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SOVEREIGN

report

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Prestigious new offices in London

Since the last issue of the report our London office have relocated to a rather beautiful 6,000 sq/ft Georgian terraced house just off Trafalgar Square located at 40 Craven Street, WC2N 5NG. Unfortunately British Telecom could not organise it for us to keep our existing telephone numbers so new fax and telephone numbers apply and these are listed on page 10 of the report. One of the best features of the new offices is a rather large basement area which is perfect for the storage of wine so if any of our clients are passing and would like to drop in for a glass or two then you would be most welcome.

Sovereign Group Partners LLP

Sovereign Group Partners LLP (or SGP), our new London based merchant banking operation, has now received the required FSA licence to offer corporate and investment advice on European companies to investors from anywhere in the world, as well as promoting global companies to European investors. The founding partners are The Sovereign Group, Gerry Scanlon who was previously head of equities research and sales for HSBC in North America, Hugh de Lusignan former head of pan European equity sales for Société Générale, and Neil Pidgeon was head of European equity research at Credit Lyonnaise. The focus of the new operation will be raising equity for private companies and we already have 30 such projects in progress. Gerry, Neil and Hugh bring a wealth of expertise and experience at the most senior level of major institutions and are a very welcome addition to the Sovereign team.

chairman

Portuguese Property

We wrote about the changes to the property regime in Portugal in the last issue. We have now been instrumental in getting new legislation onto the statute books in Malta which provides for the redomiciliation of foreign companies into and out of Malta. The 2% annual charges do not apply to Malta companies and so we believe that this could be the ideal solution for existing owners and those looking to buy. Purchasing Portuguese property through a Malta company carries all the advantages of offshore ownership without the penalties envisioned by the new tax regime. Further details are available from any Group office but, obviously, particularly our Portugal office - contact details appear on page 10.

Sovereign Germany

Our new operation in Germany has now started in earnest headed up by an experienced tax lawyer, Dr Norbert Buchbinder. The new office will be particularly active in advising German nationals on tax minimisation strategies for foreign investment and asset protection. Again, contact details of the new office appear on page 10.

howard bilton BA(Hons)
Barrister-at-Law (England, Wales & Gibraltar)
Chairman of The Sovereign Group

UK deal with Spain on Gibraltar sovereignty delayed

The UK and Spanish governments failed to secure an agreement in bilateral talks over Gibraltar by the summer, as intended. The appointment of a new Spanish foreign minister led to the postponement of further talks. UK Foreign Secretary Jack Straw told the UK parliament that Britain and Spain were, after twelve months' negotiation, in broad agreement that they should share sovereignty of Gibraltar. But two points were as yet unresolved.

Firstly he said Britain wanted a "permanent settlement", while Spain had indicated it would never give up its claim to the British colony. "Co-sovereignty cannot be just a stepping stone, however long-delayed, to full Spanish sovereignty," said Straw. "I know and understand that Spain has a long-standing historical aspiration to regain full sovereignty one day, but the agreement has to be permanent. Gibraltar has to have certainty."

Secondly, Britain was not prepared to include its military base on the rock in a joint sovereignty deal. The process was to agree a framework of a new permanent settlement for Gibraltar, to be published in a Joint Declaration, which would then serve as the basis for negotiating a comprehensive package, including a new draft treaty. The UK would ratify such a treaty only after securing the consent of the Gibraltarians in a referendum.

The Gibraltar Government condemned Straw's declaration for conceding the principle of joint sovereignty. This was tantamount to a denial of Gibraltar's right to self-determination. It would not participate in dialogue the outcome of which was pre-determined to result in any measure of Spanish sovereignty over Gibraltar.

"Joint Spanish sovereignty," said Chief Minister Peter Caruana, "can only become a reality if Gibraltar votes for it in a referendum. There is no prospect of this, and people should therefore not worry about actual implementation of joint sovereignty."

