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report

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Banks report offshore savings to UK Inland Revenue

Her Majesty's Revenue & Customs (HMRC) recently won a landmark legal case against Barclays Bank forcing it to disclose details of British residents' accounts overseas. The ruling is likely to be extended to cover overseas branches of all UK banks. The Revenue said it knew of 9,300 Barclays' customers with addresses in the UK and accounts outside the UK, but less than a fifth of these had filed UK tax returns. It should come as no surprise that engaging in simplistic tax evasion can lead to problems. We have long been advising that any offshore arrangements that rely purely on secrecy are bad arrangements. The same tax savings can be achieved quite legitimately, but require proper and careful planning.

Portugal – further bad news for property owners

The Portuguese government has recently re-emphasised the need for compliance with a 1997 law that imposes an obligation on any properties let for tourism to hold a "health and safety" licence from the local authority. If you own such a property in Portugal, whether in your own name or via a company, you are required to have one or heavy fines will be levied. Indeed some already have! Full details are available from our Portuguese office, and we would urge any property owners to seek immediate advice before local authorities are overwhelmed.

Tax Freedom Day

The Adam Smith Institute has calculated that Saturday, 3 June, is the UK'S tax freedom day – the point in the year when taxpayers stop "working" for the government and start earning for themselves. It is estimated that approximately one third of the total work force in Britain are now full time government employees. It now appears that the remaining two-thirds are also working for the government for nearly half their time – but without having applied for the job!

Cayman Islands Office

We are well advanced with plans to open an office in the Cayman Islands. This is to meet the increasing demand from our clients for Cayman hedge funds and other specialist corporate products. We will bring you further news in the next issue.

chairman

Bahrain Office

We are very pleased to announce the establishment of Sovereign Bahrain, which is a joint venture with Ohad Trust. The new Bahrain office will offer the usual range of Sovereign corporate services, but will also specialise in advising on the setting up of mutual and hedge funds, Islamic investment funds, as well as Shariah compliant trust and trustee services.

The office is under the capable stewardship of Hadi Daou. Contact details are posted on the back of this newsletter.

Sovereign Asian Art Prize

By the time you read this, the third Sovereign Asian Art Prize will have been concluded. This year we received generous sponsorship by Bel-Air Properties, which hosted the annual dinner and charity auction on 15 June at the Bel-Air clubhouse in Pokfulam. This year's US$25,000 prize was awarded to Thai artist Uttaporn Nimmalaikaew for his painting "Body (Mom) No. 8". This can be viewed on the Foundation's website at www.SovereignArtFoundation.com.

Our thanks to everyone who contributed to make this year's prize such a great success – especially those who came along and bid for paintings at the auction dinner.

SovereignGroup.com

We have just upgraded and relaunched the Sovereign Group website. The changes have been designed to make the site faster and easier to use, and to create an even better resource for our clients. We would urge all our clients to visit the new site and add it to their bookmarks. We would also appreciate any comments on the new structure and content, or suggestions for the future.

Howard Bilton BA(Hons)
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Professor of Law, St. Thomas School of Law, Miami, USA
Chairman of The Sovereign Group

Malta and EU reach agreement on amending tax regime

The European Commission announced, on 12 May, that the government of Malta had agreed to amend its preferential tax treatment of international trading companies (ITC) and companies with foreign income (CFI) by the end of 2010.

Under these regimes, which were introduced in 1994, revenues from foreign sources paid to shareholders of an ITC or a CFI are subject to minimal or no taxation. In March, the Commission deemed them to be in violation of EU state aid rules and made a formal request for their abolition.

Competition Commissioner Neelie Kroes said: "I welcome the abolition of Malta's preferential regimes as a further important step towards eliminating selective tax incentives that significantly distort the location of business activities in the Single Market."

Under the agreement, existing ITC and CFI schemes will be effectively abolished by 1 January 2007 and replaced by a new refundable tax credit system that does not discriminate in favour of foreign-owned companies.

