SETTING UP BUSINESS IN THE UK

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The Opportunities for the Foreign Domiciliary

A foreign domiciled individual establishing a business in the UK has an excellent opportunity to structure his business to take advantage of the numerous tax advantages which apply to those with a foreign domicile.

The first issue is to consider whether the business should be operated as a sole trader or partnership, or whether it would be better to have a limited company (or an unlimited company) to carry on the business. At first sight it seems to make no difference. The individual being resident in the UK and carrying on a business here would be liable to income tax on all his profits, and those profits would be similarly chargeable to corporation tax if carried on under a corporate umbrella - although there may be an advantage in terms of the rate of tax payable. If the business or the shares in the company were later to be sold at a capital gain, that gain would be within the scope of capital gains tax and no help would be available from his foreign domicile, because the asset giving rise to the gain would be situated in the UK. For the purposes of inheritance tax, the business or the shares in the company would be assets situated in the UK and fully chargeable to inheritance tax subject only to the same reliefs, such as business property relief, which would apply to UK domiciled individuals.

To obtain an advantage from his foreign domicile it is necessary for the individual to ensure that he has assets situated outside the UK so that he may benefit from the remittance basis for capital gains tax under section 12 TCGA 1992 and excluded property for inheritance tax under sections 6 or 48 IHTA 1984.

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Capital Gains Tax

If the business being carried on in the UK were undertaken not by a sole trader, a partnership or by a UK incorporated company, but by a company incorporated abroad, in say the Channel Islands, the shares in that company would be an asset situated outside the UK. Under section 275 TCGA 1992 such shares are situated where they are registered and if on more than one register, where the principal register is kept. It would not be a difficult matter to ensure that there is only one share register which is kept in the territory of incorporation. Under the circumstances envisaged, the company would inevitably be resident in the UK by reason of the central control and management being situated in the UK, but that does not have any bearing on the situs of the shares for this purpose.

If the shares in the company were to be sold at a capital gain, the vendor would be chargeable to capital gains tax only on the amounts (if any) received in the UK in respect of that gain, the gain being treated as accruing when the amounts are received in the UK: section 12 TCGA 1992. In this context "received in the UK" has an extended meaning beyond that which applies for Schedule D under section 65 TA 1988. Section 12(2) incorporates the same test that applies for Schedule E, by treating as received in the UK "all amounts paid, used or enjoyed in, or in any manner or form transmitted or brought to the UK".

So as long as the proceeds of the sale remain outside the UK and are not received here actually or constructively, no charge to capital gains tax will arise. It is not possible to avoid the charge by remitting the gain after the termination of the relevant source. There is no source doctrine for capital gains tax. Nor is it likely to be successful to segregate the capital gain from the capital in a manner which is standard practice for income tax purposes. Whilst capital and income are different in character and can easily be separated, the same cannot be said for capital and capital gains; they are both capital. Accordingly if a remittance is made of part of the proceeds of sale, it needs to be determined whether the amount remitted is all gain, all original capital or a mixture of the two. Good arguments can be advanced in respect of each possibility but the Inland Revenue's policy is to take "a due proportion", that is to say to treat the remittance as representing capital gain in the proportion that the gain bears to the sale proceeds: Inspectors Manual paragraph 1567.

An effective way to deal with the problem of a remittance is to introduce a trust into the arrangements. If the shares in the company were to be transferred by way of gift to non resident trustees in advance of any sale, the disposal to the trustees would be deemed to take place at market value by reason of section 18 TCGA 1992, the individual and the trustees being connected persons. However,

there would be no proceeds of sale and there could therefore be no amount received in the UK in respect of the gain under section 12 TCGA 1992. Furthermore, the trustees, having been deemed to acquire the shares at market value, are unlikely to realise much of a gain when the shares are sold; indeed, even if a gain were to arise and a payment made from the trust to the foreign domiciled beneficiary, he would not be chargeable to tax on the trust gain because the attribution of trust gains does not apply where the beneficiary has a foreign domicile: Section 87 TCGA 1992. Only in circumstances of preordination or where the arrangements are not genuine could the payment by the trustees to the UK beneficiary be regarded as an amount received by him in the UK in respect of the gain made on the transfer to the trustees.

Inheritance Tax

As far as inheritance tax is concerned, the foreign domiciliary will focus on ensuring that his shares in the company are excluded property that is to say:

(a) Property situated outside the UK: section 6 IHTA 1984 or

(b) Property situated outside the UK comprised in a trust which was made at a time when the settlor was not UK domiciled: section 48(3) IHTA 1984.

The inheritance tax legislation contains no specific provisions to determine whether an asset is situated inside or outside the UK. Accordingly the general law applies and registered shares will be regarded as situated in the place where they are registered unless they are transferable in more than one country; for our purposes there should be no difficulty in ensuring that the shares in a foreign incorporated company will be situated abroad.

If the individual's foreign domicile is secure in the long term, that is to say he does not intend to reside here permanently or indefinitely, then section 6 would be sufficient to ensure inheritance tax protection in respect of his shares. If however the foreign domicile is not secure for example because his future intentions are more ambiguous perhaps having been resident in the UK for a long time with no positive intention of leaving, or perhaps if the 17 year rule in section 267 IHTA 1984 may soon become applicable, section 6 will not afford him sufficient long term protection. Section 6 is only relevant while he is not UK domiciled and as soon as a UK domicile or deemed domicile arises, the excluded property status of the shares would be lost. The individual would therefore be well advised to take advantage of section 48(3) to place the shares in a trust at a time when he is not UK domiciled so that the settled property continues to satisfy

the conditions for excluded property even if he were later to lose his foreign domicile and become domiciled in the UK.

