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SOVEREIGN

report

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Hong Kong Office

We are pleased to announce that Jacques Scherman has joined the board of Sovereign Trust (Hong Kong) Ltd. Jacques is a South African-qualified lawyer who is currently combining his day job with studying for the Hong Kong law exams. Brave man!

Shanghai Office

Our Shanghai office, which provides a full range of China entry services, is now fully operational. The contact details are: Sunny Liew – Sovereign Trust (China) Ltd.
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Portuguese Amnesty

The Portuguese parliament has approved a rectification of the 2005 Budget, which we discuss on *page 4* of this issue. The changes are designed to mitigate an anticipated budget deficit for 2005 by including provisions to crack down on tax evasion and to amend various taxes. The Bill also introduces an extraordinary regime for the repatriation of certain untaxed assets – bank deposits, securities, and other financial instruments, including life insurance policies – not located in Portugal as of 31 December 2004. Portuguese resident individuals will be taxed at a rate of 5% on the value of repatriated assets, reduced to 2.5% if the assets are reinvested in Portuguese government bonds. Tax and criminal liabilities related to such assets will be nullified provided that an investigation has not already been initiated. More information is available from our Portugal office.

New Manx Vehicle (NMV)

Also on *page 4*, we carry news that the Isle of Man has published draft legislation for a new Manx corporate vehicle, the “NMV”, which is designed to be simple and inexpensive to administer while at the same compliant with international obligations. The Bill will make some fundamental changes to the Island's existing company law although these will not apply to existing companies unless they choose to re-register under the new legislation.

chairman

While the Sovereign Group broadly welcomes the concept of an IBC-style vehicle being available in a blue chip European jurisdiction, we do have certain caveats as the new proposals appear to lower the standards of control and accountability. The Bill is scheduled for introduction next year, to coincide with the Isle of Man’s move to a zero rate of corporate tax. It raises a number of important issues and some of the questions may perhaps be answered when the model articles of association are drafted. We will continue to monitor this legislation as it progresses.

Quintessentially

We don’t usually carry publicity materials from other companies but thought this one may be of interest to our readers. Quintessentially provides a full “concierge” service which promises to arrange anything you might wish, be it tables in restaurants that are otherwise impossible to book, tickets to sold out sporting events, preferential hotel rates, invitations to film premiers etc. You will find their materials in the middle of the *Report*.

Sovereign European Art Prize – a date for your diary

The inaugural competition closed for entries in the middle of October and we have received applications from some of Europe’s very best artists. The quality is staggeringly high and we are looking forward to the judging process. We are hosting a gala dinner for the prize giving, which will be held at the New Bond Street showrooms of Bonhams Auctioneers in London on Friday, 13 January 2006. We would be delighted if any of our clients and readers could attend and support this very worthy charitable cause, and enjoy what should be an evening of great fun and glamour.

Howard Bilton BA(Hons)
Barrister-at-Law (England, Wales & Gibraltar)
Professor of Law, St. Thomas School of Law, Miami, USA
Chairman of The Sovereign Group

STOP PRESS NEWS

Hong Kong Abolishes Estate Duty

The Hong Kong Legislative Council passed a Bill on 2 November to abolish estate duty. The Ordinance will come into force on 11 February 2006. Frederick Ma, Secretary for Financial Services & the Treasury, said the move could attract more investors and promote Hong Kong as an international financial centre.

PLEASE NOTE: Most Hong Kong residents will have investments in various jurisdictions outside Hong Kong and local estate duties are likely to apply to those assets. Non-Hong Kong nationals may also have trailing liabilities to worldwide estate duty in their country of origin.

We are experts in worldwide estate planning so please consult us if you think you may be subject to estate duties outside Hong Kong and wish to mitigate these to the benefit of your family.

Revised Portuguese Budget targets tax avoidance

The Portuguese parliament approved a rectification of the 2005 budget Bill on 6 July. The changes, which include measures to crack down on tax evasion and amend several taxes, are designed to mitigate an anticipated budget deficit for 2005.

The anti-avoidance measures are designed to combat dividend stripping by any entities that are subject to taxation and entities that, on whatever grounds, are tax-exempt or subject to a more favourable tax regime. The Bill provides for the introduction of a withholding tax, up to a maximum rate of 25%, for dividend distributions to both resident and non-resident individuals and companies, and to eliminate the withholding tax exemption on dividend distributions related to shares that are held for less than one year.

