SOVEREIGN

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contents

We are a little late with this issue of The Sovereign Report so, rather belatedly, I wish you all a very happy and prosperous New Year and hope you all had a good Christmas and festive season. It is also fast approaching Chinese New Year so Kung Hei Fat Choi to you all.

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Sovereign European Art Prize Dinner

It seems to come around so quickly but this year's European charity dinner and auction is due to take place in London on 15th March. We would love to see any clients or friends there, helping us to support worthy charitable causes. If you are interested in attending either the exhibition or dinner, then please visit our website for details www.SovereignArtFoundation.com or e-mail tiffany@SovereignArtFoundation.com.

Sovereign Insurance

We are delighted to announce that Sovereign is to launch an insurance business from Gibraltar to service the insurance needs of existing Sovereign clients. To this end, we appointed Steve Armstrong to head up the new operation with effect from 8 January 2007. A qualified lawyer who has specialised in insurance for 25 years, Steve can assist Sovereign clients with setting up insurance companies or captives, or with yacht, household or any general insurance needs.

UK residents with offshore bank accounts

Perhaps the biggest news is the continuing, and increasingly successful, efforts by the Inland Revenue to force offshore branches of UK banks to reveal details about UK resident. Barclays has already opened up its books, and a lot of banks will follow suit. For many years we have been advising that relying on offshore confidentiality is not good planning. Interest earned on offshore accounts has to be declared by UK residents (unless they are not domiciled) and failure to do so is tax evasion. The Inland Revenue and the general public have little sympathy with those who are caught out failing to declare.

chairman

There is more on this in the following pages but we would stress that we have considerable expertise in devising strategies whereby tax on monies offshore can be legitimately avoided. Please contact us for details.

Thai foreign ownership rules

You may have read that Thailand has amended its existing foreign ownership legislation to the general disadvantage of non-Thai nationals. In fact, it is simply enforcing the existing legislation. It has been common practice to hold Thai assets, including freehold land, in a company that is majority owned by Thai nationals (as required by the law), but where enhanced voting rights give control to the minority shareholders. The “new” laws prohibit such minority control. This will be of concern to anybody who owns property in Thailand through one of these structures. We have solutions, so please contact the Hong Kong office if this matter is of concern to you.

New head in Jo'burg

Chrizette Roets also joined Sovereign on 8 January to head up our Johannesburg office. She is an attorney of the High Court Of South Africa and served articles in Johannesburg at Webber Wentzel Bowens, one of South Africa's leading law firms. Chrizette holds an LLB degree from the University of Pretoria, which she obtained cum laude in 2003.

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

EU pursues Asian compliance with savings tax directive

The European Commission has again pressed Hong Kong and Macao to comply with the EU savings tax directive in respect of tax interest earned by Europeans in the two Chinese special administrative regions.

Thomas Roe, the Commission's envoy to Hong Kong and Macao, made an appeal on 31 October, only a fortnight after a Hong Kong official had stated it would be extremely reluctant to assist the EU to apply the savings directive.

The move follows the relative failure of the EU savings tax directive. In the first six months of the law's operation, Switzerland raised only €100m, Luxembourg collected €48 million, Jersey €13 million, Belgium €9.7 million, Guernsey €4.5 million, Liechtenstein €2.5 million, and Ireland only €400,000.

Laszlo Kovacs, the EU tax commissioner, wants to bring both Hong Kong and Singapore into Europe's tax net by persuading them to apply the July 2005 Savings Directive, which aims to tax the interest on European citizens' offshore savings.

The Commission estimates that, as of August, there were more than 37,000 EU citizens resident in Hong Kong – a figure that does not include Hong Kong citizens who also hold EU passports.

In July a Commission memo, citing 2005 data from the Bank of International Settlements, noted that there were "external" – or non-banking sector – deposits of $158.1bn (€124bn, £83bn) in Singapore and $82bn in Hong Kong.