The type of trust is not of immediate significance, but it could assume some importance later. The transfer to the trust would be a transfer of excluded property being property within section 6 and no inheritance tax implications would arise. A discretionary trust or a trust which confers a life interest on the settlor or his family would be equally effective but the combination of the two could lead to difficulty. Where the trust confers an initial life interest on the settlor or his spouse and thereafter the settled property is held on discretionary trust, the discretionary trust regime will apply to the settled property if at the time the interest in possession ceases, the life tenant is UK domiciled: section 82 IHTA 1984. In these circumstances the application of section 48(3) is excluded by section 82 and the protection from the 10 year and exit charges would be denied.

Where one spouse is UK domiciled and the other is not it will be tempting to take advantage of the position of the foreign domiciled spouse to achieve inheritance tax savings along the above lines. In doing so it is very important to ensure that the UK domiciled spouse is not the settlor of the settlement subsequently created. Where for example, assets are given by a UK domiciled husband to his foreign domiciled wife who then settles the assets on trust for herself for life and remainder to the children, it is very likely that the husband will be regarded as the settlor being:

> " a person who has provided funds directly or indirectly for the purposes of or in connection with the settlement": section 44 IHTA 1984.

The conditions of section 48(3) would not therefore be satisfied as the settlor would be the UK domiciled husband. Accordingly there should be no necessary connection between the transfer to the spouse and the subsequent settlement preferably should be established in due course by the spouse of her own free will and having taken separate professional advice regarding the consequences. It is also important that the transferor spouse should have no conscious association with the settlement in question. In these circumstances the husband would be greatly assisted by the words of Lord Keith *in Fitzwilliam v IRC* 67 TC 614:

"The words "for the purpose of or in connection with" denote that there must be at least a conscious association of the provider of the funds with the settlement in question. It is clearly not sufficient that the settled funds should historically have been derived from the provider of them. If it were otherwise anyone who gave

funds unconditionally to another which that other later settled would fall to be treated as the settlor or as the settlor of the funds".

Section 739 Consequences

Whilst this structure clearly has substantial capital gains tax and inheritance tax advantages care must be taken to avoid the application of section 739 which could cause serious damage. It may be thought that section 739 has no application here because although the creation of this structure would undoubtedly be a transfer of assets within the meaning of section 739, there would be no income becoming payable to persons resident or domiciled outside the UK. The business would be operated in the UK through a UK resident company fully chargeable to corporation tax on all its profits. However, section 742(8) TA 1988 provides that for the purpose of section 739, a company "incorporated outside the UK shall be treated as if it were resident outside the UK whether it is so resident or not". Accordingly, the income and profits of the company would be within the scope of section 739 notwithstanding that the company is in fact UK resident and fully chargeable to corporation tax on its profits. The Inland Revenue are therefore entitled to charge the company's income to tax in the hands of the individual resident in the UK despite the fact that corporation tax may have been paid on that income, the argument being that section 739 has the effect for all the purposes of the Income Tax Acts, a phrase which does not include corporation tax. The clear opportunity for double taxation in these circumstances was considered in the recent case of *Dimsey* but the Court of Appeal were not troubled by this possibility. They said:

> "There is a theoretical liability to double taxation. We were told that the practice is not to exact tax twice. We wholly accept that the subject is not to be taxed by discretion. Were a situation to arise in which contrary to their plain statement to the Court the Revenue sought in a section 739 case to exact tax from both the transferor and the offshore transferee, the High Court might be invited to prohibit it as an abuse of power".

Many might think that it had been conclusively determined by the House of Lords in *Vestey v IRC* 54 TC 503 that to allow the Inland Revenue the right to tax the same income twice was wrong in principle - notwithstanding their undertaking not to do so. However, the famous words "one should be taxed by law, not untaxed by concession" cut no ice with the Court of Appeal and we must be content with the above statement. But little comfort can be derived from these words because it may be remembered that the Court of Appeal said exactly this in the early days of section 703 TA 1988 in *CIR v Cleary* 44 TC 399. When

faced with the taxpayers' argument that the Crown's interpretation gave rise to tax twice on the same income, Lord Denning said:

> "I am sure that the Courts are well able to take care of that contingency. They would not allow [the taxpayers] to be taxed twice over in that way".

Unfortunately however, a different view was taken by the House of Lords who said there was nothing in the section to exclude the possibility of double taxation. There seems to be no reason why a similar analysis should not be used in the context of section 739.

To avoid this possibility it would be preferable for the UK operating company to be incorporated in the UK but for it to be the wholly owned subsidiary of another UK resident company, which had been incorporated abroad. In this way, there could be no attribution of the trading company's income to the UK individual but only of the dividends paid to the parent which would be wholly controllable by the taxpayer.

Existing Business

In some cases the foreign domiciled individual will have already started his business in the UK and it will have grown to a substantial value. He may realise now that this was not the ideal structure, but did not appreciate the position at the time the original arrangements were made. His opportunities for remedial action have been severely curtailed by the Inland Revenue's press release of 9th November 1999. The traditional advice in respect of business carried on by a company was to form an offshore company and cause it to become UK resident whereupon the shares in the UK trading company could be transferred by way of gift to the new company and hold over relief claimed under section 165 TCGA 1992. However, this opportunity is no longer available because hold over relief under section 165 is now denied in respect of a transfer of shares where the transferee is a company - although the same effect may be able to be achieved by the issue of bearer shares.

Where the UK business is being carried on by a sole trader or partnership, section 165 is not needed because the individual can use section 162 to transfer the business as a going concern to a company in exchange for shares obtaining the mandatory rollover of the capital gains into the shares of the company. Providing the company was incorporated outside the UK and the shares are registered abroad, this would provide the appropriate configuration for the capital

gains tax and inheritance tax protection although again it would be desirable for there to be a foreign incorporated holding company to avoid the risk of attack under section 739 TA 1988.