In respect of personal income tax, the revised Bill introduces some amendments to capital gains and international tax credit rules. Previously, capital gains obtained by individuals from the sale of shares were not subject to tax, provided the individual shareholder had held the shares for more than 12 months. Under the new rules, those capital gains will be subject to tax if the corporation involved in the transaction owns real property that represents more than 50% of its assets.

The general international tax credit rule is that resident entities must include in their taxable base any gross income arising abroad. Taxes paid abroad by a resident individual or company on its foreign-source income may be credited against the taxpayer's tax liability on its total income, subject to the ordinary credit system.

Under the amendments, that credit, calculated on a per-country basis, is limited to the lower of the foreign income tax actually paid, or the Portuguese income tax that would be due on that portion of the income if no credit were granted, after the deduction of all costs, losses, and expenses directly or indirectly related to the income received (for companies), or after the deduction of specific deductions made in accordance with the individual income tax (for individuals. Unused credit may no longer be carried forward for five tax years, as was previously the case.

Sovereign comment
Tax treaties are supposed to override domestic tax law but these amendments seem to be in conflict with a number of Portuguese tax treaties. In our view this means either that Portugal will have to renegotiate its tax treaties or that this law is unenforceable and contrary to international law.

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Gibraltar Budget tax cuts

Gibraltar's 2005 budget, announced by Chief Minister Peter Caruana on 22 June, abolished tax on savings income, defined as dividends arising from investments quoted on a recognised stock exchange and as interest paid directly or indirectly by banks and other financial services institutions licensed in Gibraltar.

The budget also abolished the tax applied to dividends paid by one Gibraltar company to another Gibraltar company, the tax on dividends and interest paid by a Gibraltar company to a non-resident, and the requirement to withhold tax from dividends in accordance with section 39 of the Income Tax Ordinance. Stamp duty is to be abolished on all transactions except for real estate and share capital transactions. The stamp duty applied to share capital is to be set at £10.

In a separate matter, the ECJ ruled on 21 July that the UK is obligated to implement in Gibraltar exchange of information rules for VAT and excise taxes in Council Directive 77/799/EEC on mutual assistance in the field of direct and indirect taxation. The UK has argued that Gibraltar had no responsibility to comply given that EU rules on VAT and excise duties do not apply on the Rock. But the ECJ said Gibraltar needed to exchange information with other tax authorities to safeguard its own interests.

Sovereign comment
Gibraltar is making great efforts to simplify its tax system and make it more attractive to both residents and non-residents. It is probably also paving the way for the wholesale tax changes which may be necessary once the exempt company regime has been abolished.

Isle of Man publishes new company proposals

The Isle of Man Government published, on 2 August, draft legislation for the creation of a new Manx corporate vehicle, the "NMV". The new legislation has been prepared, after close examination of the vehicles available in other onshore and offshore jurisdictions and is designed to be simple and inexpensive to administer and to meet international obligations.

In particular, the new structure will remove the requirement to have Isle of Man-based directors and company secretaries and, in some cases, for annual returns. The consultation document states: "The conclusions to date are that corporate directors should be permitted within certain limitations, annual returns should only be required for companies undertaking business locally, and that the provision of corporate administration services to an overseas company should not result in a place of business being established in the Island."

The proposed NMV will not require an annual general meeting, authorised share capital, or a capital maintenance requirement. It will provide for a simple redomiciliation procedure and shares of no par value. Unlimited capacity but restricted objects, and protected cell companies will be permissible. There will be no financial assistance prohibitions.

Scheduled for introduction next year, to coincide with the Isle of Man's move to a zero rate of corporate tax, NMV companies will be available in addition to existing Isle of Man companies, which will be retained.

Sovereign comment
Last year in the BVI, the leading incorporator of offshore companies, 60,000 new companies were put on the register. By contrast, the Isle of Man registry incorporated 2,593 new companies. This disparity can partly be explained by the fact that BVI companies are much cheaper to incorporate and easier to administer. This NMV seems designed to compete with the BVI product, but has the added advantage of a European location, some coincidental business hours with the Far East and a blue chip reputation. The proposals as they stand raise a number of questions, but we think this initiative may stand a good chance of having great success.