Sovereign comment

It is difficult to see what Spain and the UK hope to achieve. The UK has made it absolutely clear, and successive governments have repeated this line, that no deal will be done over Gibraltar without the consent, given in referendum, of the Gibraltar people. In turn the Gibraltar people have made it absolutely clear that they will not approve any deal which gives Spain any sort of sovereignty over Gibraltar including joint sovereignty with the UK. Those who have not spent time in Gibraltar will find it difficult to comprehend the strength of feeling engendered in Gibraltar about this matter and it is difficult to envisage the Gibraltar people changing this attitude and agreeing to become politically linked to Spain in any way. Whatever Britain and Spain decide it would seem as though the present status is set to continue indefinitely despite the obvious economic benefits that a deal with Spain would bring to Gibraltar. Under the joint sovereignty plan Gibraltar would, in fact, gain greater autonomy than at present so there need to be no worries about the future of the financial centre in Gibraltar even if, which is most unlikely, a deal were to be done with Spain.

europe

G-7 Ministers threaten sanctions over Swiss banking secrecy

Finance Ministers from G-7 industrial nations meeting in Canada said Switzerland may face sanctions if it keeps a law requiring banks not to disclose client information.

Italian Economics Minister Giulio Tremonti said: "Switzerland has announced that full access to their bank information isn't an option. The time has come for us to consider what possible means of pressure may be exerted to persuade Switzerland that exchange of bank information is a must."

The comments follows criticism in a recent OECD report which said Switzerland's bank secrecy and the use of foreign investment mandates, called fiduciary investments, enable non residents to avoid withholding taxes.

According to an annual survey of 1,000 people by the Swiss Bankers' Association, some 73% of Swiss people said the country should maintain its secrecy laws.

Sovereign Comment. Our own information is that it is unlikely that the Swiss will agree to repeal their secrecy laws but instead will offer to impose some kind of withholding tax on savings which, they argue, will achieve this same aim i.e. to stop tax evasion and avoidance. As reported in previous issues of the Sovereign Report, the EU Directive on savings is unlikely to be implemented without the acquiescence of the Swiss so the whole process may stall as a result. Interestingly the EU directive requiring automatic exchange of information when an EU resident banks across an EU border is thought unlikely to apply to British nationals banking iN Gibraltar because Gibraltar is part of the UK.

FATF launches review of Forty Recommendations

The Financial Action Task Force (FATF) has launched a review of the Forty Recommendations to account for changes in money laundering techniques and trends, and current areas of weakness. The three major areas identified by the FATF in which possible changes could be made to FATF standards are:

- Customer identification and due diligence, suspicious transaction reporting and regulation and supervision.
- Corporate vehicles. FATF typologies exercises have consistently identified difficulties in identifying the ultimate beneficial owners and controllers of corporate vehicles (companies, trusts, foundations etc).
- Non-financial businesses and professions. The FATF is considering whether the Forty Recommendations should be extended to cover seven categories of non-financial businesses and professions: casinos and other gambling businesses; dealers in real estate and high value items; company and trust service providers; lawyers; notaries; accounting professionals; and investment advisors.

Sovereign comment

The need for due diligence and know -your-customer principles is becoming a major cost to banks and other financial services businesses (including ourselves). It is now virtually impossible to move any sizeable tranche of funds without full documentation and explanation by way of support for the request. These rules become particularly onerous whenever there is an offshore element to the transaction and clients frequently find it difficult to understand why relatively simple requests are frequently carried out only with delay due to the need for this background information and documentation. We have sympathy with client's frustrations but the law is perfectly clear: if a transaction is not properly explained it is suspicious by definition and has to be reported to the relevant authorities under the money laundering legislation.

Bahamas to review financial regulatory regime

The new Bahamas government is to review all financial sector legislation passed by the previous government and also intimated that it will extend the deadline for compliance with anti-money laundering rules to the end of 2002.

Prime Minister and Minister of Finance Perry Christie said in the Budget speech on 30 May that the review would apply to legislation passed to achieve compliance with the OECD, the Financial Stability Forum and the Financial Action Task Force. Christie's Progressive Liberal Party won the general election in May.

The government is to consult with the financial services industry to identify the areas which the industry considers are excessively burdensome and which do not contribute to combating serious financial crime. In particular, the government will examine the procedures under the Financial Transactions Reporting Act 2000. Christie said the review would seek to reduce costs and inconvenience, without compromising the effectiveness of the anti-money legislation.

"Although the associated mandated exercise on verification of the identities of existing clients of financial services providers, which began early in 2001, is continuing reasonably satisfactorily, ongoing feedback suggests that the compliance deadline for domestic institutions might have to be extended by another six months to the end of 2002," he said.

The previous government passed a series of laws in December 2000 giving enhanced powers and operational independence to the Central Bank, enhanced co-operation with external regulatory bodies, the upgrading of the supervisory and regulatory regime for banks, and strengthening of customer identification requirements and the requirement to report on suspicious transactions to a Financial Intelligence Unit.

