any case where EU law rights have been exercised.

INFRINGEMENT PROCEEDINGS AND THE PROPOSED CHANGES

The European Commission has commenced infringement proceedings against the UK in relation to the Transfer of Assets Abroad legislation and section 13 TCGA 1992 (considered below). The UK Government issued a consultation document in which it proposed amendments on 30 July 2012.

It is noteworthy that in its press release the European Commission expressly referred to both the right of establishment and the free movement of capital, (as the latter has been entirely ignored in the consultation document):

> *"In both cases, the Commission considers there to be discrimination, seeing as investments outside the UK are taxed more heavily than domestic investments. The difference in tax treatment between domestic and cross-border transactions restricts two fundamental principles of the EU's Single Market, namely of the freedom of establishment and the free movement of capital contrary to Articles 49 and 63 of the Treaty on the Functioning of the European Union (TFEU) and Articles 31 and 40 of the EEA Agreement".*

The proposals take a similar approach to both provisions focussing on economically significant activities.

Transfer of assets abroad – the proposed changes

1. For the transfer of assets abroad legislation a new defence is proposed to be introduced alongside the motive defence:

   742A Post-5 April 2012 transactions: exemption for genuine transactions

   (1) Subsection (2) applies for the purpose of determining the liability of an individual to tax under this Chapter by reference to a relevant transaction if:

   (a) the transaction is effected on or after 6 April 2012, and

   (b) conditions A and B are met.

   (2) Income is to be left out of account so far as the individual satisfies an officer of Revenue and Customs that it is attributable to the transaction.

   (3) Condition A is that:

   (a) were, viewed objectively, the transaction to be considered to be a genuine transaction having regard to any arrangements under which it is effected and any other relevant circumstances, and

> (b) *were the individual to be liable to tax under this Chapter by reference to the transaction,*
>
> *the individual's liability to tax would, in contravention of Title II or IV of the Treaty on the Functioning of the European Union, constitute an unjustified and disproportionate restriction on a freedom protected under that Title.*
>
> (4) *Condition B is that the individual satisfies an officer of Revenue and Customs that, viewed objectively, the transaction must be considered to be a genuine transaction having regard to any arrangements under which it is effected and any other relevant circumstances.*
>
> (5) *Without prejudice to the generality of subsection (3)(a) or (4), in order for the transaction to be considered to be a genuine transaction the transaction must not:*
>
> (a) *be on terms other than those that would have been made between persons not connected with each other dealing at arm's length, or*
>
> (b) *be a transaction that would not have been entered into between such persons so dealing,*
>
> *having regard to any arrangements under which the transaction is effected and any other relevant circumstances.*
>
> (6) *Subsection (7) applies if any asset or income falling within subsection (11) is used for the purposes of, or is received in the course of, activities carried on in a territory outside the United Kingdom by a person (the relevant person) through a business establishment which the relevant person has in that territory.*
>
> (7) *Without prejudice to the generality of subsection (3)(a) or (4), in order for the transaction to be considered to be a genuine transaction the activities mentioned in subsection (6) must consist of the provision by the relevant person of goods or services to others on a commercial basis and involve:*
>
> (a) *the use of staff in numbers, and with competence and authority,*
>
> (b) *the use of premises and equipment, and*
>
> (c) *the addition of economic value, by the relevant person, to those to whom the goods or services are provided,*
>
> *commensurate with the size and nature of those activities.*

(8) In subsection (7)(a) "staff" means employees, agents or contractors of the relevant person.

(9) To determine if a person has a business establishment in a territory outside the United Kingdom, apply sections 1141, 1142(1) and 1143 of CTA 2010 as if in those provisions:

(a) references to a company were to a person, and

(b) references to a permanent establishment were to a business establishment.

(10) Subsection (5) does not apply if:

(a) the relevant transfer is made by an individual who makes it wholly.

(i) for personal reasons (and not commercial reasons),

and

(ii) for the personal benefit (and not the commercial benefit) of other individuals, and

(b) no consideration is given (directly or indirectly) for the relevant transfer or otherwise for any benefit received by any individual mentioned in paragraph (a)(ii),

and all assets and income falling within subsection (11) are dealt with accordingly.

(11) The assets and income falling within this subsection are:

(a) any of the assets transferred by the relevant transfer;

(b) any assets directly or indirectly representing any of the assets transferred;

(c) any income arising from any assets within paragraph (a) or

(b) ;

(d) any assets directly or indirectly representing the accumulations of income arising from any assets within paragraph (a) or (b).

(12) In subsections (10) and (11) references to the relevant transfer are to:

(a) if the transaction mentioned in subsection (1) is a relevant transfer, the transfer, or

(b) if the transaction so mentioned is an associated operation, the relevant transfer to which it relates.

2. The obviously discriminatory provision treating UK resident companies which are incorporated outside the UK as being non-resident, and therefore a person abroad, is also proposed to be removed. Interestingly, however, the equally (albeit indirectly) discriminatory treatment of non-domiciled person as being persons abroad is to remain unchanged.