The ITC regime will not be available to Maltese-registered companies after 31 December 2006, but existing ITCs may continue to operate under the current regime until 31 December 2010. The number of new ITCs that can be incorporated before the 31 December 2006 shut-off is to be limited to the average number of ITC companies that have been registered annually over the last five years.

Malta had initially proposed to convert, by 2012, both schemes into a tax refund system by extending the "refundable tax credit system for all companies distributing their revenues as dividends to their shareholders, both resident and non-resident, regardless of their legal form or status, the business activity exercised, their size, sector, and the source and type of the income derived by the companies."

In Malta's view, such a system, although still advantageous for foreign investors, would cease to be selective and thus would constitute a general tax measure. But the Commission requested Malta to accelerate introduction.

Sovereign comment

Those offshore financial centres that operate a dual system of taxation – different tax rates for companies owned by non-residents and residents – have come under increasing pressure from the OECD and the EU to reform. The Isle of Man has moved to a unitary tax system that is, happily, zero percent. Jersey and Guernsey are heading the same way. Gibraltar has had to rid itself of the exempt and qualifying company regimes but awaits confirmation that its new proposals will be acceptable to the EU. Cyprus revised its tax system not long ago and Malta is one of the last in Europe to make these changes. We can expect the introduction of a system at least as attractive as the present one, but which will apply to all companies.

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UK Budget targets trusts

UK Chancellor Gordon Brown, tabling his tenth Budget on 22 March, announced a major change to the inheritance tax (IHT) treatment of trusts. This will apply not only to any new trust created on or after Budget Day, but also existing trusts.

The proposed new rules will apply to all new and existing Accumulation and Maintenance (A&M) or Interest in Possession (IIP) trusts. These were previously treated as a Potentially Exempt Transfer, attracting no IHT if the settlor survived by seven years, but will now be subject to the same IHT rules as presently apply to discretionary trusts.

As from 22 March 2006, all transfers into a settlement over the "nil rate band" (£285,000 from 6 April 2006) will be taxed at 20% as an IHT lifetime charge. The settlement is also subject to an IHT charge every ten years – currently 6% of the value of the settlement fund over the "nil rate band", and "exit" charges when property is paid out of the settlement – currently at a maximum of 6%. Under transitional rules, there will be a period to 6 April 2008 in which changes can be made to existing settlements.

Sovereign comment

These new provisions are thought to affect over a million existing UK taxpayers who have made wills which will cause trusts to be formed on their death. Those wills will now have to be revised. It seems it is always more politically expedient to hammer wealthy individuals with a change in the rules than raise the overall rates of tax.

Gibraltar to apply EU Savings Tax Directive

The UK and Gibraltar signed an agreement last December for Gibraltar to apply the EU Savings Tax Directive. A draft Tax Information Exchange Agreement was published by UK Revenue & Customs in April.

Under the agreement, the UK will automatically provide information on the UK savings income of Gibraltar tax residents to the government of Gibraltar. Gibraltar will apply withholding tax to the Gibraltar savings income of UK tax residents during the transitional period provided for under the Directive. When this period ends, Gibraltar will automatically exchange information with the UK.

Although Gibraltar had fully implemented enabling legislation for the Savings Tax Directive when it came into force on 1 July 2005, it was found that it could not be applied in Gibraltar because Gibraltar and the UK are not considered separate member states under the Directive.

The UK Revenue said that, as with its existing savings agreements with its Crown dependencies and Caribbean overseas territories, the agreement with Gibraltar would be implemented in the UK in the form of a tax information exchange agreement.

A second agreement reached with the UK will enable investment services firms established in Gibraltar to passport, that is to market and sell, their products and services into the UK market. The investment services passporting agreement is to come into effect as soon as Gibraltar passes the necessary legislation. Chief Minister Peter Caruana said the agreement was very positive news for the Gibraltar finance centre.

Sovereign comment

The EU Savings Directive applied only to accounts held by an EU resident in another EU state. It was thought that British residents holding accounts in Gibraltar would be unaffected because Gibraltar is constitutionally part of the UK and not therefore cross border. The UK came under pressure to alter this apparent anomaly and has now moved to do so. Any UK resident who holds accounts in Gibraltar should contact their nearest Sovereign office for advice.