But the validity of the legislation has been challenged in the Supreme Court in a suit backed by the Bahamas-based Nassau Institute and the Bahamas Bar Association.

Sovereign comment

The feeling in Bahamas was that the last government rolled over far too quickly and easily in response to demands from the US in particular. Hastily produced legislation was implemented, then changed, then changed back again causing serious confusion and lack of confidence in the jurisdiction. This is borne out by the incorporation statistics for new companies. In 1999, 15,600 new companies were put on the register but by the end of 2001 this figure had fallen to 4,836 new companies in that year. The new government appears to have a more sensible attitude and this is to be welcomed. The Bahamas is a leading offshore financial centre but has not done itself any favours recently. Our office in the Bahamas is looking forward to a rather more sensible approach and to re-establishing the Bahamas as a threat to the predominance of the BVI for new incorporations.

UK Overseas Territories and Bermuda move forward on financial regulation

The UK's Caribbean Overseas Territories and Bermuda issued a second report on implementation of the recommendations of the KPMG review of compliance with international standards and best practice of financial regulation, including anti-money laundering.

The Overseas Territories (OTs) – Anguilla, British Virgin Islands, Cayman Islands, Montserrat and the Turks & Caicos Islands – and Bermuda jointly commissioned an independent review by KPMG which was published in October 2000.

The UK government said progress in three priority areas had been impressive:

- All OTs had adopted comprehensive anti-money laundering legislation.
- Independent regulatory authorities were up and running in Bermuda, British Virgin Islands, Montserrat and Turks & Caicos; Anguilla and Cayman Islands were planning to legislate in the first half of this year.
- All the OTs, apart from Anguilla, had taken the necessary compulsory powers to obtain information about regulatory issues and share it with foreign regulators. Anguilla is to include such powers in the legislation to establish the independent regulatory authority. Bermuda is to compel unregulated persons and bodies to provide such information to the authorities on the same basis as regulated financial institutions.

The separate proposals for further reforms to financial regulation submitted to the UK Treasury were published in May. We will continue to monitor any changes to legislation or regulations that may affect clients, particularly in the jurisdictions where Sovereign has offices – the BVI and TCI.

US FinCEN issues further Financial Advisories

The US Treasury's Financial Crimes Enforcement Network (FinCEN) issued financial Advisories against Grenada, Myanmar, Ukraine, Egypt and Nigeria. It warns banks and other financial institutions operating in the US to give enhanced scrutiny to all financial transactions originating in or routed to or through these jurisdictions, or involving entities organised or domiciled, or persons maintaining accounts, in them.

The counter money laundering regime embodied in the legal, supervisory, and regulatory systems of these jurisdictions, it said, suffer from serious systemic problems. All institutions are particularly advised to give enhanced scrutiny to transactions or relationships that do not involve established and adequately identified and understood commercial or investment purposes.

FinCEN Advisories are currently in force against: the Seychelles, Cook Islands, Dominica, Marshall Islands, Nauru, Niue, Philippines, Russian Federation and St Vincent.

Advisories previously issued against Panama, Liechtenstein, Cayman Islands, Bahamas, Antigua, St Kitts & Nevis, Lebanon and Israel have all now been withdrawn.

Hong Kong confirms tax-free status of offshore funds

Financial Secretary Antony Leung confirmed that the policy of not taxing offshore revenue remains in place in response to concerns raised by offshore fund managers that their funds could be taxed in Hong Kong. Managers became concerned that tax breaks might be closed when Hong Kong's inland revenue department asked about 200 non resident funds to file returns for the financial year 2000.

Although the Inland Revenue Code provides for any fund to be taxed if it has an advisor or manager based in Hong Kong who trades on its behalf , the government has never attempted to enforce this tax in relation to offshore funds.

The Inland Revenue says it sent out the letters to the funds to determine how the department should treat Hong Kong-sourced income earned by offshore funds managed in Hong Kong. The policy of not taxing offshore revenue remains in place, the department said.

Leung said: "We do not tax offshore funds. These actions were triggered by the availability of new information about the identity of fund management companies."

After a long period of consultation, the Securities & Futures Commission has published guidelines, effective on 17 May, governing the sale of hedge funds to retail investors. Hong Kong is now the second Asian market after Singapore to offer hedge funds.

