THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

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PAPER 2.09 – UNITED KINGDOM OPTION

Suggested Solutions

PART A

Question 1

1.1

Tax Treatment of income streams

Tea Ltd is not a small company. Distributions received will therefore be treated under Chapter 3, Part 9 CTA 2009.

Expresso

A distribution in respect of Tea Ltd's 5% holding in Expresso Ltd should be exempt under s931F CTA 2009 or 931G CTA 2009. Given that the distribution is exempt, credit will not be available for the withholding tax suffered.

Mocha

Mocha is a branch of a UK company. A UK company is subject to corporation tax on its worldwide income.

A UK company can in certain circumstances elect for the income of a branch to be exempt from UK corporation tax.

As Mocha is a branch not a subsidiary the amount distributed is irrelevant, the income and expenses of the branch are brought into the UK corporation tax computation of Tea Ltd. On the assumption that Mocha's profits are equivalent to profits calculated for UK tax purposes, £2m would be brought into the UK tax computation of Tea Ltd.

UK domestic legislation allows for double taxation relief in respect of the local tax suffered by Mocha. Double taxation relief is restricted to the UK tax on the overseas income that gave rise to the overseas tax.

UK tax on £2m profits in respect of Mocha at 20% would be £400,000. Less local tax of £300,000, results in an additional UK tax liability of £100,000.

If the election could be made this additional liability could be avoided. However, there are provisions in place that restrict the exemption where the UK has previously claimed losses.

Latte

Tea Ltd controls Latte, the dividend received is therefore exempt under s931E CTA 2009 with no credit for withholding or underlying tax.

Hot Chocolate

Tea Ltd owns a 51% share in Hot Chocolate. Prima facie the dividend from Hot Chocolate is exempt under 931E. In this case the dividend would not be subject to UK taxation and there would be no credit for underlying or withholding taxes suffered.

If the dividend is exempt in the UK then the withholding tax suffered will increase to 30% rather than 5% due to the terms of the relevant double tax treaty.

It is possible under section 931R CTA 2009 to elect that a dividend should not be exempt from UK tax. In this case the dividend would be taxable income for UK purposes, with credit relief available for the underlying tax and withholding tax paid.

If this treatment is adopted the withholding tax applied to the dividend will be 5%.

It is necessary to perform alternative calculations to determine whether it would be tax efficient to make the election.

	Dividend subject to UK taxation	Dividend exempt from UK taxation
Gross dividend	£1,180,000	£1,000,000
ULT suffered	£180,000	£180,000
Withholding tax	£50,000	£300,000
Total overseas tax	£230,000	£480,000
UK Taxation		
At 20% on gross amount	£236,000	-
Less ULT	(£180,000)	-
Less credit for WHT, capped at total UK tax	(50,000)	-
Final UK tax	£6,000	-
Total taxation	£236,000	£480,000

The above figures show that it would be most tax efficient to claim for the dividend to be taxable.

The total additional liability for Tea Ltd is therefore estimated as £100,000 in respect of Mocha and £6000 in respect of Hot Chocolate.

1.2

Supplies of goods

Goods leaving the UK have a UK place of supply (VATA 1994 s.7)

To Hot Chocolate – Hot Chocolate is resident outside of the EU, goods supplied by Tea Ltd will be UK supplies of goods (VATA 1994 s.7(7)(a) and will be zero rated exports under VATA 1994 s(30)(6). Local taxes may apply.

Evidence of export such as a Bill of Loading will be required.

To Latte – Latte is resident in the EU and VAT registered in Italy. Supplies of goods to the EU are termed dispatches. Tea Ltd should zero rate the supplies and Latte will apply a reverse charge under the appropriate domestic rules.

To Mocha – Mocha is a branch of Tea Ltd and so on basic principles there is no supply. However, VATA 1994 Sch 4 para 6 deems there to be a supply of goods for VAT purposes and the treatment will be as for Latte above.

Supplies of Services

Management services provided from the UK to a relevant business person have a place of supply where the recipient belongs (s7A VATA 1994).

Hot Chocolate – Supplies of services to Hot Chocolate are outside the scope of UK VAT. Local taxes may apply.

Latte – Supplies of services to Latte are outside the scope of UK VAT. Latte will be required to make a reverse charge under its appropriate domestic rules.

Mocha – Where management services are provided to a branch there is no supply for VAT purposes. The exception would be if Mocha were in a VAT group with an entity other than Tea Ltd, following the Skandia case.

1.3

Following the introduction of the UK exemption for profits and losses of foreign permanent establishments and the distribution exemption there remain significant differences in tax treatment between subsidiaries and branches. A UK company carrying on business overseas will still have to consider the facts of the situation and the relevant UK tax provisions.

The exemption is not available for all branches, for example where the branch of a small company is in a territory without a double tax treaty with the UK. Although a dividend paid from the subsidiary in these circumstance would not be exempt, establishing a subsidiary could defer the UK liability on the profits.

The exemption is not available for all activities – a branch carrying on investment activity cannot benefit from exemption. In this case a subsidiary may defer or reduce UK tax on the profits.

Where an election has not been made and a branch is loss making, losses may reduce the UK corporation tax liability. This will not be the case for a subsidiary.

The above could be of particular relevance if there is a high risk that a venture will not be successful. Losses from the establishment of a subsidiary would be of a capital nature, whereas losses from a branch (in the absence of an election) would likely be trading losses. Intra EU group loss relief may be available but is more limited.

The territory of investment may levy taxes differently on a branch or a subsidiary. There may be a withholding tax on dividends but no withholding on remittance of branch profits. There may be differences between the tax base, or even the tax rate for a branch as compared to a subsidiary.

There may be differences in VAT treatment, for example if overseas operations provide services to a head office that itself makes exempt supplies the VAT position may be more favourable if the services are provided by a branch.

Specific tax rules may act differently with regard to branches and subsidiaries, as although an election may exempt profits attributable to PE, a branch is not a separate taxable person from the head office. For example the proposed nexus rules for the Patent Box.