Uruguay proposes to end SAFI regime

The Uruguay government issued proposals for a comprehensive tax reform on 7 November 2005 under which Financial Investment Corporations (SAFIS) would be brought under a new general tax regime and then phased out by 2010.

The proposals, drawn up by a task force of the Ministry of Finance, are intended to promote equality in tax structures, improve efficiency and stimulate investment and employment. It aims to simplify the tax structure, make it more consistent and gradually reintroduce personal income tax. It will also repeal some taxes that currently produce little or no revenue.

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Under the proposals, a new dual-rate personal income tax system would be introduced, with progressive rates of tax from 10% to 25% on earned income, and a 10% flat rate on capital income. The existing corporate and agricultural tax regimes would be replaced by a single "economic activities" tax under which:

- the tax rate on business entities would be reduced from 30% to 25%;
- income of non-resident entities would be taxed at a rate of 10%;
- the carryforward of losses would be extended from three to five years; and
- the concept of permanent establishment and transfer pricing rules would be adopted.

SAFI's, which are offshore entities currently subject to a sole tax of 0.3% on their fiscal equity, would be included in the general tax regime. Existing SAFI's would need to apply the general tax regime before 31 December 2010. New SAFI's would not be permitted as from the effective date of the tax reform law.

According to the task force report, SAFIs are outdated vehicles that do not meet the requirements of comparable laws in other countries or the recommendations of multilateral organisations such as the OECD. The proposed reform is due to be submitted to the Uruguay Parliament during 2006, with the changes entering into effect in 2007.

Sovereign comment

Uruguay has long been considered the Switzerland of South America. Setting up an "offshore company" in Uruguay was a favoured move for residents of South America due to its geographical proximity, Spanish language and the comparative stability of the Uruguayan political regime.

Many in South America use Panama for similar reasons and this change in legislation will probably mean a bonanza for Panamanian lawyers as clients will simply switch from the Uruguayan version to the Panamanian one.

Bush renews US Patriot Act

President Bush signed into law a renewal of the USA Patriot Act on 9 March, one day before 16 provisions were due to expire. Bush's signature came two days after the House gave final approval to the legislation following objections that it infringes privacy. Political battles over the legislation forced Congress to extend the expiration date twice.

The legislation renews the expiring provisions of the original Patriot Act, including that foreign intelligence or counter intelligence officers should share information obtained as part of a criminal investigation with counterparts in domestic law enforcement agencies.

The Patriot Act enables the US Treasury to track and identify funds through sharing of information with the financial sector both vertically – between the government and the industry – and horizontally – by providing a safe harbour that allows industry members to share information with each other.

The Patriot Act also assists the Treasury to prevent money laundering and terrorist financing through greater transparency of correspondent accounts maintained by US banks on behalf of foreign banks. The Act expressly prohibits shell banks from participating in the US financial system and insists upon strict record keeping regarding the ownership of each non-US bank that maintains a correspondent account with a US institution.

It also authorises the Treasury to designate foreign jurisdictions or institutions as a "primary money laundering concerns" and take a range of regulatory actions, including requiring US financial institutions to terminate correspondent relationships with the designated entity or jurisdiction, against them.

Sovereign comment

The Patriot Act offers just as many opportunities to clamp down on tax evasion as it does on terrorist activities. So it's no great surprise that the Act was renewed. It would be much more surprising if it was ever allowed to lapse. The general public can no longer assume that they have a right to confidentiality and privacy.

BVI leads in IBC registrations

Over 57,000 new International Business Companies (IBCs) were registered in the British Virgin Islands in 2005, more than any other offshore jurisdiction, according to figures released by the BVI International Finance Centre.

It is the third highest annual number of new incorporations in the BVI in 20 years, and took the total number of BVI IBCs to almost 700,000 since their introduction in 1984.

The BVI also witnessed significant growth in the registration of BVI Business Companies since the enactment of the BVI Business Companies Act (BVI BCA) in January 2005. The BVI BCA provides for the incorporation of both internationally operating companies and companies doing business in the BVI under one statute. Over 1,100 companies were registered under the new Act in 2005.