US indicts tax professionals over tax shelters

The US government has indicted nine tax professionals for conspiring with accountant KPMG to commit tax shelter fraud. At the same time, the government announced a deferred prosecution agreement with KPMG, under which the firm will pay US$456 million and admit to criminal wrongdoing.

It is alleged that between 1996 and 2003, KPMG, the nine indicted defendants and others conspired to defraud the IRS by designing, marketing, and implementing four illegal tax shelter schemes. The individuals include seven former KPMG tax partners and a former tax partner of the law firm Sidley Austin Brown & Wood.

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The indictment alleges that as part of the conspiracy to defraud the government, KPMG, the nine defendants, and their unnamed co-conspirators prepared false and fraudulent documents, as well as false representations that investors were required to make to obtain opinion letters from KPMG and law firms.

The indictment charges that the nine individuals concealed the shelters from the IRS by not registering them, by preparing returns that fraudulently concealed the losses, by attempting to conceal from the IRS the tax shelter losses and transactions "with sham attorney-client privilege claims," and by obstructing IRS and Senate investigations into their shelter activities.

The deferred prosecution agreement provides that prosecution of the criminal charge against KPMG will be deferred until 31 December 2006, if some conditions, including payment of the US$456 million in fines, restitution, and penalties, are met. The US$456 million payment includes: US$100 million in civil fines for failure to register the tax shelters with the IRS; US$128 million in criminal fines to match fees earned by KPMG on the four shelters; and US$228 million in criminal restitution representing lost taxes to the IRS as a result of KPMG's intransigence in turning over documents and information to the IRS.

The agreement requires permanent restrictions on KPMG's tax practice and calls for permanent adherence to higher tax practice standards regarding the issuance of some tax opinions and the preparation of tax returns. It also prohibits KPMG's involvement with any prepackaged tax products and restricts KPMG's acceptance of fees not based on hourly rates. Richard Breeden, former chair of the Securities & Exchange Commission, has been appointed to serve as the independent monitor for three years.

Sovereign comment

Many wondered whether KPMG would go the same way as Arthur Andersen as a result of these prosecutions. We would point out that offshore structures can be an extremely effective tax saving device for US persons, but the anti-avoidance rules aimed at combating them are becoming ever more complicated. Proper professional advice before implementation is vital.

UK approaches Bermuda on EU Savings Tax

Bermuda's Minister of Finance Paula Cox told the island's parliament on 8 July that her department had been approached by the UK government to begin discussions about Bermuda adopting measures to apply the EU Savings Tax Directive, which came into force on 1 July.

Bermuda was the only British overseas territory not to be included in the Directive for the purposes of exchanging information on EU citizen's savings accounts with their home member state's tax authorities. It is understood that Bermuda was left out only because EU draftsmen thought that it was in the Caribbean.

While Bermuda and other financial centres such as Singapore and Hong Kong remain outside the Directive, Cox said the long process of negotiation resulted in a “complex set of rules which have had unanticipated outcomes” for funds and collective investment schemes. “The upshot is that even though Bermuda is outside of the Directive, the manner in which some countries have applied ‘their home rules’ which give effect to the Directive has impacted negatively on funds domiciled in Bermuda but whose paying agents are located in a country subject to the Directive.”

Some European countries, notably Switzerland and Ireland, have already included Bermuda in the scope of the directive and are withholding 35% tax, putting Bermuda funds at a considerable disadvantage.

Sovereign comment

What a laugh. The draftsman thought Bermuda was in the Caribbean but that shouldn’t have made any difference. The EU Directive requires all EU member states to implement the Savings Directive and to impose it on all territories under their control. Bermuda is unarguably under the control of the UK for these purposes so its geographical location should have been immaterial.

TCI to upgrade offshore regime

The Turks & Caicos Islands (TCI), following a change of government in late 2003, indicated that there would be a renewed commitment to the financial sector in respect of non-regulatory legislation.

The government has since announced its intention to introduce, in the short term, legislation to provide for the introduction of protected cell companies and charitable foundations, an overhaul of the Mutual Funds Ordinance to include an expert funds regime and amendments to the Insurance Ordinance.