But Martin Glass, Hong Kong's deputy secretary for financial services and the treasury, argued that the territory was legally and constitutionally constrained in its ability to share information with other tax authorities, including China.

Singapore has refused to discuss the issue. EU commissioner for external relations Benita Ferrero-Waldner said the EU had wanted to include the savings directive as part of negotiations over a potential economic partnership and co-operation pact. But Singapore had refused to include the issue on the agenda.

Sovereign Comment

If an EU resident earns interest on monies banked then that interest is both reportable and taxable. Failure to report is tax evasion and in most countries this constitutes a criminal offence. Many EU residents who previously banked in places like the Channel Islands, Gibraltar, Cayman or BVI have switched their accounts to a country not covered by the EU Directive, such as Hong Kong or Singapore. This does not mean that the interest no longer has to be reported. It does and it is still taxable. It is however possible to set up a compliant and legal structure to hold offshore funds that will also relieve the owner of the burden to either report or pay tax on the income generated.

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Agreements over Gibraltar signed

The UK, Spain and Gibraltar signed, on 18 September 2006, a range of 'historic' agreements in Cordoba. Areas covered by the agreements include the expanded use of Gibraltar Airport, the full inclusion of Gibraltar in EU air liberalisation measures, recognition by Spain of Gibraltar's international dialing code and unblocking by Spain of Gibraltar mobile telephone roaming in Spain. The signing completed 20 months of talks under the terms of the Joint Communiqué of 16 December 2004.

A joint statement said: "These agreements show our commitment to the solution of specific problems but have no implications whatsoever regarding sovereignty and jurisdiction, or regarding any issues thereby affected, and any activity or measure undertaken in applying them, or as a consequence of them, is understood to be adopted without prejudice to the respective positions on sovereignty and jurisdiction."

Sovereign Comment

This agreement does not mean that the issue of Sovereignty over Gibraltar has gone away, but it signals a less antagonistic approach by Spain. Gibraltar has had great success in attracting high net worth individuals who can reside in Gibraltar and pay only a fixed rate of tax, up to a £20,000 pa maximum, irrespective of their worldwide income. But the inability to fly anywhere out of Gibraltar, except London, has been a drawback. The new agreement should remedy this and make Gibraltar an even more attractive place of residence for wealthy individuals. Please contact our Gibraltar office for more details.

Isle of Man introduces New Manx Vehicle

The Isle of Man Companies Act 2006, which introduces a new simplified corporate vehicle into Manx Law, was brought into force on 1 November 2006. Royal Assent was received on 14 October 2006.

The Act provides a streamlined process for setting up and running a company in the Isle of Man and complements the zero rate company tax strategy introduced in April 2006. It has been designed for a range of corporate transactions and is likely to be particularly useful for public offerings, securitisations, asset and project finance.

Key elements of the new Act include: greater flexibility of use; simplified reporting; use of regulated corporate directors; one director, individual or corporate; use of registered agents, in place of company secretary; unlimited corporate capacity, but restricted objects permissible; no preclusion of financial assistance; pre-incorporation contracts can be adopted; simple merger and consolidation procedures; introduction of protected cell companies for general business use; and simplified corporate redomiciliation from other jurisdictions.

The New Manx Vehicle (NMV) is based loosely on the international business company (IBC) model and is introduced alongside previous Isle of Man Company Legislation (the Companies Acts 1931-2004). Companies formed under the 1931 Act are permitted to convert to the 2006 version in the future.

Sovereign Comment

We have followed the progress of this new legislation with interest and, of course, our Isle of Man office is able to advise on all aspects of the NMV and how it may be used in the structuring of even the more complex situations.

Our opinion is that this new legislation combined with the new zero corporation tax policy creates an excellent model for both the practitioner and client going forward. For further information please e-mail: iom@SovereignGroup.com.

Cayman "tweaks" its mutual funds legislation

The Cayman Islands has brought in several amendments to the Mutual Funds Law (2003 Revision), the most significant being a doubling of the prescribed minimum initial subscription for registered funds from US$50,000 to US$100,000.