The BVI BCA has been introduced over a two-year transitional period and, as of January 2006, all new companies incorporated in the BVI will be registered under the new statute.

Sovereign comment

Shortly after the enactment of the BVI International Business Companies Ordinance in 1996, the BVI became the most popular offshore jurisdiction in which to incorporate. Previously the most popular jurisdiction had been Panama, but political instability during General Noriega's regime effectively put an end to that. Many other jurisdictions offer a similar, and sometimes superior, product, but nowhere has marketed itself as well as the BVI.

Hong Kong exempts Offshore Funds from Profits Tax

New legislation to exempt offshore funds from profits tax was published in the official gazette on 10 March. Originally announced in the 2003-2004 budget, the proposed exemption would apply with retrospective effect to the year of assessment 1996/97.

Noting that other major international financial centres, such as New York and, London, all exempted offshore funds from tax, Frederick Ma, Secretary for Financial Services and the Treasury, said the proposed exemption was vital for Hong Kong to reinforce its status as an international financial centre and enhance its competitiveness.

Under the Revenue (Profits Tax Exemption for Offshore Funds) Law, an offshore fund entity (which covers individuals, partnerships, corporations and trustees of trust estates) will enjoy tax exemption by satisfying two conditions - non-residence and not carrying on any business in Hong Kong other than the “qualifying transactions”.

The common law rule of "central management and control" will be used to determine residence, while “qualifying transactions” include securities, futures, foreign exchange, deposit-making and commodities.

The Law also contains provisions to prevent residents taking advantage of the proposed exemption by transferring funds to non-resident companies. These will apply from the year of assessment 2006/07, will not impose any new tax and will not be invoked in respect of offshore profits, capital gains or dividend income, which remain tax-exempt in Hong Kong.

The Hong Kong Inland Revenue Department (IRD) has also issued a revised Practice Note on the general tax anti-avoidance provisions.

The general anti-avoidance provision (section 61) empowers an assessor to disregard transactions that are deemed to be artificial or fictitious when making an assessment. A transaction will be considered from the inception of an idea to final completion, and even if a part of the transaction is real, the transaction as a whole may still be held to be artificial.

The second general anti-avoidance provision, section 61A, applies to any transaction that is entered into for the sole or dominant purpose of obtaining a tax benefit. Based on the Australian general anti-avoidance provision, it enables the Revenue to ignore any such transaction, or any part of it, in making an assessment to tax.

Sovereign comment

The new act clarifies what was already thought to be the case. Hong Kong has been losing out to Singapore in the race to attract fund managers because Singapore’s tax legislation has afforded greater certainty. The Act does not exempt all offshore funds that are managed from or in Hong Kong. Certain conditions have to be met and certain precautions taken. Our Hong Kong office has conducted an in depth analysis of the new legislation and would be happy to advise any existing or potential fund managers.

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UAE tax treaties with Spain and Malta

The United Arab Emirates signed income tax treaties in Abu Dhabi with Spain and Malta on 5 March and 13 March respectively. The UAE is the first Gulf Cooperation Council (GCC) country to sign an income tax treaty with Spain. The treaties provide for the avoidance of double taxation on income and capital in both countries.

Sovereign comment

The UAE does not levy either corporate or personal taxation, so it is surprising that many countries have chosen to enter into treaties with them whose stated aim is the avoidance of double taxation. Generally, countries enter into such treaties to encourage investment so it is no surprise that Spain and Malta wish to ensure that there are no barriers to the wealth of the UAE being invested in their country. Happily these treaties will also create considerable tax planning opportunities. Our Dubai office would be happy to advise.

First Dubai hedge fund

The Dubai Financial Services Authority (DFSA) has granted the first licence to a hedge fund to operate from within the Dubai International Financial Centre (DIFC). Dubai is making a concerted effort to become a major financial centre. It already has attractive tax legislation, comparatively cheap labour and a good geographical location. We are convinced it will grow rapidly into a major centre for fund administration.