In the longer term the government has promised that there will be a restructuring and modernisation of the TCI's Companies Ordinance and Trusts Ordinance. The legislative framework will also be kept under ongoing review to ensure that the jurisdiction's financial sector continues to develop.

Sovereign comment

TCI is a jurisdiction we favour. Its company’s legislation was based on the original Cayman Island legislation that has proved popular with corporate professionals around the world. The TCI company product is similar to the Cayman Island company, but at a much lower price. It was actually the first OFC to create a simple IBC type product (although it called it the TCI exempt company) and this came on to the statute book many years before the equivalent BVI model. However, a lack of government commitment to the financial sector seems to have cost TCI dear – it seems to have gone backwards rather than forwards over the last 10 years. We remain a fan but it is high time that our efforts to promote the jurisdiction were backed up by those of the government.

Hong Kong and China open tax treaty talks

Officials from Hong Kong's Inland Revenue Department met with their People's Republic of China (PRC) counterparts in September for preliminary discussions to expand and update the 1998 Income Tax Memorandum & Arrangement between China and Hong Kong.

Hong Kong is seeking to negotiate a comprehensive tax treaty in order to clarify the tax rules and ease the tax burden for the growing number of companies based in the territory, which are doing business with the mainland.

Under the existing 1998 tax agreement, Hong Kong firms with manufacturing operations in China are permitted to split their profits equally between the two jurisdictions, while individuals are granted relief from double taxation. But the tax agreement does not currently apply to firms in the service industry, nor does it extend to withholding taxes on interest, royalties and dividends.

While this is likely to result in considerable tax savings for Hong Kong-based firms doing business in China, a comprehensive new agreement is likely to include a tax information exchange provision, which could mean increased scrutiny from the Chinese tax authorities. It could also result in a crackdown on transfer pricing.

Meanwhile the Finance Ministry of the PRC announced on 13 June 2005 that it was temporarily reducing the tax on dividends and the issue of bonus shares with immediate effect. Investors previously paid a 20% tax rate on all dividends and bonuses. Under the new measure, only 50% of dividends and bonuses will be subject to that tax, the ministry announced through a joint statement with the State Tax Administration. The reduction is only temporary and the Finance Ministry has not provided details on its duration.

Sovereign comment

These are interesting days. Hong Kong now has comprehensive tax agreements with Thailand and Belgium. We believe that a comprehensive tax agreement with China can only benefit Hong Kong and help to maintain its position as the pre-eminent service centre for the Asia Pacific region.

The clarity brought by a tax treaty would be very welcome to tax practitioners in both China and Hong Kong because there are currently too many grey areas. Both Mauritius and Singapore have tax treaties with China that make them a suitable route for investing into China. We believe most investors would prefer to route their investment through Hong Kong but, at present, more certainty and better tax rates can be obtained in the other two jurisdictions. We would hope this treaty would provide Hong Kong companies with benefits which are at least as good as those which can be obtained by Mauritius and Singapore companies under their respective treaties. It would not make sense for the treaty to any less beneficial.

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India-Mauritius tax treaty may be reviewed

India and Mauritius held a first round of discussions on a Comprehensive Economic Cooperation Partnership Agreement (CECPA) in August. As part of the ensuing talks, India has proposed a re-negotiation of the existing India-Mauritius tax treaty so as to include safeguards against third country residents from enjoying benefits under the treaty.

India has informed Mauritius that all aspects of the CECPA relating to preferential trade, free trade, tax treaty, customs co-operation and investment protection should be taken up for discussion.

The move follows the recent signing of the India-Singapore Comprehensive Economic Co-operation Agreement (CECA), which threatens to reduce the importance of Mauritius as the investment gateway to India. If Mauritius agrees to the re-negotiation of the tax treaty, India may push to incorporate the "limitation on benefits" clause to regulate the usage of conduit companies for claiming treaty benefits. The recently amended India-Singapore tax treaty provides for a limited version of "limitation on benefits" clause.

Sovereign comment

Not again! This is getting tedious. We wish that Mauritius and India could make their minds up about this one, as it seems that every issue of *The Sovereign Report* contains the latest musings on the tax treaty. This helps no one because investors need certainty.