Question 2

2.1

Overseas companies are subject to UK corporation tax if they carry on a trade in the UK through a Permanent Establishment (PE). As the UK and Sweden have a Double Taxation Agreement (DTA) we need to turn to the Treaty to determine the creation /definition of a PE . Article 5 of the OECD model treaty states that a PE is created where an overseas entity has:

- a fixed place of business through which a business is wholly or partly carried on; or
- an agent habitually carries on business activities as authorised for an on behalf of the company.

A fixed place of business is defined to include:

- a place of management;
- a branch;
- an office;
- a factory;
- a workshop;
- a mine, an oil or gas well, a quarry or other place of extraction of natural resources; or
- a building site or construction or installation project.

The above is not an exhaustive list.

In regard to a building site, or construction or installation project, a PE exists if it lasts more than twelve months. This test is applied to each individual site or project. The time period includes preparatory work in the country where the construction project is to be carried on.

However, a company will not be regarded as having a PE if it carries on its business through an independent agent acting in the ordinary course of its business or if the activities are of preparatory or auxiliary nature.

Activities will be of preparatory or auxiliary nature if they relate to the use of facilities or maintenance of stock for the storage, display or delivery of goods, maintenance of stock of goods for processing by another person, or the purchasing of goods or merchandise or collection of information for the company.

As stated above, Article 5 of the OECD model treaty provides a definition of a PE. The existence of a PE in a territory is similar to the concept of a "branch" under company law. Generally an overseas resident individual has a substantive presence in a territory if he/she meets the threshold of having a PE.

Additionally, if that individual is carrying on a business through the PE then tax may be due in the territory in which the PE is established as well as the country of residence. Therefore, on its own, without a business activity being carried on through it, a PE may not of itself give rise to a tax charge.

The commentary to the model treaty states:

"Whilst no formal legal right to use a particular place is required for that place to constitute a permanent establishment, the mere presence of an enterprise at a particular location does not necessarily mean that that location is at the disposal of that enterprise."

It then goes on to provide some examples to illustrate this:

1. A salesman who regularly visits a major customer to take orders and meets the purchasing director in his office to do so. The commentary states:

   "in that case, the customer's premises are not at the disposal of the enterprise for which the salesman is working and therefore do not constitute a fixed place of business through which the business of that enterprise is carried on (depending on the circumstances, however, paragraph 5 could apply to a deem a permanent establishment to exist)."

2. An employee of a company who, for a long period of time, is allowed to use an office in the headquarters of another company (e.g. a newly acquired subsidiary) in order to ensure that the

latter company complies with its obligations under contracts concluded with the former company. The commentary states:

"In that case, the employee is carrying on activities related to the business of the former company and the office that is at his disposal at the headquarters of the other company will constitute a permanent establishment of his employer, provided that the office is at his disposal for a sufficiently long period of time so as to constitute a "fixed place of business" and that the activities that are performed there go beyond the activities referred to in paragraph 4 of the Article."

Given that a PE is a fixed place of business, this implies that there is some permanency and that there is a space of some kind taken up by a business. However, if it can be demonstrated that it is of a temporary nature it may not be a PE. But if the intention at the outset is one of permanence, then even in circumstances of a sudden nature that curtails operation in unforeseen circumstances, there is more likely to be a PE. Additionally, frequent use of an office/premises for short periods of time is suggestive of permanence.

Based on the above, in our case Hugo is a dependant agent rather than an independent agent, given that he has a contract of employment with Rally AB. Additionally, the use of his home (which has been provided by his employer) as an office and the provision of an office space by the JV partner to perform duties of his office for a "sufficiently long period of time" indicates that a "fixed place of business" is likely to exist. Furthermore, given that Hugo holds a very senior position he is likely to have the authority to conclude sales contract (unless his job specification specifically states that he does not have the authority to conclude contracts) . Hugo is also expected to stay in the UK for approximately a year which implies that the intent at the outset is that of permanence.

Subsequent, to securing and concluding the contract , the implementation of the project is likely to take five years (which exceeds the twelve month period stipulated in Article 5).

So, taking all of the factors into consideration, it appears that a PE will be created by Hugo's activities in the UK.

<u>2.2</u>

In order to determine the UK tax residency position of Hugo we need to consider the Statutory Residence Rules which were introduced in the UK with effect from 1 April 2013. The Statutory Residence Test (SRT) is applied to determine an individual's residence status for income tax and capital gains tax but not for National Insurance purposes.

The SRT has three parts:

1. The "automatic overseas test" - if any of these tests are met, the individual is conclusively not resident in the UK for that tax year.

2. The "automatic residence test" - if any of these tests are met then the individual is resident for UK tax purposes for that tax year.

3. The "sufficient ties test" - this comprises different factors including counting days but which will only need to be considered if the first two tests cannot determine the residence status. Essentially, this test considers whether the individual has a sufficient UK ties such that they are UK resident when taking into account the number of days present in the UK.

We will consider each one of the above in more detail below:

<u>Automatic Overseas Test</u>

The Overseas tests comprise:

1. Leavers – spend less than 16 days in the UK;

2. Arrivers – spend less than 46 days in the UK;

3. Works full time abroad, and spends less than 91 days in the UK in the tax year, and less than 31 days where work in the UK for more than 3 hours.; and

4. Dies abroad having been not UK resident for two years and has spent less than 46 days in the UK.

In Hugo's case, tests 1 and 3 are not applicable. In the case of 2, the arrival date is in December 2016 and Hugo is likely to spend in excess of 46 days in the UK to 5 April 2017. Therefore, Hugo does not meet any of the above tests so therefore we need to turn to the Automatic Residence Test.

Automatic Residence Test

The automatic residence test is met if the individual meets any of the four automatic UK tests and none of the automatic overseas tests. The automatic UK residence tests are as follows:

1. Present for 183 days in a tax year in the UK;

2. The individual has a home in the UK available for more than 90 days and visits that home for 30 days in the tax year and either:

    a. this is the individual’s only home; or
    b. the individual has an overseas home but does not use it for at least 30 days in the tax year.