The guidelines divide hedge funds into three categories – single hedge funds, fund of hedge funds and hedge funds with a capital guarantee. For single hedge funds, a retail investor must subscribe at least US$50,000, while funds of hedge funds, seen to be less risky, will require a minimum investment of US$10,000. No minimum investment has been set for guaranteed capital funds.

Hong Kong Monetary Authority chief executive Joseph Yam said the Authority is monitoring the development of hedge funds closely. He said the Authority supported greater transparency and disclosure, and would continue to press for further reforms of the international financial architecture to reduce the vulnerability of medium-sized open financial markets.

asia+ pacific

Hong Kong enacts Securities & Futures Ordinance

The Securities & Futures Ordinance which consolidates and modernises the 10 existing ordinances regulating the securities and futures markets was gazetted on 28 March. The government plans to bring the new regulatory regime into force before the end of 2002.

The main features of the new Ordinance include:

- a new streamlined single licensing regime;
- new proportionate disciplinary sanctions to combat market misconduct;
- new measures to protect the interests of investors, such as personal rights of action through the civil courts for loss caused by market misconduct or false or misleading public statements concerning securities;
- a new investor compensation scheme; and
- a tighter regime for disclosure of interests in listed companies.

Consultation is currently underway on the 38 pieces of subsidiary legislation that have been identified as necessary to enable commencement of the Ordinance.

Niue to end offshore banking

The Niue government has announced that it is to stop licensing offshore banks but will continue to provide registration services for international business companies. The decision to end offshore banking was made in a bid to get off the Financial Action Task Force's money laundering blacklist and the OECD's tax haven blacklist.

Singapore budget introduces major tax concessions

The Singapore government announced a series of new tax concessions for the business and financial sector in the Budget in May. The measures are intended to enhance Singapore's competitive position within the region.

The standard corporate income tax rate is to be reduced from 24.5% to 20% over three years. To simplify the tax code, the current full imputation corporate taxation system will be replaced by a one-tier corporate taxation system under which the tax collected from corporate profits will be final and dividends are exempt from 1 January 2003.

Further concessions, specifically designed to attract more mutual funds, will exempt investment income of foreign investors from funds managed by fund managers in Singapore and extend the 10% tax rate on fee income for fund managers to qualifying boutique fund managers.

Other incentives for the financial sector include:

- Enhanced tax incentives for the wealth and asset management industries;
- Enhanced tax incentives to promote the growth of the derivatives market;
- Enhanced tax incentives to strengthen the equity capital market;
- Tax concessions for special reserves of general insurance companies set up to underwrite certain offshore risks;
- And existing financial sector incentives to be merged into an umbrella Financial Sector Incentive scheme to simplify the tax system.

A government committee has recommended a two-phase approach to reforming the domestic and international companies law. The first phase will focus on streamlining the legislation and migrating regulations covering listed companies to the Securities & Futures Act. The second recommends that a new Companies Act be drafted, modelled on the UK draft companies legislation.

The recommendations include: the introduction of legislation on limited partnerships and limited liability partnerships; review of the Trust Companies Act; and to introduce protected cell company legislation for insurance, securitisation and funds.

Indian ruling renews threat to Mauritius tax treaty

The ability of foreign institutional investors (FIIs) to benefit from capital gains tax exemption under the India/Mauritius tax treaty has again been brought into question after the High Court in Delhi quashed an Indian government circular issued specifically to provide clarity in the matter.

Under the treaty, capital gains tax is payable in only one country. FIIs and other investment funds incorporated in Mauritius are considered as resident in Mauritius and 'liable to tax' under the Mauritius tax law. Such entities are therefore exempt from paying capital gains tax in India – including on income arising from sale of shares – while capital gains tax is zero-rated in Mauritius.

In 2000, Indian tax officials began to issue assessments against 20 foreign investment companies which, they claimed, were abusing the spirit of the treaty to avoid paying tax in either jurisdiction.

In response to complaints from genuine investors, the Central Board of Direct Taxes issued a Circular requiring tax inspectors to accept a Mauritius residence document as evidence that the treaty should be applied.

But on 31 May, in response to a public interest application, the Delhi High Court held that the Circular was ultra vires in that it fettered unduly the powers of the Indian Income Tax Law and was, as a result, quashed. Avoidance of double taxation meant that a person has to pay tax at least in one country.