FATF and APG meet in Singapore

The Financial Action Task Force (FATF) and the Asia/Pacific Group on Money Laundering (APG) held a first joint meeting in Singapore with a view to better combating money laundering and terrorist financing in the Asia-Pacific region.

FATF and APG members agreed to further co-operation on issues related to the links between corruption and the fight against money laundering and terrorist financing, and the implementation of counter measures for alternative remittance systems.

Further to its objective of strengthening the global network against money laundering and terrorist financing, the FATF is to hold a joint typologies exercise with GAFISUD, its regional partners in South America, in Rio de Janeiro in November, and a joint meeting with ESAAMLG, its regional partner in Southern and Eastern Africa, in Cape Town in February 2006.

The FATF has published its annual review of Non-Cooperative Countries and Territories (NCCTs). It welcomed progress by the countries on the NCCT list – Myanmar, Nauru, and Nigeria – and encouraged them to continue implementing reforms so that they could be removed from the list in the near future. In the meantime, the FATF continues to call on financial institutions to scrutinise transactions with persons, businesses, or banks in listed countries, as per FATF Recommendation 21.

Sovereign comment

It is probably no coincidence that the latest meeting took place in Singapore. The OECD (the FATF is a "branch" of the OECD) has long been trying to bring Singapore and Hong Kong into the fold. As regular readers of the report will recall, Singapore and Hong Kong were left off the list of tax havens compiled by the OECD despite their having tax planning advantages which were equal to all the other jurisdictions on the list. The focus of the OECD is to implement exchange of information on tax matters but, as neither Singapore nor Hong Kong are members of the OECD, there is little that can be done without their cooperation.

Canadian Court uses treaty tiebreaker rules for residence

The Tax Court of Canada has applied treaty tiebreaker rules to determine an individual taxpayer's country of residence in two recent decisions. In *Allchin v The Queen* of 8 April and *Yoon v The Queen* of 22 July, it considered residency under the 1980 Canada-US tax treaty and the 1980 Canada-Republic of Korea treaty, respectively.

The main issue in each case was whether the taxpayer was resident in Canada during the years in question, and was therefore subject to the Canadian tax on worldwide income. In both decisions, residency was determined on the basis of the relevant treaty's third tiebreaker rule – the location of the individual's "habitual abode."

In *Allchin*, the taxpayer, a Canadian citizen and US green card holder, was reassessed for her 1993-1995 tax years on the basis that she was a resident of Canada. During the years in question, she was living and working in the US and filed US tax returns as a US resident, but maintained substantial connections with Canada. The Tax Court of Canada affirmed the assessments. But the Federal Court of Appeal held that the Tax Court judge had failed to consider that, as a green card holder, Allchin could also have been a resident of the US. An analysis under the treaty tiebreaker rules was therefore required.

The first two tiebreaker rules in the treaty – determining a taxpayer's permanent home and centre of vital interests – were deemed to be inconclusive. The Tax Court therefore moved to the third tiebreaker rule and concluded, after considering the number of days the taxpayer spent in the US and with the nature of her lifestyle and activities there, that the taxpayer's habitual abode during the years in question was in the US.

In *Yoon*, the taxpayer was born and raised in South Korea. In 1975, she moved to Canada, married, and became a Canadian citizen. In 1984 she and her two children moved back to South Korea, where she rented a home. Her husband remained in Canada, where they had bought a home and planned to retire. During the tax year in question, Yoon was employed in South Korea and had social, cultural, and religious connections there.

The Tax Court maintained that a finding that she was not resident in Canada during that period was sufficient to dispose of the appeal but, because both sides raised the possibility of dual residency, the tiebreaker rules in the Canada-Republic of Korea treaty were addressed. The OECD commentary states that habitual abode means "the State where (the individual) stays more frequently." Because Yoon spent more days in South Korea than in Canada during the year in question, her habitual abode was found to be in South Korea.

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Sovereign comment

These decisions show that determining an individual's residency status requires a highly factual analysis. Increasing international mobility can lead to complex tax situations and make it more difficult for courts to reach a conclusive determination under the first two tiebreaker rules. This may result in more cases being decided on the basis of an individual's habitual abode.