3. Works full time in the UK for 365 days or more without a significant break and in any one tax year more than 75% of these days are in the UK.

4. Where a person dies and they were UK resident in each of the three preceding years and broadly have a home in the UK when they died.

Again, Hugo does not meet any of the above conditions. Therefore, we need to turn to the Sufficient Ties Test.

Sufficient Ties Test

If an individual does not meet any of the Automatic Overseas or the Automatic Residence tests , the sufficient ties test must be considered.

There are two levels of test – one for arrivers, and a more stringent one for leavers.

Someone leaving the UK will generally be a leaver for the first three years after leaving and from the fourth year be treated as an arriver for these purposes – in other words the rules relax from the fourth year of non UK residence.

The main differences in the number of days an arriver/leaver can spend in the UK without triggering UK residency is shown below:

	Maximum number of days spent in the UK	
Number of Ties to the UK	Arriver	Leaver
1	182	120
2	120	90
3	90	45
4	45	15

The ties are as follows:

1. Family tie - This test of connection concerns the individual’s ‘relevant relationships’ with people (spouse, civil partner, ‘common law’ partner, a child under 18 years) who is resident in the UK. Children in full time education in the UK are not counted provided they do not spend more than 21 days in the UK outside of term time.

2. Accommodation tie - This tie exists if the individual has ‘a place to live’ in the UK which is available to them for a continuous period of at least 91 days in that year , and at least one night is spent there. If the accommodation belongs to a close relative, the threshold is 16 days. A ‘place to live’ includes a holiday home and a property not owned by the individual.

3. Work tie- An individual has a work tie if they work (more than 3 hours a day) in the UK for at least 40 days (continuously or intermittently) in that year. Working includes travelling time where paid for by the employer, and job related training.

4. 90 day tie - This test is fulfilled for a year if the individual spends more than 90 days in the UK in either the year preceding the current tax year and/or the year before that one.

5. Country tie - An individual has a country tie if the UK is the country in which they meet the midnight test for the greatest number of days in that year. The ‘midnight test’ is met if the individual is present in that country at the end of the day. If the midnight test is met for the same number of days in two or more countries (and that number is the greatest number of days the individual meets the midnight test in any country), the individual has a country tie provided just one of those countries is the UK.

Hugo meets the" Work Tie" and "accommodation tie" as he will be working in the UK in excess of 40 days and accommodation is available to him for the tax year to 5 April 2017. However, given that he meets only two of the ties and he needs to be present in the UK for 120 days in order to be treated as UK resident. Given that the proposed arrival date is 1 December 2016 he will be resident in the UK for 124 days (if does not spend any days overseas after his arrival date) for the period to 5 April 2017. Therefore, he is tax resident in the UK for the tax year 2016/17. However, as he arrived in the UK part way through the 2016/17 tax year we need to consider the Split year rules .

Split Year Rules

For the tax year to 5 April 2017, ie the tax year of Hugo's arrival in the UK, we need to consider the "Split Year" rules. The rules state that the tax year is split - "UK part" and an "Overseas part". Any overseas income arising during the "Overseas Part" is ignored for UK tax purposes. The "UK part" will start from the day Hugo starts full-time work in the UK.

Based on the Hugo is tax resident from the date he takes up duties of his office in the UK to 5 April 2017. Furthermore he will be treated as tax resident for the period from 6 April 2017 to the date of departure in October/November 2017 (as he will be present in the UK for 183 days (under the Automatic Residence Test).

PART B

Question 3

3.1

A company is" thinly capitalised" if it is funded by more debt than it than it could borrow without support from group companies. Where a company is funded more with debt than equity, this may lead to excessive tax relief in respect of interest payable/paid by the borrower company as usually tax payable is higher where a company is funded with equity rather than debt since dividend payments are not deductible in computing the tax payable. But in the case of a highly geared company the interest charges will decrease the distributable reserves available to pay dividends to shareholders . In this case, where the shareholders and the lender is the same, e.g. group companies, it becomes less important whether the return on the investment is in the form of interest or dividends. Given that interest charges have a direct impact on the level of tax payable by a company, debt funding is a useful tax planning tool for groups especially for entities situated in jurisdictions with higher tax rates.

The UK's thinly capitalisation rules apply the transfer pricing "arm's length" principle to determine the amount which a company, on a standalone basis and without any group support, is able to borrow at any given time. However, a company can take into consideration the value of its own subsidiaries, hence, the consolidated accounts should be used to evaluate the thin capitalisation position.

Given that there are no safe harbour provisions each individual case is dealt with by HMRC on its own merits. In determining the interest deductibility, HMRC will look at the terms and conditions of the arrangements, between the connected parties including amongst other things, the amount of the loan, the rate of interest charged and the duration . A restriction should only be made if the actual interest borne is more than would have arisen had an "arms length" rate of interest been applied to a commercially acceptable size of loan.

In ABC's case the thin capitalisation position should be assessed based on its consolidated accounts for the period to 31 March 2016. The financial statements for the 2016 year indicate that ABC is thinly capitalised in view of the £40 million debt and equity of (£7 million). Hence, the debt to equity ratio, i.e. level of total liabilities (£40 million) divided by the shareholders equity (-£7 million) is -5.71. Therefore, the level of interest deductible is likely to be restricted. ABC has two options available which are:

- self assess the level of deduction . However, in this case, HMRC can make an enquiry into the corporation tax return; or

- negotiate an Advance Thin Capitalisation Agreement (ATCA) under the Advance Pricing Agreement legislation (s218 TIOPA 29010). This method provides certainty of the level of deduction as it is agreed in advance.

HMRC Statement of Practice (SP) 01/12 sets out the ATCA process. ABC should provide to HMRC certain financial information including copies of all loan agreements, the latest financial statements, the group's financial forecasts, strategy, etc.

An ATCA will generally cover a period of three or five years, dependant on the terms of agreement with HMRC.