A high level meeting between the two countries to "discuss the administrative measures to secure the proper implementation of the treaty provisions" was scheduled for July.

Sovereign comment

Supposed threats to the India/Mauritius treaty appear to come regularly and often but the treaty seems to have worked without interruption since inception. It is correct that the treaty mentions in its preamble that the purpose of the treaty is to avoid double taxation i.e. it specifically does not say that the purpose is to avoid all taxation. The offshore company regime in Mauritius (now called Global Business Companies Category 1) used to allow for zero tax companies but now such companies pay 3% tax and this new regime was initiated to address criticisms that such companies were using treaties and avoiding all taxation. As always uncertainty is not good for business and many non resident Indians now choose to invest back into India via Cyprus instead of Mauritius as the Cyprus/India treaty is almost as good and does not appear to be under threat. Sovereign has an office in Cyprus able to assist those who have an interest in this matter.

Irish High Court publishes Ansbacher report

The Irish High Court ruled in favour of full disclosure of a report containing the names of nearly 200 individuals and companies who were account holders at Ansbacher (Cayman) Limited. The report, which took court-appointed inspectors three years to complete, examines a secret, unlicensed banking scheme operated from 1971 until the mid-1990s by Ansbacher (Cayman) Limited which enabled clients to lodge money offshore while secretly making the funds available in Ireland.

The report says the Ansbacher's affairs were "deliberately complex and secretive" and were "conducted with intent to defraud" the revenue authorities. It said it set up "sham" trusts, which "facilitated widespread tax evasion".

The High Court appointed the inspectors in September 1999 to investigate the operations of Ansbacher (Cayman) Limited. Ireland's revenue department initiated the investigation after large scale tax evasion was revealed during hearings in 1997 held by government appointed tribunal chaired by Justice McCracken. According to the inspectors say the amount deposited peaked at £204m in 1984 and involved 462 Irish and foreign depositors, including former Irish prime minister Charles Haughey. The report is expected to be closely examined by international tax authorities.

Lawyers for those named said High Court hearings on the report should be heard in-camera. They claimed that publication would be tantamount to identifying their clients as tax-evaders, or guilty of similar wrong-doings.

But High Court President Mr Justice Joseph Finnegan said: "In the interests of the concerns of a wide interest of commercial life, for public confidence in the tax regime and the banking regime, and in the workings of exchange control, the balance falls firmly in favour of disclosure."

Sovereign comment

This affair has been rumbling on for many years and gained much publicity due to the supposed involvement of former Prime Minister Charles Haughey. Ansbacher now appears to be divesting itself of its offshore interests and has recently announced that it is disposing of its business in BVI and consolidating all its trust business in one Caribbean centre only – the Cayman Islands.

First UK lawyer jailed for laundering proceeds of crime

UK lawyer Jonathon Duff was jailed for six months for failing to disclose suspected money laundering. He is the first solicitor to be prosecuted for the offence since new legislation was introduced in 1994.

Duff, of Drummonds solicitors in Chester, was questioned by HM Customs & Excise probing the affairs of two men he represented who were convicted of conspiring to import cocaine in 1999.

At Manchester Crown Court, he pleaded guilty to two counts of failing to disclose suspected money laundering. He was sentenced to six months for failing to disclose the first count and three months for the second, to run concurrently. Duff told the court he only became aware that the financial transactions between himself and one of the clients may have been drug related when he represented him at his trial.

He said he had then misinterpreted the provisions of Section 52 of the Drug Trafficking Act 1994, believing he did not have to disclose previous transactions if his suspicion was only aroused afterwards.

Sovereign Comment. The danger of being unwittingly caught up in a money laundering offence is a constant nightmare for practitioners generally and offshore practitioners in particular. Our comments in relation to the FATF announcements on the European page 4 apply.

Gibraltar announces zero rate of company taxation

The Gibraltar government announced that it is to introduce a zero rate for company profits tax with effect from 1 July 2003. This zero rate will apply to all companies in Gibraltar, whether local or international and whether doing business locally or abroad.