ECJ gives "most favoured nation" ruling

The European Court of Justice, ruling in *D v. Inspector of Taxes* (C-376/03), rejected the "most favoured nation" argument in a Dutch-German tax case and held that differences in tax treaties are allowed within the European Union.

The appellant, a German resident who owns immovable property in the Netherlands, appealed against the refusal of the Dutch tax authorities' to grant him a wealth tax allowance. He argued that the Netherlands' tax treaty with Belgium provided a wealth tax allowance for Belgian residents who own immovable property in the Netherlands, but the same benefit was not available to German residents under the Netherlands-Germany tax treaty. In a preliminary opinion in October 2004, Advocate General Dámaso Ruiz-Jarabo Colomer held that the tax treaty did give rise to discrimination between taxpayers residing in Belgium and those residing in Germany.

But in a judgment handed down on 5 July, the ECJ held that the appellant, as a resident of Germany, could not invoke the tax treaty between Belgium and the Netherlands because the reciprocal rights and obligations of that treaty applied only to persons resident in those two contracting states. As a consequence, taxpayers residing in Belgium were not in the same situation as taxpayers residing outside Belgium.

A rule, such as the one in the Belgium-Netherlands tax treaty granting residents of Belgium a Dutch wealth tax allowance, could not be regarded as a benefit separable from the rest of the tax treaty. It was an integral part of the treaty and contributed to its overall balance, the ECJ held. Differences in tax treaties were therefore permissible within the European Union.

Caribbean Court of Justice hears its first case

The Caribbean Court of Justice began hearing its first case, an appeal against a libel verdict by Barbadian courts, on 11 August. Based in Port-of-Spain, Trinidad, the court replaces the UK-based Privy Council, which has served as the final court of appeal court for former British Colonies since 1833.

Although the court was inaugurated in April, only Barbados, where there was political consensus, and Guyana, where there was no third-tier court, have so far formally adopted the CCJ in its criminal and civil jurisdictions. Other members of the 16-nation Caribbean Community are dealing with legal obstacles or resistance from critics who fear the court could be vulnerable to political pressure.

Sovereign comment

It is our impression that most commentators would have a greater degree of confidence in the UK Privy Council than any Court of Final Appeal in the Caribbean. Nevertheless the authority given to the UK Courts over matters concerning independent territories does seem an anachronism these days. We will continue to recommend jurisdictions where the UK courts have the final say as their experience, history and perceived sense of fairness is, we believe, a major advantage.

Hong Kong signs tax treaty with Thailand

The Hong Kong SAR and Thailand signed a tax treaty on 7 September 2005. The treaty, a full scope Double Taxation Agreement (DTA) based on the OECD model, will enter into force after it has been ratified by both governments, and will apply in Thailand from 1 January and in Hong Kong from 1 April, in the next calendar year.

Under the agreement, the Thai Government will not tax profits remitted by a branch office in Thailand to a head office in Hong Kong. Such remittances are currently subject to a 10% withholding tax in Thailand. Thai withholding tax for royalties that are received from Thailand by a Hong Kong resident and that are not attributable to a permanent establishment will be reduced to 5% if paid for the use of, or the right to use, any copyright of literary, artistic or scientific work; and 10% if paid for the use of, or the right to use, any patent, trademark, design or model, plan, secret formula or process. The current rate is 15% on the gross amount of royalties.

In the case of interest received by a Hong Kong resident, when the interest arises in Thailand and is not attributable to a permanent establishment, the current Thai withholding tax is 15% of the gross amount. Under the treaty, the Thai withholding tax rate will be reduced to 10% if interest is paid to a financial institution or insurance company, or if interest is paid with respect to indebtedness arising from the sale on credit of equipment, merchandise or services.

The treaty also provides capital gain exemption in relation to gains derived by a Hong Kong resident from the alienation of shares in a Thailand company which does not derive more than 50% of its asset value directly or indirectly from immovable property situated in Thailand. At present, a gain derived by a foreign investor on the sale of shares in a Thailand company is generally subject to a rate of 15% if the gain is paid "in or from" Thailand.

As with the Hong Kong-Belgium treaty, the exchange of information article follows the more restrictive 1995 OECD model and contains a limitation that information received by the competent authorities of Thailand can only be released to a third party with the consent of the competent authorities of Hong Kong. It goes further than the Belgium treaty in that the exchange of information does not extend to non-residents of Hong Kong.