An ATCA should be agreed before interest is paid as thin capitalisation will impact not only the corporation tax liability of ABC but also the WHT payable to US Inc.

The "arms length" principle does not just apply to interest charges but also interest income received by UK companies. In this situation, interest must be adjusted upwards if the actual amount charged is less than the amount that would be charged between unconnected parties.

3.2

There is no withholding Tax on certain interest types of interest payments:

- interest paid to banks;
- interest paid on short loans, i.e. loans for a duration of less than 12 months;
- quoted Eurobonds; or

- discounts of premiums, which are not characterised as interest.

In the case of ABC, WHT treatment of the interest payments is as follows:

Bank – No WHT due.

US Inc – Under s874 ITA 2007, ABC is required to withhold income tax at a rate of 20%, file a completed Form CT61, and account and pay the WHT to HMRC , 14 days after each quarter end during which the interest is paid. However, given that there is Double Tax Agreement (DTA) between the US and UK , the reduced treaty rate could be applied subject to obtaining an advance clearance from HMRC. In this respect, ABC should apply for the Double Tax Treaty Passport DTTP) which , subject to HMRC acceptance, would allow interest payments to be made gross to US Inc. The loan between US Inc and ABC will be registered and is publicly available.

The DTTP will last for five years and can be renewed for a further 5 years provided there have been no material changes since the original DTTP was issued.

The DTTP covers all loans and will be effective for any further loans made by US Inc, provided ABC notifies HMRC of the same.

Founder Shareholders – The founder shareholders were issued Preference shares. The accounting treatment of Preference shares is akin to debt, i.e. the preference dividend payments are recognised in the financial statements under UK GAAP as interest payments rather than dividends. However, the £750,00 payable to the Founder shareholders will be treated as distributions/dividends and will not attract any tax relief in the corporation tax computation for ABC. Given this, deduction of income tax at a rate of 20% is not applicable in this case.

The £750,000 will be taxable as dividend income on the Founder Shareholders at their marginal rate of tax and will receive a 10% tax credit.

<u>3.3</u>

The EU Directive in respect of Interest and Royalties came into effect from 1 January 2004.

It applies to associated companies that are resident within an EU member state. The EU directive is also applicable to "Permanent Establishment" (PE) in a member state of a company of another Member State.

Under the EU Directive interest and royalty payments can be made without deduction of withholding tax at source by the payer. In order to qualify for the exemption the following conditions need to be fulfilled:

1. The beneficial owner of the interest or royalty payments must be a company of another Member State of the European Union, or a PE in a Member State of such a company;

2. The payment must be one that arises in the UK as determined in the specified Article 1.2 of the Directive. This means that the payer of the interest must be a UK company or a PE in the UK of an EU company;

3. The person beneficially entitled to the interest or royalties must be an EU company (or PE of such a company)

4. The payer and payee must be "associated" companies. This means that one company must directly hold 25% or more of the capital and/or voting rights in the other or that a third company directly holds at least 25% of the capital/or voting rights in each of them; and

5. Exemption from UK tax will only be available for interest payments provided a claim has been accepted by HMRC (in practice a CAR Residency) and an exemption notice has been issued to the payer accordingly.

The Exemption notices for interest payments are covered under Article 1.11 to 1.14 which sets out the process and requirements in order to allow an exemption for interest payments (and does not apply to royalty payments - see below). In essence, the procedure for obtaining exemption from HMRC is similar to a claim under a Double Tax Agreement. However, in this case, it is the recipient that must make the application rather than the payer. Furthermore, the Passport Scheme is unavailable in respect of the Interest and Royalty Directive.

Anti-avoidance

There is anti-avoidance legislation to deny exemption from UK tax where the main or one of the main purpose is to take advantage of the Directive.

Question 4

Selina,

Many thanks for your email.

As we previously discussed, you remain subject to UK tax on certain sources of income and gains:

Income tax

There are two ways that the UK subjects individuals to income tax. UK residents are subject to tax on their worldwide income, while non-residents are subject to tax on income with a UK source.

UK source income includes interest on UK bank accounts, rent from UK property, royalties from the UK and income from UK employment. The way this is collected is by taxing the income at source by imposing a withholding tax and/or by requiring you to file a self-assessment tax return.

Capital gains tax

Non-UK residents can still be subject to UK capital gains tax if they:

- have been resident in the UK during at least four of the seven tax years prior to departure; and
- are non-resident in the UK for five years or less

In this case the gain would be taxed in the year you resume residence.

There are similar rules in place for income tax, but these only apply for certain types of income that should not be relevant in your case.

Non-residents are subject to tax on gains on sales of UK residential property. I will consider how this relates to your flat below.

How UK tax is calculated

There is a maximum limit for the UK tax liability of non-residents which in some circumstances will restrict the UK tax due, we will need to calculate this maximum and your liability under normal rules (see below).

Double taxation

As you are resident for US income tax purposes the US may also bring your worldwide income into tax. This means that the same income could be subject to tax in both countries.

The UK and the US have entered into a double tax treaty, the purpose of a treaty is to prevent double taxation while ensuring equitable taxing rights between the US and the UK. As a US resident the treaty should limit the tax you will pay in the UK to certain UK source income.

Some UK source income, for example interest, is not taxable in the UK under the treaty. A claim will need to be made under the treaty for you to receive the interest for the 2015/16 without tax being withheld. Tax is no longer automatically withheld on interest from UK bank accounts after 6 April 2016.

As US resident you will be subject to tax on income and gains under the US domestic rules, if you pay US tax on amounts that the UK also subjects to tax you should be able to claim double taxation relief, so that you only pay tax once.

The UK-US treaty permits the UK to tax certain types of income and gains, but does provide that relief should be given for the tax paid where US tax is charged as well. You should consult with your US accountant about how this will be calculated and claimed.

Looking at each item of your UK source income in turn:

Interest from a UK bank account

This is UK source income and subject to withholding tax under the UK domestic rules. However, the double tax treaty provides that only the US can tax your income. For the 2015/16 tax year you will need to apply to your UK bank in order to receive the interest without UK tax being deducted.