Singapore Budget contains new incentives

The Budget statement contained several significant tax proposals and incentives, and a commitment that Singapore's existing network of 50 tax treaties is to be expanded and updated. Following the conclusion of a tax treaty protocol and comprehensive economic cooperation agreement with India last year, Singapore is now holding tax treaty negotiations with several countries, including China.

Gains derived by an approved holding company from the disposal of shares of subsidiaries are to be exempt from tax, from 17 February 2006, provided that the holding company owned at least 50% of the shares of the subsidiaries for a minimum of 18 months. Tax incentives are also to be extended to partnerships on a scheme-by-scheme basis.

Other measures designed to develop Singapore as a full-service global financial centre include the extension of allowances for the acquisition of intellectual property to economic, and not just legal owners, of intellectual property on an approval basis, and a new tax incentive scheme that will exempt from tax resident funds with foreign investors. The tax treatment of Shariah-compliant financial products is to be harmonised with conventional products to ensure a level playing field for tax, and an income tax exemption will be granted to approved captive insurance companies for a period of 10 years.

Prime Minister and Minister for Finance Lee Hsien Loong said the government was examining the abolition of estate duty and should reach a conclusion by the next budget.

Sovereign comment

Singapore is continuing its strenuous efforts to turn itself the service centre of choice for the Far East. Hong Kong undoubtedly fulfils that role at present, but Singapore will soon be running a close second and would like to overtake as soon as possible.

UK Appeal Court upholds decision on corporate residence

The UK Court of Appeal, on 26 January 2006, upheld a decision of the High Court that a Dutch company used as part of a tax planning structure was not resident in the UK for tax purposes. The High Court had reversed an earlier decision of the Special Commissioners that the Dutch company was resident in the UK.

In *Wood & another v Holden (Inspector of Taxes)*, a complex scheme devised to avoid tax on substantial gains accruing to a husband and wife on the sale of their trading companies achieved its purpose. The transactions ensured that the disposal was made between members of a non-resident group of companies so that the gain was not to be attributed to the husband and wife under s13 of the Taxation of Chargeable Gains Act 1992.

The sole issue for decision was whether the Commissioners were entitled to conclude that under the common law of corporate residence the taxpayers had failed to establish that the Dutch subsidiary was not resident in the UK for tax purposes.

The Commissioners had found that the only acts of management and control by the Dutch subsidiary were board resolutions and the execution of documents effected without any decision making. They concluded that the actual effective decision making was taken in the UK, that being where central control and management actually abides.

The Court of Appeal disagreed. It said that the High Court had been correct to hold that the only conclusion open to them was that Dutch subsidiary was resident in the Netherlands. The directors of Dutch subsidiary were not by-passed. There was no evidence that the tax-payer's UK-based accountant had dictated their decisions. A management decision did not cease to be such because it might have been taken on fuller information. Ill-informed decisions by directors remained management decisions. On the basis of the "central management and control test" the Commissioners' decision could not stand and the Revenue's appeal failed.

Sovereign comment

We have reported previously on this case. The decision is helpful in clarifying where the location of central management and control is for corporate residence purposes. The Inland Revenue lost the case in the end but certain principles are worth repeating here:

- Directors must be knowledgeable and sufficiently well informed to take a decision.
- Directors must have spent sufficient time on the affairs of the company to manage its affairs properly. This will normally mean that they must also receive sufficient fees for having spent that time
- The referral by the directors of certain matters to professional advisors is also an important factor in being able to demonstrate independent mind and management.

Dutch Court rules on company residence

The Tax Court of Amsterdam ruled in February that a Dutch BV (private limited liability company) that transferred its effective management to Greece, was subject to tax in Greece and could not therefore, under tax treaty arrangements, be assessed tax in the Netherlands on the same income.

A Dutch resident individual had incorporated the BV in 1990 and, from the end of 1995, its assets consisted solely of Luxembourg portfolio investment accounts and a current account with a Dutch bank. In 1995 the sole shareholder and his spouse moved permanently to Greece and, in 1996, the company notified the Dutch tax inspector that it had become a resident of Greece.