Sovereign comment

Hong Kong is keen to establish a network of tax treaties with its major trading and investment partners. It signed its first treaty in December 2003 with Belgium. Treaty talks have also been held with Macau, Vietnam and some OECD members.

It is quite unusual to find new treaties being signed when the recipient of the income would not generally impose tax and this will further enhance Hong Kong's status as the pre-eminent service centre for the Far East.

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OECD issues new Model Tax Treaty

The OECD published a new model income tax treaty and commentary on 7 September. The new model incorporates changes to the model that were released in draft form in March 2004 and approved by the OECD Council on 15 July this year.

The principal changes include a revised article 26 on exchange of information, by which "foreseeably relevant" replaces "necessary" as the determining criterion for exchanging tax information in Paragraph 1. The OECD commentary states that the change in wording is designed to "achieve consistency" with the OECD Model Agreement on Exchange of Information on Tax Matters. It further warns against "fishing expeditions" by tax authorities.

A new paragraph 4 of article 26 provides that a treaty partner must use its information gathering measures to obtain requested information even if the treaty partner may not need the information for its own tax purposes. The new paragraph 5 provides that a treaty partner may not decline to provide tax information on the grounds that a financial institution or fiduciary holds it, or because the information relates to ownership interests.

Sovereign comment

Most counties have adopted the OECD model treaty as their standard model when negotiating new treaties. This new model enhances the exchange of information clauses. The lack of the requirement that the information be needed for the use of the treaty partner is interesting.

Singapore signs tax treaty protocol with India

India and Singapore signed a protocol on 29 June to amend the 1994 India-Singapore income tax treaty. The amendments came into effect on 1 August 2005.

As with the current India-Mauritius income tax treaty, capital gains on the sale of shares in India by a Singapore tax resident are exempt from tax in India under the protocol. This exemption will continue to apply for as long as the exemption in the India-Mauritius tax treaty continues in force. In addition, interest on a loan made by a Singapore bank is taxable at 10% under the protocol whereas, if a loan is given by a Mauritius bank, the interest is exempt from Indian tax.

But unlike the Mauritius treaty, the protocol categorically prevents abuse of beneficial tax treaty provisions by laying down that a tax resident of either of two countries will not be entitled to the benefit if its affairs are arranged primarily to take advantage of them.

It also defines a shell or conduit company as one whose annual expenditure in the contracting state is less than S$200,000 or INR 50,000 in the 24 months previous to the date of alienation of shares in the company.

This limitation on benefits clause does, however, only deny relief in respect of capital gains tax, whereas the Indo-US treaty denies such benefit in respect of any income.

Sovereign comment

Singapore might be a viable alternative to Mauritius for investing in India but only for larger companies who are prepared to put the necessary infrastructure in place in Singapore to qualify under the treaty. Cyprus seems to have been overlooked – perhaps because it has been little used. Cyprus has an excellent treaty with India and there do not appear to be any current threats to that treaty.

Changing your domicile

Domicile involves complex issues of law. An individual can be resident in more than one country at the same time, but can only have one domicile. A person is generally domiciled where his or her permanent home is situated. A "domicile of origin" is acquired at birth, normally from one's father. The domicile of a minor normally follows that of the person on whom he or she is legally dependant – a '"domicile of dependency". However, a "domicile of choice" can be acquired from age 16. This broadly involves leaving an existing country of domicile to settle in another country, and requires strong proof of having moved to the other country permanently or indefinitely. Living in another country is not conclusive evidence of an intention to change domicile.

An individual who is domiciled in the UK is liable to Inheritance Tax (IHT) at a rate of 40% on their worldwide estate. A non-UK domiciled individual is also liable to IHT, but only on chargeable property in the UK. Four recent decisions in the UK courts shed some light on this difficult area of law.

In ***Mark v Mark***, a wife asserted that she was domiciled in the UK rather than her home country of Nigeria, and on that basis had the right to have her divorce hearing heard in the UK. The husband contended that she could not allege that she had acquired a UK domicile because she was in the UK illegally.