Dividends

The UK does not levy a withholding tax on dividends. During the year to 5 April 2015 UK dividends carried a notional credit of 1/9, which is relevant in calculating your maximum UK tax liability. The UK-US treaty limits the UK tax you can suffer on a UK dividend to 15%, but given that your UK liability should be offset by the notional credit this is superfluous. It is also worth noting that from April 2016 the first £5,000 of dividend income will be exempt from UK tax.

Royalties

As with interest the royalties have a UK source, UK domestic legislation imposes a withholding tax on dividends paid from the UK. However the treaty means that the UK will not charge tax. Again a claim under the treaty to receive the royalties gross should be made.

Rent from UK property

You will be classed as a non-resident landlord and subject to income tax on rents received. The UK – US treaty provides that the UK can tax income from real property such as rents.

The income tax needs to either withheld by your agent or tenant or you need to apply to HMRC to receive the amounts without having tax deducted and report the income and pay tax under the self-assessment procedure.

As your UK tax affairs are up to date and you have retained ties to the UK we should be able to agree that you receive rents gross. Let me know if you agree and I will arrange the required forms.

UK Income Tax Liability calculation

Your maximum UK income tax liability on the above figures would be:

Tax deducted, including notional tax, from 'disregarded income' £3,000 x (1/9)	£333
Tax on rental income ignoring personal allowance £3,600 x 20%	£720

The personal allowance is ignored in this calculation.

Total maximum liability	£1,053

Your liability ignoring the maximum would be:

Dividends	£3,000
Rent	£3,600
Personal allowance	(£10,600)
Taxable income	Nil

Accordingly, you should have no UK income tax liability for the 2015/16 tax year. As a non-resident you will need to claim your personal allowance. If you have suffered any withholding taxes we should be able to claim a refund.

Gains on sales of shares

Capital gains on the sale of UK shares will not be subject to capital gains tax unless you return to the UK within 5 years. If you do return to the UK your annual exempt amount will be available.

Sale of London flat

There are two possibilities when you sell your flat. You will be subject to UK capital gains tax on non-residents and you could also be a temporary non-resident in which case you will have an additional liability when you return to the UK, the treatment will depend on when you return to the UK.

In either case it is likely that principal private residence relief (PPR) will substantially reduce your gain.

If you do not return to the UK within 5 years you will be subject to non-resident capital gains tax only.

If you sell the flat before October 2016 it is likely that you will not pay capital gains tax. Non-residents only pay tax on gains after April 2015. The PPR rules mean that the last 18 months of ownership of a property that was once your main home is exempt from tax, so if you sell within 18 months of April 2015 there will be no taxable gain.

If you sell after October 2016 then only some of the gain will be taxable. The gain will be calculated based on any increase in value between 5 April 2015 and the date of sale. A proportion of the gain, corresponding to the 18 months exempt ownership period, will be exempt.

In addition you can claim an annual exempt amount of £11,250.

Even if you have no tax to pay you must report the transaction to HMRC within 30 days of conveyance. If you return to the UK within 5 years then capital gains made during your period of non-residence will become chargeable in the year you return.

The portion of the gain not charged to non-resident capital gains tax will come within the scope of UK capital gains in your year of return.

You will still be able to claim PPR, but in this case the whole gain on your flat will be potentially chargeable – not just the gain relating to after 5 April 2015.

I hope the above is helpful, please do let me know if you have any further questions.

Kind regards,
AN Advisor

PART C

Question 5

FA 2015 introduced the Diverted Profits Tax (DPT) regime in order to combat and counteract contrived transactions /arrangements undertaken by large multinational enterprises (MNE) in order to divert profits from the UK.

DPT is applicable to a UK resident company , a non UK resident company that has a permanent establishment and large companies that have no UK taxable presence that conduct activities in the UK in connection with the supply of goods or services or other property to UK customers but in such a manner that it avoids creating a taxable presence in the UK. Additionally, the circumstances in which it achieves this generally involves arrangements or entities which lack economic substance.

When does DPT apply to a UK resident company?

In the case of a UK resident company the DPT legislation applies where, for an accounting period:

- a "material provision" is made by a UK resident company and another person who is a connected party for the purposes of UK transfer pricing legislation;

- the "material provision" results in an effective tax mismatch outcome for the relevant accounting period, i.e. it gives rise to a reduction in the tax liability of the UK resident company (by either increasing the expenditure or reducing its income) and the material provision is not matched by an increase in the tax liability (whether UK or overseas) of the other connected person that is at least equal to 80 per cent of the reduction in the UK resident company's corporation tax liability

In the case of York Group, the proposed transactions are all intra group, ie between connected parties, for the purposes of the UK transfer pricing legislation. Additionally, since the tax payable by the SPV will not equate to at least 80% of the reduction in the tax liabilities of the UK entities, York Limited fulfils the above conditions.

There are two exceptions to the above conditions , which are as follows:

1. Where the UK resident company's increase in expenses/reduction in income arises wholly from loan relationships or deemed loan relationships (within the meaning of Parts 5 and 6 of the CTA 2009), or a loan relationship (or deemed loan relationship) and a derivative contract (within the meaning of Part 7 of the CTA 2009) taken together, where the derivative contract is entered into solely to hedge risk arising from the loan relationship (e.g. an interest rate swap or a currency swap); or

2. Where the payment is made to:

    - a registered pension scheme or an overseas pension scheme;
    - a charity;
    - a person entitled to sovereign immunity; or
    - an offshore fund or an authorised investment fund which either meets the genuine diversity of ownership, or at least 75 per cent of the fund’s investors are throughout the accounting period, registered pension schemes, overseas pension schemes, charities or persons entitled to sovereign immunity.

The transactions between the SPV and York Limited are unlikely to fall within the loan relationship rules and the payments are within York Group so the above is inapplicable.