In 2000 the BV informed the Dutch tax inspector that it still had not been able to obtain formal registration in Greece and still had not received any corporate income tax assessments there. The tax inspector confirmed that the company was a resident of Greece, but, in 2002 and 2003, imposed tax assessments for 1996 and 1999.

The tax inspector argued that, under the treaty, it was not sufficient for the effective management of the company to be situated in Greece, the company had actually to be subject to tax in Greece to be considered a resident. It had filed Greek tax returns, but it had not yet received any Greek tax assessments.

The Court disagreed and cancelled the tax assessments. It held that the tax treaty did not require that a resident must actually be subject to tax in the relevant state to be considered a resident of that state. It found that such a requirement could not be derived from the OECD commentary to the 1977 model tax treaty, on which the Greece-Netherlands tax treaty was based.

Sovereign comment

This is a welcome victory for the taxpayer although he may find that paying tax in Greece is at least as painful as paying tax in the Netherlands. As the Court stated, it is not necessary to show that you are paying tax in a particular place in order to be tax resident there. This has been previously demonstrated in relation to tax cases brought by treaty partners of the UAE. It does however certainly help to rebut a suggestion that you should be taxable somewhere if you can show you are paying tax somewhere else.

Person held to be UK resident

The Special Commissioner ruled that visiting the UK for less than 91 days a year is not the only determinant of whether a person is UK resident for tax purposes.

In *Shepherd v HMRC*, Mr Shepherd was an airline pilot who was born and domiciled in the UK. In 1987 he and his wife purchased a UK property in their joint names. They later separated but did not divorce and continued to live in the UK property.

Shepherd knew that he would have to retire in 2000 and, in 1998, applied to the Cyprus authorities for permanent residency and an immigration permit. From October 1998 onwards, he rented flats in Cyprus before purchasing an apartment in 2002.

In May 2003, the Revenue issued a notice of determination that Shepherd was resident and ordinarily resident in the UK for the tax year 1999/2000. Shepherd appealed. During 1999/2000 Shepherd spent 80 days in the UK, 77 days in Cyprus, 180 days flying and 28 days holidaying elsewhere. While in the UK he stayed at the house he shared with his wife.

Dismissing his appeal, the Commissioner held that Shepherd's absences from the UK were temporary. His presence in the UK after October 1998 was substantial and continuous and there was no distinct break.

Sovereign comment

It is not sufficient to appear to have left the UK, you must also break your connection. with the UK and establish a substantial connection somewhere else. The Inland Revenue can always make a case if a person's visit to the UK are habitual and substantial and they cannot point to a residency elsewhere.

Isle of Man issues guidance on new corporate tax regime

The Isle of Man's new "zero percent" corporate tax regime was brought into effect on 6 April, with further changes scheduled to take effect a year later.

The standard rate of zero percent is to apply to all forms of income received by all companies with the two exceptions: licensed Manx banks will pay a 10% tax on their business income, and income received by companies that is derived from land and property in the Isle of Man will also be taxed at a rate of 10%. Resident companies will pay an annual corporate charge of £250.

The taxation of non-resident companies follows that of resident companies, as of 6 April 2006. Companies registered as being incorporated outside the Isle of Man, but having a place of business there, will be taxed on their Manx-source income at the standard rate or at 10% depending on the type of income that they receive. Companies incorporated outside the Isle of Man but having their management and control there will be considered normally tax resident, and so their worldwide income will be taxed at the standard rate or at 10% depending on its nature. Both such companies will also pay the corporate charge.

The Income Tax (Corporate Taxpayers) Act 2006 also repeals the special regimes for exempt companies, exempt insurance companies, exempt managed banks, international business companies, and non-resident company duty. Following the repeals, which are due to take effect from 6 April 2007, companies in each of the special regimes will be deemed resident companies subject to the rules as above. And as of 6 April 2006, applications for any of former special regimes will not be accepted.

The 2006 Bill will also introduce, from 6 April 2007, a current year accounting period basis of assessment for companies to replace the existing preceding year basis.