The High Court disagreed in 2002 and held that it was the wife's intentions that were of paramount importance. It did not matter that it was not legal for her to remain in the UK. What mattered was whether it was her intention to remain indefinitely as required in order to pick up an UK domicile of choice. The Court of Appeal in 2005 agreed, stating: "that intention and residence are matters of fact is, however, just as true when the residency is unlawful...".

Upon a further appeal the House of Lords upheld this decision, saying: "The object of the rules determining domicile was to discover the system of law with which the individual was mostly closely connected for the purposes of determining a range of matters principally related to status or property."

In ***Cyganik v Agulian & Others***, the High Court ruled that the deceased had acquired a domicile of choice in England at the time of his death. The case involved a deceased Cypriot national "N" who had obtained and retained British nationality because he was born in Cyprus in 1939 when it was still a British colony. His mistress claimed maintenance under section 2 of the Inheritance (Provision for Family & Dependants) Act 1975. The case could only be heard in the UK if the deceased had been domiciled in the UK at the time of death so this issue was heard as a preliminary matter.

N was born in Cyprus in 1939, came to England in 1958 but returned to Cyprus in 1972. He returned to the UK shortly after the Turkish invasion in 1974 and had remained in the UK for the rest of his life, although he had made frequent visits back to Cyprus, retained a number of Cypriot properties and also habitually transferred cash over to Cyprus, apparently for his retirement. He died in London in 2003.

It was adjudged that he had obtained a domicile of choice in the UK despite these connections. His mistress was therefore barred from her claim.

> "Any long-term British expatriate who intends staying out of the UK should consider establishing their domicile with certainty."

In ***Morgan v Cilento***, the High Court determined that the playwright Anthony Shaffer had retained an Australian domicile of choice and therefore his mistress was prevented from claiming under the Inheritance (Provision for Family & Dependents) Act 1975, which can only be applied where the deceased is UK domiciled.

Shaffer was born in the UK to British parents and therefore obtained a UK domicile of origin. In 1968, he formed a relationship with the Australian actress Diane Cilento and moved to Australia in 1975. He qualified for permanent residency in Australia, voted in Australian elections, married Cilento in Australia, had his bank account and credit card in Australia and submitted to the Australian tax office that he was a permanent resident and was staying there indefinitely.

In 1998 Shaffer met Jo Capece and the following year began a relationship with her. In 2001 he installed Capece in an apartment in London for which he paid, and left Australia saying that he found it "a cultural wilderness". He died shortly afterwards in the UK.

Lewison J stated: "I must attempt to assess his state of mind up to the day he died... it may be that his intention to return to Queensland was withering. But I do not consider that it died before Anthony did." The court could not therefore hear the substantive action.

22 profile

In ***Allen & Hately v HMRC***, Winifred Johnson, the deceased, was born in England in 1922 and married in 1951. In 1953 the couple moved abroad to live in the West Indies, Venezuela, Indonesia and Nigeria over the next 30 years. They never owned or rented any property in the UK. Mr Johnson retired in 1982 and they settled in Spain. They bought a house and obtained residency permits; this was the only house they ever owned.

Mr Johnson died at the end of 1996. Mrs Johnson, who had been diagnosed with Parkinson's disease in 1975, came to stay with her half sister in England. In 2001, she purchased the adjourning house with the intention of living there supported by care agencies. She died in hospital in England in 2002. The Revenue issued a determination that Mrs Johnson had abandoned her domicile of choice in Spain, so that her domicile of origin in England revived and she retained her English domicile until her death. Her executors appealed.

The Special Commissioner disagreed. Mrs Johnson had retained her house in Spain, paid for its maintenance and for someone to care for her pets. No one was allowed to use the house in her absence. The purchase by Mrs Johnson of the UK property did not demonstrate that she had ceased to intend to reside permanently in Spain but was a means of ensuring for her continued care without moving to a residential care home.

Sovereign comment

All these cases demonstrate the potential dangers to which you expose yourself and your estate by failing to establish your domicile in advance of it coming under the scrutiny of the Revenue or the courts. The very high costs entailed in these court actions could have been avoided. Any long-term British expatriate who intends staying out of the UK should consider establishing their domicile with certainty. Sovereign has considerable expertise in this area and a 100% success record in establishing non-domicile status.

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