DPT legislation also applies under the following conditions:

- the insufficient economic substance condition is met. Broadly, this is that it is reasonable to assume that the transaction(s) were intended to achieve the tax reduction and it is not reasonable to assume that, judged at the time the transaction (s) were entered into, over the life of the transaction(s) the non-tax benefits would exceed the tax benefits;

- the UK resident company and the connected person are large (as defined under the transfer pricing rules) for that accounting period.

The main purpose of the proposed structure is to reduce the effective tax rate of York Group and also to shift income out of the UK to a territory that has a lower tax rate.

York Group will need to have justifiable commercial reasons/documentary evidence in respect of the proposed invoicing structure otherwise the transactions will be regarded as transactions or series of transactions which lack economic substance and which ultimately will give rise to an "effective tax mismatch outcome".

With regard to the royalty charge, an independent valuation indicated that a royalty fee of between 5% and 7% is appropriate, whilst York Group proposes to charge a royalty fee of 25%.

Both of these conditions therefore apply to York Group.

York Group is large and therefore will not qualify for the exemption from DPT. Hence, York Group will fall within the DPT regime.

DPT is a completely separate and distinct tax and impacts groups with an annual turnover in excess of £10 million (small and medium enterprises are exempt). It applies to diverted profits arising on or after 1 April 2015 at a tax rate of 25%.

<u>HMRC notification requirements</u>

Where York Group meets conditions 1, 2 and 4 (indicated above) it must notify HMRC in writing within three months of the end of the relevant accounting period that it considers that a charge to DPT arises. Failure to notify may result a penalty of 100% of the DPT charge. Furthermore late payment penalties may arise.

HMRC must issue a preliminary notice within two years of the end of the relevant accounting period. This time limit is extended to four years where a company has failed to notify HMRC accordingly.

Subsequent to issuing a notice, HMRC must perform a review of the DPT charge within a period of twelve months following the end of thirty days after the issue of the charging notice. Where an overpayment of DPT arises, this will be repaid to the Group. However, in the case of an underpayment, a supplementary charging notice increasing the amount of tax charged is issued.

If the Group considers that the level of DPT is incorrect, the Group must appeal within 30 days of the end of review period if it considers that the charging /supplementary charging notice is incorrect. The First -tier Tribunal may confirm, amend or cancel the notice.

<u>Other factors</u>

Given that the DPT rate of tax is higher than the rate of corporation tax, York Group could make a transfer pricing adjustment (so that an arm's length principle is adopted) in computing its taxable profits for the relevant accounting period. Providing that this adjustment is made before the end of HMRC review period, the increase in the company's taxable profits can be taken into calculating (that is, reducing) its profits for the purposes of calculating the charge to DPT. This adjustment would, however, eliminate the benefit of the proposed structure for York Group.

Question 6

6.1

Under UK legislation a company is treated as resident either it is incorporated in the UK or if it is centrally managed and controlled in the UK.

If the company is also treated as resident in another territory however, a treaty can apply to determine residence as not being in the UK (under a tie breaker clause).

The OECD model treaty takes into consideration the "effective management and control" rather than "central management and control" to determine the residency position of a company. Effective management control means the day to day decisions made by the management team in respect of the business operations of a company, such as, Human Resources function, preparing budgets and forecasts, procurement, management of customers and suppliers, of the business unit, etc. Central management and control are key strategic decisions that take place at Board level such as approval of budgets, significant capital expenditure, approval of auditors, acquisition and disposal of business units, fiancé and investment, etc.

Given that the Double Tax treaty between UK and Luxembourg is based on the OECD Model treaty, it should be possible to move residence under the tie breaker clause. In this respect, Zeus can become non-resident by transferring the "effective management and control" of Zeus Limited , ie the day to day running of the business , to Luxembourg. This essentially means that a Management team will need to be appointed in Luxembourg who should take on full responsibility of making business decisions of the company's operations.

6.2

When a company migrates, it will cease to be within the charge to corporation tax. Hence, it will be treated as if it has ceased to trade. The corporation tax implications of migrating Zeus will be as follows:

- Its corporation tax chargeable accounting period will end (CTA 2009 s10(1)(a)).
- Stock held on the balance sheet will be treated as disposed of on a cessation (CTA 2009 s162).
- Balancing allowances and charges will arise in respect of the capital allowances pools on plant and machinery (CAA 2001 s61).
- Loan relationships are deemed to have been disposed of and immediately reacquired at fair value (CTA 2009 s333).
- Capital assets, e.g. land and buildings, are deemed to have been disposed of and reacquired at market value (TCGA 1992 s185).
- Intangible fixed assets (created or acquired post 1 April 2002) are treated as disposed of and reacquired at market value (CTA 2009 s859).
- Derivatives will be treated as assigned and immediately reacquired at fair value (CTA 2009 s609).
- If the goodwill relates to a business that was carried on pre 1 April 2002 it will be treated as a capital disposal, if it relates to a business carried on after that date it will be treated as an income disposal.

Zeus is deemed to have disposed of and repurchased its chargeable assets at market value immediately before migration, except for any situated in the UK which are to be used for the purposes of the trade that continues to be carried on in the UK via a PE.

6.3

The potential exit charge arises as follows:

Asset	Original Cost	Book Value	Market Value	Gain
Stock		£5m	£5m	£0
Building	£5m	£4m	£10m	£5m
Plant and Machinery	£8m	£6m	£3m	(£2m)*
Goodwill	£3m	£2m	£50m	£48m
Other tangibles (e.g. Customer List, Patents, Software)			£100m	£100m
Total Gain				£151m

* The following note applies:
8 - 3 = 5 (b/fTWDV) - 3 (MV) = (2) (Balancing Allowance).
CGT = Proceeds 3 - Cost (8 (less CAPs 5) 3 = NIL

Question 7

Inheritance Tax

George is considering transferring UK and non-UK commercial property.