Treasury Minister Allan Bell said: "First and foremost the Isle of Man Government wishes to provide businesses with a fiscal environment that provides stability and that enables them to grow. At the same time we will fulfil our international commitments; further enhancing our reputation for competitiveness coupled with responsibility."

Sovereign comment

This is welcome clarification. The new Isle of Man tax system of zero percent for most companies and only 10% for financial institutions was extremely attractive on paper but certain clarifications were required. These have now arrived and the Isle of Man is now experiencing unprecedented growth in its financial services sector.

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Russia finalises draft tax amnesty Bill

The Russian Finance Ministry submitted for government approval in March a final draft of revised legislation to introduce a tax amnesty. The proposed amnesty will become effective on the date of its official publication and will expire after the deadline for the filing of 2006 tax returns in April or May 2007.

The measure, which requires approval by both chambers of parliament and the signature of President Putin, was revised in December 2005 to extend the list of assets that individuals would be permitted to declare.

Under the revised proposal, individuals would no longer be required to transfer the declared funds to, or deposit the funds in, Russian banks and would only have to file simplified tax returns and pay the standard 13% rate of individual income tax on those funds.

Sovereign comment

Tax evasion in Russia has long been a national sport. It is doubtful whether this tax amnesty will have much effect because many Russians have removed their money from Russia not simply for tax reasons, but also because of fears of government confiscation and political instability. The prison sentence handed to Mikhail Khodorkovsky is unlikely to calm those fears. We believe that most Russians will continue place money offshore rather than take advantage of this amnesty.

Spain sets out tax and anti-avoidance proposals

A draft law published in January sets out a number of proposed reforms to the corporate income tax, the tax on non-residents and personal income tax, completing the tax reform initiative launched by the recent draft Law for the Prevention of Tax Fraud. The tax authorities have invited comment and, if approved by parliament before the end of this year, it is anticipated that the law will come into force on 1 January 2007.

The most significant reform proposals include a staged reduction in the corporate income tax rate from 35% to 30% over a five-year period to 2011. At the same time, "deductions" granted to encourage certain activities would be reduced by 20% each year until phased out.

At a personal level, most income from movable capital and capital gains derived from the transfer of assets, regardless of how long the property has been held, would be taxed at a fixed rate of 18%. Changes would also be made to the calculation of tax payable, rates and deductions for a private residence; and the transitional regime for capital gains derived from assets acquired before 31 December 1994 would be amended.

The Spanish government has also announced a number of proposed anti-avoidance measures. An entity domiciled in a tax haven, or that is resident in a zero tax jurisdiction, would be deemed resident in Spain for corporate tax purposes, if its main assets are in Spanish territory or its main activity is developed in Spain, unless it can prove that its effective management is performed abroad and that its incorporation and operations have a sound economic basis. If deemed tax resident in Spain, an entity would be taxed on its worldwide income.

Capital gains on transfers of shares or participations in entities whose main asset is Spanish real estate are subject to non-resident income tax in Spain. For entities that are resident in jurisdictions where there is no effective exchange of information, the capital gain would be calculated based on the fair market value of the Spanish real estate.

Sovereign comment

Any person or corporation doing business in Spain would be wise to review their tax affairs and seek advice as soon as possible. Our Gibraltar office can assist.

The Charitable Foundation

Charitable foundations can be effective vehicles for succession and tax planning. They provide a flexible and secure means to support charitable aims, while also offering income, capital gains and estate tax mitigation. Many countries provide incentives to the non-profit sector but the US model has been significantly more effective than others – US charitable assets now total over US$1.1 trillion, equivalent in size to the world's eighth largest economy.

Section 509 of the IRS code creates two main classifications: Private Foundations and Public Charities. Private Foundations depend on a single family of contributors for funding and do not enjoy financial support from the public. They are required to distribute 5% of their capital per annum to charitable causes, are exempt from Federal income tax and are eligible to receive deductible charitable contributions. But past abuses have caused the IRS to interpret the charitable status of Private Foundations more strictly, and they are now subject to onerous operating requirements.