The main elements of the proposed new company taxation system are:

- company profits tax will be zero. The existing tax exempt status and tax qualifying status are to be abolished.
- a new "Company Payroll Tax" will be introduced in respect of employees in Gibraltar. This will be charged at a sum per annum per employee. This payroll tax is a tax on the company and is payable by the company only.
- a new Business Property Occupation Tax will be introduced in respect of property occupied in Gibraltar by companies for business purposes.
- the Payroll Tax and the Business Property Occupation Tax together will be capped at a sum equal to 15% of profit. All local companies currently pay tax at the rate of 20% or 35% of their profit. If there is no profit there is no tax liability.
- all companies will pay an annual companies registration fee of £300 p.a. (if the company has income) or £150 (if the company has no income) inclusive of current annual return fees.
- subject to EU clearance under State Aid Rules, financial services providers and utility companies will pay a new tax on profit. The intended rate of profits tax for financial services providers is 8%, and will be subject, aggregated to the other taxes, to a maximum cap of 15% of profit.

The government said the need to reform company taxation was not a matter of choice – a series of international factors had made reform inevitable. Some, such as EU State Aid Rules, were mandatory, while others, such as the EU Code of Conduct of Business Taxation, were initiatives deployed through political pressure. In both cases the fundamental requirement was the elimination from the tax system of discrimination between residents and non-residents.

Sovereign comment

Gibraltar's clarification of its tax proposals is extremely welcome. There has been some uncertainty about what will happen in the future after the EU instructed Gibraltar to do away with its exempt and qualifying company regimes on the basis that they represented illegal state aid. The new tax regime looks extremely attractive for clients but those in the financial service industry based in Gibraltar who have previously enjoyed exempt status look set to suffer. But from a client's point of view zero tax status remains, albeit in a different format, so any fears that clients may have had about the tax status of their companies can be allayed.

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IRS steps up search for tax shelter documents

The IRS and Justice Department took the unprecedented step of releasing the names of about 100 individuals it said had bought tax shelter products from KPMG in a summons seeking documents filed in federal court.

Chief Counsel John Williams said the IRS expects to issue other summonses to sellers of tax shelters when they refuse demands for details about their products.

The US has also now signed an agreement with the Netherlands that will allow for exchange of information on tax matters between the US and the Netherlands Antilles. It follows similar agreements signed recently with Antigua, the Bahamas, BVI and the Cayman Islands.

Sovereign Comment. The IRS is becoming increasingly aggressive in stamping out tax schemes and holding the advisors who promote them to account. US tax planning is still alive and well, and we have our associated tax planning department based at St Thomas University in Miami, but must be undertaken with great care and skill. We are well placed to advise on this. The US has stated that it expects to sign tax information exchange agreements with all the major offshore centres and those agreements can be used to obtain information about any offshore structure, its dealing and its beneficial ownership. Confidentiality is, we believe, a thing of the past. All tax plans must be able to stand up to scrutiny if required.

Isle of Man announces move to zero standard corporate tax rate

The Isle of Man is proposing the introduction of a standard zero rate of income tax for business with effect from 2006. The government said the move constitutes an "elegant solution" to the EU Code of Conduct on Business Taxation and was a further evolution of its national tax strategy approved in October 2000.

Key targets of the original national tax strategy included the reduction of standard income tax rates for businesses and individuals to 10%, within three to five years. Implementation of the new zero rate proposal will be subject to Tynwald approval.

Treasury Minister Allan Bell said: "The creation of a zero corporate rate applied to resident and non resident businesses alike would preserve the international business we would wish to retain, allow the economy to diversify still further and give the Island a powerful competitive advantage for the future." As with its commitment to the OECD "harmful tax" initiative, the Isle of Man's compliance with the EU Code of Conduct is conditional upon its adoption throughout the EU and its dependencies and associated territories.

The government said it is also prepared to adopt appropriate exchange of information systems in relation to the proposed EU Savings Directive. This would again be subject to third country agreement and conditional upon the Directive being fully implemented throughout the EU and its dependencies and associated territories.

Sovereign comment

The reduction in corporation tax will affect resident tax paying companies only rather than the exempt and non resident companies which are, by definition, owned by non resident clients. The EU Savings Directive represents a different problem for the Isle of Man as it would be applicable to all EU member states and all territories under their control thereby including the Isle of Man. At least that is the view of the UK government. The Isle of Man has taken the same stance as it did with the OECD by agreeing to be bound by the proposals as long as all OECD members – or in this case all other EU members and Switzerland – are similarly bound by the Directive.

Employee Benefit Trusts (EBTs) for UK Companies

Outstanding advantages can accrue from setting up Employee Benefit Trusts (EBTs) and Sovereign has found there has been increasing demand for their use by UK companies as tax-efficient investment vehicles.