UK property

The UK assets are within the scope of UK inheritance tax. The transfer to the trust will be a lifetime transfer by George, with IHT chargeable at 20% on the market value with additional tax if George dies within 7 years. There would also be 10 year anniversary charges and exit charges to consider. There is a nil rate band available (£325,000) which may offset the IHT due, subject to the amounts and other gifts George has made.

Non-UK property

The key concept for inheritance tax with regard to non-UK assets is domicile.

George is likely not UK domiciled. He will become deemed domiciled when he has been UK resident for 17 years.

Domicile status of a trust – a trust is a separate legal person, a trust established by a non-domiciled settlor will itself be non-UK domiciled.

Non-UK assets (such as the non-UK properties) held by a non-domiciled trust are excluded property for IHT purposes. This means that even if George becomes deemed domiciled in the UK the trust property will remain outside the UK IHT net.

There is therefore an IHT advantage to establishing a trust and transferring non-UK property if George intends to remain in the UK for the next 2 years. The residence of the trust is not relevant for the IHT position.

Residence status of a trust

A trust will be UK resident if:

- all the trustees are UK resident; or,
- at least one trustee is resident in the UK and the settlor was either domiciled or resident in the UK at the time the settlement was made.

As George is currently resident in the UK, in order for the trust not to be UK resident none of the trustees should be resident in the UK.

If George would like to appoint family members as trustees their residence will need to be considered. It would be possible to establish a trust with professional trustees that are resident in an appropriate territory.

Costs of an offshore trust

When considering if an offshore trust would be beneficial, as well as considering whether there any UK benefits it must also be considered whether there are:

- any local taxes in the territory of residence of the trust, or other territories of the settled property;
- the costs of establishing and running the trust such as professional and legal fees; and
- any initial tax cost such as capital gains taxes or stamp duties.

There are territories that levy little or no tax on such a trust. For example the Channel Islands.

UK Capital Gains Tax

Initial transfer – if George as a UK resident transfers assets to a non-resident trust he will be liable to UK capital gains on the transfers. If the transfer is to a resident trust there is a possibility of hold over gift relief on the UK properties as these would be a chargeable lifetime transfer for IHT purposes. Gift holdover relief is not available on a transfer to a non-resident.

Gains made by trustees – trustees of a non-resident trust are usually outside the scope of UK CGT, unless the gains relate to a UK trade or UK residential property. There are however anti-avoidance provisions that could tax either the settlor or the beneficiaries.

As the trust is for the benefit of his grandchildren George will be regarded as retaining an interest in the trust (s86 TCGA 1992). A settlor charge may then apply in years where George is UK domiciled and UK resident.

If George retires to Canada and is not UK resident and domiciled, the trust beneficiaries may become liable for capital gains tax under s87 TCGA 1992 if they receive a capital payment from the trustees that is matched by a capital gain.

If George is to remain UK resident there is therefore no capital gains advantage of a non-resident trust and there may well be taxable gains on the settlement.

<u>Income arising</u>

The trustees will be liable to UK income tax on rents from UK properties. The first £1000 of income is taxable at the standard rate and any amount over this will be charged at the rate applicable to trusts (45%). A trust does not receive a personal allowance.

George will not retain an interest in the trust – he should therefore not be charged to tax on income earned by the trust property.

If the beneficiaries are not entitled to the income they will not be subject to tax on the income earned by the trust assets.

If the beneficiaries are UK resident and they receive income from the trust this would be subject to UK income tax as untaxed income. While the grandchildren are minors, income paid to them for education expenses may be deemed income of their parents. There is no automatic relief for tax paid by the trustees, although relief for some of the tax suffered by the trustees is available by concession where conditions are met.

Not withstanding the above the Transfer of Assets Abroad legislation must also be considered. S720 ITA 2007 may result in a charge on George if he retains any benefit of income from the trust. S731 ITA 2007 may result in a charge on beneficiaries where they receive a benefit as a result of the transactions that is not otherwise brought into tax.

Taxes on income arising in other territories should also be considered.

The income tax position with regard to the UK properties is therefore worse than if they are not settled on a trust.

<u>Conclusion</u>

In order to determine if there would be a benefit to George establishing a non-resident trust we will need more information and should carefully weigh the costs and potential benefits.

There are possible future additional UK tax costs associated with transferring the UK properties, such as the initial IHT and CGT costs and the high rate of tax paid by a non-resident trust on UK property income and potential loss of double taxation relief.

Although there may be IHT benefits and, depending on the circumstances, potential income tax benefits for the non-UK assets this needs to be weighed against any upfront gains that would trigger an immediate capital gains charge and any other costs of establishing and running the trust.

Question 8

Nikki,

Many thanks for your questions. I have set out a response to your queries below.

1. Tax implications of designer's remuneration

   On the assumption that the designer has not previously been UK tax resident, if he is present in the UK for fewer than 46 days then he will be automatically regarded as not resident in the UK.

   If the 46 day limit is exceeded then additional "Sufficient Ties Tests" will be considered. On the basis that the designer spends less than 90 days in the UK, he should not be UK resident as all four UK 'Ties' under the test would be need to be met and it does not appear that he has family, accommodation or country ties.

   As a non-UK resident the designer's earnings from the employment with Gearz will be apportioned between UK duties and non-UK duties. The apportionment will be made based on the number of UK and non-UK work days in the year.

   The non-UK work days will not be subject to UK tax.

   The earnings in respect of UK duties will be subject to UK income tax, the personal allowance will be available by making a claim, and Gearz Ltd will be required to account for PAYE in respect of the employment. You will need to apply for a direction from HMRC to operate PAYE only on the percentage of earnings relating to the UK work.

   NIC will also be due on UK earnings, as the UK work is not a temporary assignment.

   Travel expenses paid to the designer will not be a taxable benefit on the basis that he is not domiciled in the UK and has not been resident in the UK in the two years before his arrival.

   Wider tax implications for Gearz

   As the designer's home is not a fixed place of business of Gearz ltd there should not be a risk of a French permanent establishment of Gearz Ltd as a consequence of the arrangement.