Public Charities meanwhile must enjoy support from a broad range of the public, organise fund raising activities, support a broad range of charitable purposes and make regular donations out of funds received. The level of activity necessary to be classed as a Public Charity would generally be prohibitive for most individuals.

There is, however, a third, "hybrid" type of entity that combines charitable giving with the optimum tax mitigation. A Private Foundation is permitted to support a public charity and, in so doing, be classed as a Public Charity. Known as a Supporting Charity [Section 501(c)(3) of the IRS code], this arrangement delivers a variety of tax advantages, as well as providing the founder and his family with long–term influence over the management of the charitable assets.

Structured correctly and managed properly, a Supporting Charity provides the following advantages:

- Contributions can generally be made without incurring transfer/excise taxes;
- For US persons, contributions can be tax deductible;
- The founder can maintain control over the management and disposition of the underlying assets;
- Long-term recognition to the founder's name. A "one-off" gift may deliver short-term recognition, but a Charity endures for generations;
- Opportunities for estate, capital and income tax mitigation;
- Employment opportunities for children and grandchildren;
- Liquidation of appreciated assets, often without tax consequence;
- Asset protection;
- Security and confidentiality as a non-reportable structure.

OVERVIEW OF STRUCTURE

The Charity is a company limited by guarantee (as opposed to limited by shares). To be classified as a Supporting Charity, it is necessary for the company to reach agreement with an existing Public Charity, generally by means of a contract setting out the level of support that it will provide. This may not be straightforward. Public Charities may stipulate a minimum level of support and impose further requirements.

To eliminate any such obstacles, Sovereign clients can make arrangements with The Sovereign Art Foundation ("SAF"). This is a charity set up by Sovereign's chairman and registered in Hong Kong. It engages in a broad range of publicly-supported activities, including the annual Sovereign European and Asian art prizes. These are high-profile events which raise funds to support worthy causes in the field of arts. The SAF will readily agree to be supported by the Supporting Charity.

The US Contribution Element – to obtain a charitable deduction on a US income tax return, the contribution must be made to a US-approved charitable organisation, which may then distribute to a non-US charity. Sovereign can arrange this. The US Charity has certain oversight requirements, including an obligation to verify that a non-US Charity to which its makes a gift is qualified under US law. Gifts made to a Charity that is not US-approved may not be tax deductible by the donor, but the Charity will still enjoy the other advantages afforded by its charitable status.

The Foreign Element – for US persons, a Charity should be established in a jurisdiction where the charitable concept is similar to that of the US. Hong Kong is such a jurisdiction. A Charity should generally distribute a minimum of 50% of its income, but we recommend that 85% is distributed. The level of income received by the Charity, however, can be carefully controlled by the use of a wholly-owned holding company and further underlying companies. These subsidiaries can carry on trade, hold further assets and employ staff but, unless the holding company pays a dividend, no income is received by the Charity. In this way, the holding company's board of directors can control the precise amount of annual distributions.

REPORTING OBLIGATIONS

The Charity may invest its assets anywhere in the world, including the US. But, with the exception of certain investments and business conducted in the US, the Charity has no reporting obligations, either to the IRS or any US authority that oversees charities.

MANAGEMENT OF THE STRUCTURE

Most clients will readily understand the workings of the Charity because it is set up as a company, but the following points are worthy of note:

Management and Directors – The directors can include family members. We recommend that at least some of the directors are professional persons who are familiar with the correct workings of a charity and can offer guidance and assistance. Sovereign can provide suitably qualified persons. Family members who are employed as directors or consultants, or hold other positions in the Charity, may be paid reasonable fees and expenses in accordance with market rates, but any remuneration would, of course, be taxable in the hands of the recipient.

Members – Memberships in the Charity would generally be issued on terms that carry votes, but no entitlement to distributions of income or capital – as all such distributions must be made to charitable causes. A guarantee membership expires on death, thereby obviating the need for any transfer of the membership on demise and allowing for succession planning to be built into the structure of the Charity. Careful drafting can generally accommodate any and all wishes of the founder.

The Committee – A committee may be appointed to act as a check and balance on the directors and give certain reserved powers to family members. This is particularly relevant where the directors are non-family members.

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