The principal benefits of EBTs are that:

- Contributions to the trust are tax deductible;
- Trust funds can be invested and rolled up tax free;
- Distributions may, in certain circumstances, be tax free;
- The structure is readily accepted by the UK Inland Revenue

An EBT is a trust established by an employer to provide current and future benefits to company directors and employees together with their spouses and dependants who will be the beneficiaries. If the EBT is established in an offshore jurisdiction the income and gains of the trust can be rolled up free of UK tax on all but UK-source income and completely free of capital gains tax.

At the same time the employer's contributions should be tax deductible when arriving at a company's UK corporation tax liability because, in the eyes of the Inland Revenue, there is commercial justification of setting up such a scheme in order to provide an incentive to attract, retain and motivate good quality staff. Former employees and their dependants may also be included in the class of beneficiaries.

The benefits provided by the trust can be either in cash, by way of bonuses, or in kind, by way of shares or the provision of benefits, accommodation or the use of assets owned by the EBT. For instance, the trustees might acquire a property abroad for the use of the beneficiaries as an incentive reward during the period of ownership. In this case, the company would have obtained a tax deduction on the contributions to the EBT and sheltered profits from UK corporation tax, whilst the trust benefits from any income from the property and the capital appreciation free of UK capital gains tax. If the property was in the UK then would of course be tax due on any income arising from the property.

Alternatively, the EBT might make an interest free loan to all or one of the beneficiaries. Here, although the borrower will be charged income tax at their marginal rate of tax on the interest foregone, there would be a considerable saving when set against the interest due on a commercial loan. At the same time, under current UK employee benefits legislation, if the loan did not exceed £5,000 then it would be free of income tax in the recipient's hands.

This also represents a considerable tax saving on drawing a salary equal to the amount borrowed. Another common application of employee benefit trusts is to provide a vehicle for a share option scheme or to hold shares in the company as a long term incentive for key employees.

"If the EBT is established in an offshore jurisdiction the income and gains of the trust can be rolled up free of UK tax on all but UK-source income and completely free of capital gains tax."

The EBT is usually a discretionary trust established under English law in an offshore jurisdiction. The trustees should be offshore professional trustees to ensure that the EBT is resident and controlled and managed outside the UK.

After an initial nominal contribution the trust funds can be augmented by a series of periodic contributions or perhaps loans from the employer, loans from third parties and by the accumulation of income within the trust together with the realisation of tax-free capital gains if the EBT is offshore.

To ensure that the contributions are treated as revenue expenditure and allowed as a deduction against UK corporation tax, they must be seen to be wholly and exclusively for the purposes of the trade of the company. To determine this the Inspector of Taxes may look at the original purpose of the trust and will expect decisions to set up and make contributions to the trust to have been reflected in the minutes of director's meetings.

Care should also be taken to ensure that distributions from the EBT are not disproportionately in favour of a controlling director as opposed to other directors or employees (although this cannot apply where there are few, or perhaps only one, director/employees). At the same time, in practical terms, it would be advisable to ensure that the EBT does not wait too long after the initial contributions to make distributions or confer benefits.

Where the company setting up the EBT is a close company, that is to say it is under the control of five or fewer persons, or indeed under the control of their directors, the transfers into the EBT may represent a diminution of their estate chargeable to UK inheritance tax. But providing the contribution is allowed as revenue expenditure reducing the profits of the company for UK corporation tax purposes, it will be outside the scope of inheritance tax.

Clearly, an EBT can present a significant taxation advantage, particularly if it is held offshore and not chargeable to UK tax on capital gains and non-UK income. But it must be properly established with regard to all the appropriate tax articles and must be seen primarily to have been established for the benefit of the company directors, employees and their families. The Inland Revenue will happily accept the offshore EBT and allow the company contributions as a deduction from profits when calculating UK corporation tax unless they feel that the EBT has been set up solely to reduce that tax charge. Great care must therefore be taken throughout the lifetime of the EBT to ensure compliance with these guidelines.

If you think that an EBT may be effective as a tax efficient structure for providing benefits to employees then please contact our London office for more information (see page 10 for contact details).

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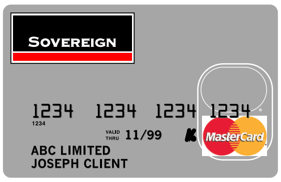

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