   It is unlikely that there will be any obligation to operate French payroll taxes, although it would be advisable to check the position with a French adviser. I can let you know a name if that would be helpful.

2. Director remuneration

   The US director will be subject to UK income tax and national insurance in respect of directors fees relating to duties carried out in the UK. She will not be entitled to a UK personal allowance on the basis that she is not an EU / EEA citizen.

   As the director travels to the UK for board meetings and associated briefings it seems likely that the fees will all relate to duties performed in the UK. Gearz Ltd will be required to operate PAYE in respect of the fees so the director will be paid net.

   The director may be entitled to double taxation relief in the US and should speak to her accountant. In respect of the equity award. As the award is in relation to the UK directorship and these duties are carried out in the UK it will be treated as UK earnings. This means that the difference between the market value of the shares and any amount actually paid by the director will be subject to UK income tax and NIC.

   As a limited company it may not be clear what the market value of the shares are and we will likely need to carry out a valuation.

   The shares could be awarded by way of an unapproved option, in this case the director will pay UK tax on any gain on exercise of the option.

3. Consultancy services

Consultancy services are not subject to PAYE. However, care should be taken to ensure that there is a true contract for services and the individual should not actually be treated as an employee of Gearz.

It should also be ensured that the consultancy fees are not related to the duties as a director.

The consultancy services are being supplied to a UK company, the place of supply will be the UK. This means that Gearz Ltd will need to make a reverse charge in respect of the VAT.

The US bank account should not give rise to a US taxable presence (although this should be confirmed with a US adviser). It would however be US source income if it earns interest. The UK – US treaty provides that no US tax should be suffered, if the amount is material we may need to apply for relief for withholding taxes.

The balance in the US bank account is a monetary asset and will be translated into sterling at the balance sheet date. Foreign exchange gains and losses may arise that would be subject to UK tax. These amounts are likely to be immaterial if the US balance is not significant, timing the payments so that there is no significant balance at the year-end may help to mitigate potential unrealised gains.

I hope that answers your questions. Please let me know if you would like to discuss the matter further.

AN Advisor

Question 9

Helena,

Many thanks for your email. We feel strongly that IoMWeb ltd needs further consideration.

The UK transfer pricing provisions are broad in their scope, case law has shown that the rules look at 'provisions' between parties and these are widely drawn and comprise more than just the transactions between the parties.

Notwithstanding this, even on the assumption that the transfer pricing is accurate there could still be exposure to UK tax. This could either be because the Isle of Man company is itself subject to UK corporation tax or it could be because its UK shareholder is subject to UK tax in respect of profits earned by the Isle of Man company.

Liability of IoMWeb to UK Corporation Tax

Although not expressly ruled out by the previous enquiry it might have been expected that these points would have been considered by HMRC as part of that exercise. We would need to see the extent and detail of the enquiry and analysis to determine this.

Even if they were considered they main remain a risk given the group's profile and the agreement of prior years' does not rule out a future challenge.

UK Residence

Firstly, the Isle of Man company could be argued to be resident in the UK if its place of central management and control is here. If the company is resident in the UK it will be subject to UK corporation tax on its worldwide profits.

Even if profits have been correctly allocated to the activities carried out in each territory by the transfer pricing rules, if the company were UK resident profits attributable to both jurisdictions would be within the charge to UK tax.

Permanent establishment

If the Isle of Man company is not resident in the UK it could potentially earn profits subject to UK tax through a UK permanent establishment.

Again the allocation of profits to a permanent establishment is different to the application of transfer pricing provisions. A permanent establishment is a UK 'nexus' of the Isle of Man company to which profits would need to be attributed, this considers provisions and activities within the company itself and not provisions between the company and other parties.

Liability of the UK shareholder

The UK has anti-avoidance provisions to prevent groups artificially arranging their legal structure in order that profits arise in low tax jurisdictions. Here the risk is that the group arranged for the contract to be entered into by IoMWeb with the aim that the profit on that contract should be subject to a lower tax rate.

Controlled foreign company provisions

If the Isle of Man company is not subject to UK tax itself, the UK resident shareholder could be liable to tax on an apportionment of the Isle of Man profits.

The UK has CFC legislation which acts to prevent the artificial shifting of profits to low tax jurisdictions overseas.

The fact that the subsidiary was considered by HMRC a number of years ago does not provide comfort under the current CFC rules, not only do we need to consider the current activities of the company as these may have changed regardless of assurances, the UK CFC rules have undergone significant amendment.

For a trading company, the starting point will be to see whether the "Chapter 4 Gateway" is breached. The key factor is where the significant people functions that generate the profits of the company are located.

If the people who manage the risk of the third party contract carry out those functions in the UK (regardless of who the employing company is) then the profits are likely attributable to UK SPFs which could lead to an apportionment of profits.

Although transfer pricing concepts are used in the CFC rules the fact that the transfer pricing has been agreed does not prevent a CFC apportionment. Whereas the transfer pricing rules respect the factual and legal position of legal entities and the ownership of assets, the CFC rules create a fiction that the Isle of Man company is a branch of the UK entity and look at the activities carried on, therefore they do not apportion value to factors such as legal ownership and will look at the facts of the position as to where the value of the contract was created and the risks of the contract are managed.

Diverted Profits Tax ("DPT")

The DPT was introduced in FA 2015 and so would not have been considered at the time of the earlier enquiry. DPT can apply to profits where measures have been taken to avoid a UK taxable presence or where there is an involvement of entities or transactions lacking economic substance.

In this case, the DPT provisions may require detailed consideration. The IoMWeb company makes a large profit on a small asset base, presumably utilising assets that were developed in the UK.

Although the full facts are not yet known there is a risk that the Isle of Man company was established with no real purpose other than to generate the profits from the contract in a lower tax jurisdiction.

If the DPT applies it is charged at a 25% rate, there is also a notification requirement that, for the 2015 year end, would now be passed.

I hope that is helpful and provides what you need for now. If you need any more from me please let me know.

Kind regards,
AN Adviser