Section 13 TCGA 1992 – the proposed changes

3. The proposed changes to section 13 TCGA 1992 involve additions to subsection (5) so that it will provide that:

(5) This section shall not apply in relation to—

(a) …

(b) a chargeable gain accruing on the disposal of an asset used, and used only—

(i) for the purposes of a trade carried on by the company wholly outside the United Kingdom, or

(ii) for the purposes of the part carried on outside the United Kingdom of a trade carried on by the company partly within and partly outside the United Kingdom,]3 or

(ca) a chargeable gain accruing on the disposal of an asset used, and used only, for the purposes of economically significant activities carried on outside the United Kingdom by the company through a business establishment in a territory outside the United Kingdom, or

(cb) a chargeable gain accruing to the company on the disposal of an asset which is effectively connected with any part of a business establishment in a territory outside the United Kingdom through which the company—

(i) carries on a trade wholly or partly outside the United Kingdom, or

(ii) carries on economically significant activities outside the United Kingdom, or

(cc) a chargeable gain accruing to the company on a disposal of an asset where it is shown that neither—

(i) the disposal of the asset by the company, nor

(ii) the acquisition or holding of the asset by the company,

formed part of a scheme or arrangements of which the main purpose, or one of the main purposes, was avoidance of liability to capital gains tax or corporation tax, or

(d) *to a chargeable gain in respect of which the company is chargeable to tax by virtue of section 10B.*

4. A new section 13A TCGA 1992 gives guidance in the interpretation of subsection (5):

13A Section 13(5): interpretation

(1) For the purposes of section 13(5)(b) a disposal of an asset is to be regarded as a disposal of an asset used for the purposes of a trade carried on wholly outside the United Kingdom by a company if

(a) the asset is accommodation, or an interest or right in accommodation, which is situated outside the United Kingdom, and

(b) the accommodation has for each relevant period been furnished holiday accommodation of which a person has made a commercial letting.

(2) For the purposes of subsection (1)(b) each of the following is "a relevant Period" -

(a) the period of 12 months ending with the date of the disposal and each of the two preceding periods of 12 months, or

(b) if the company has been the beneficial owner of the accommodation (or interest or right) for a period longer than 36 months, the period of 12 months ending with the date of the disposal and each of the preceding periods of 12 months throughout which the company has been the beneficial owner of the accommodation (or interest or right).

(3) The reference in subsection (1)(b) to the commercial letting of furnished holiday accommodation is to be read in accordance with Chapter 6 of Part 4 of CTA 2009, but

(a) as if sections 266, 268 and 268A were omitted, and

(b) as if, in section 267(1), the reference to an accounting period were a reference to a relevant period as defined by subsection (2) above.

(4) *For the purposes of section 13(5)(ca) activities carried on by a company through a business establishment are ,economically significant activities, if they are activities which consist of the provision by the company of goods or services to others on a commercial basis and involve:*

(a) *the use of staff in numbers, and with competence and authority,*

(b) *the use of premises and equipment, and*

(c) *the addition of economic value, by the company, to those to whom the goods or services are provided,*

commensurate with the size and nature of those activities.

(5) *In subsection (4) "staff"means employees, agents or contractors of the company.*

(6) *For the purposes of section 13(5)(ca) "business establishment means a permanent establishment as defined by sections 1141 to 1144 of CTA 2010.*

(7) *For the purposes of section 13(5)(cb) "effectively connected" has the same meaning as it would have for the purposes of the OECD model if that paragraph were contained in that model. References here to the OECD model have the same meaning as in Chapter 3A of Part 2 of CTA 2009 (see section 18S).*

Does the consultation make these provisions EU compliant?

It is noteworthy that the interpretation of EU law in the consultation document (and in particular the rather narrow justifications which the CJEU has permitting in relation to tax avoidance and the balanced allocation of taxing power) is rather more in line with what HMRC wish it to be than what the CJEU has actually said.

It is also noteworthy that the amendments entirely ignore the right to free movement of capital and as such the provisions continue to be at odds with the rights conferred by Article 63 of the Treaty on the Functioning of the European Union. In that respect, the idea that simply holding assets in a foreign company can be prevented consistently with EU law is entirely at odds with the approach of the CJEU in C 451/05 *ELISA* – a case where a Luxembourg company held French land and which the CJEU held was firmly within the scope of the provision on free movement of capital.

Interestingly, however, one of the suggestions is that the application of section 13 TCGA 1992 should be further restricted to those with a 25% interest. If that were to be the case, it might allow HMRC to argue that free movement of capital is not in point, although given the nature of the tax and the charge, it is doubtful whether such an argument would succeed.

Even as regard the right of establishment, it is doubtful whether economic activity must be significant, while the requirement of an arm's length transaction has no justification in EU law (notwithstanding the slightly odd approach of the CA to proportionality in *Thin Cap*).

The changes are nonetheless undoubtedly useful. They will remove some instances from the scope of the charges while the new motive defence in section 13 TCGA 1992 (where the motive must relate to CGT or CT) is undoubtedly a useful addition.

RECOVERY OF TAX PREVIOUSLY PAID

A High Court claim in restitution can be made to reclaim tax previously paid under either the Transfer of Assets Abroad legislation or section 13 TCGA 1992. Those claims can be made in respect of tax paid under mistake of law and also in respect of tax paid pursuant to an unlawful demand (the so called *Woolwich* claim).

A group litigation order can also be obtained where appropriate to reduce the costs of such claims.

In the latest instalment of the *FII* litigation, the Supreme Court held that the attempts to curtail the limitation period for a claim for tax paid under mistake of law in section 320 FA 2004 and section 107 FA 2007 (which are subject to infringement proceedings by the European Commission) was unsuccessful, although it has referred the matter to the CJEU.

This means that under section 32(1)(c) of the Limitation Act 1980 a claim can be made at any time from 6 years after the discovery of the mistake of law. That would potentially allow tax to be reclaimed going back a significant number of years (the *Woolwich* claim would apply only to the last six years).

This, does, however, raise a question as to when a claimant could "with reasonable diligence" have discovered the mistake of law. The decision in *Cadbury Schweppes* was given on 12 September 2006. It is arguable that the issue should have been known at that time or shortly thereafter. In the circumstances, it would seem prudent to issue proceedings as quickly as possible to stop time running.