The latter figure therefore becomes the new benchmark for what constitutes a non-retail investment, but the new law contains "grandfathering" provisions so that existing registered funds with a minimum initial subscription below US$100,000 will be permitted to continue to operate on that basis.

The Mutual Funds (Amendment) Law 2006 also provides that foreign funds may carry on business in or from the Cayman Islands, without having to be licensed by the Cayman Islands Monetary Authority (CIMA), provided that they are: subject to equivalent regulation; marketed through a regulated Cayman service provider; and where the securities offered are listed on a stock exchange approved by the CIMA and offered to the public in the Cayman Islands.

Certain obligations on administrators licensed in the Cayman Islands, which previously only applied in cases where they provided a principal office, have now been extended to all mutual funds. These include ensuring that a promoter is of sound reputation and that administration is undertaken by persons with sufficient expertise.

The supervisory powers of CIMA have been extended to include the ability to cancel a compliance certificate or the registration of a fund in certain instances, such as where the fund is carrying on business in a manner that is prejudicial to investors.

The Mutual Funds (Annual Returns) Regulations have also been passed to bring into effect CIMA's electronic reporting initiative from early 2007. This will enable regulated funds to submit annual returns using a secure and paperless system and provide CIMA with accurate, electronic data for use in reporting aggregate information on the funds industry.

Sovereign Comment

Sovereign has considerable expertise in setting up, managing and administering offshore funds. We can set funds up in many jurisdictions but hedge funds have tended to favour Cayman, one of the world's most expensive places in which to do business. Sovereign has formed an alliance with a local law firm in Cayman to offer much lower fees for the formation of funds, fund management companies and preparation of full fund documentation. In short we offer a turn-key solution. Anybody interested in this service should contact funds@SovereignGroup.com.

Canada targets offshore tax havens

Canadian Finance Minister Jim Flaherty set into legislative motion a process to restrict the use of offshore "tax havens" by introducing, on 10 November 2006, an amendment to the Income Tax Act to prevent "non-resident trusts and foreign investment entities" from using them to avoid paying tax.

Flaherty said the use of offshore tax havens was costing the government considerable amounts of revenue. Last year, Statistics Canada reported that Canadian direct investment in such shelters has risen eightfold since 1990 to C$88 billion in 2003, with much of the money being invested in the Caribbean. The largest increases went to Barbados, Bermuda, the Cayman Islands, the Bahamas and Ireland, the five countries being among the 11 nations with the most Canadian assets.

Federal Auditor General Sheila Fraser reported that multinational firms operating in Canada have avoided "hundreds of millions" of dollars in taxes over the past decade through the use of tax havens.

Flaherty said: "The motion will amend existing income tax rules to help ensure that income earned by Canadians through foreign jurisdictions, including tax havens, is subject to tax as if it had been earned in Canada."

The proposed amendments, which carry through on long-standing proposals that were first announced in the 1999 Budget, deal primarily with the taxation of income earned through the use of non-resident trusts and foreign investment entities, the department said.

The proposed amendments are separate from the overall review of income trust funds, which is still underway. Flaherty defended his decision to break an election promise not to tax income trusts, saying that the loss in revenues resulting from the escalating number and size of corporations that were converting into trusts would have eventually pushed the federal government back into a deficit.

There had been some C$70 billion (US$61.83 billion) worth of income trust announcements so far this year, which was "not right and not fair," said Flaherty. "It is the responsibility of the Government of Canada to set our nation's tax policy, not corporate tax planners."

BVI legislates for private trust co's

The British Virgin Islands brought in new laws, as of 1 January 2007, designed to make it easier for private trust companies to set up in the BVI. Under the proposals trust companies that do not offer their services to the general public will be able to apply for the new exemption from the licensing requirements and other provisions of the BVI Banks & Trust Companies Act.

Unremunerated BVI companies that merely hold assets as nominees or “bare trustees” and which do not offer, or purport to offer, their services to the general public are expected to be automatically exempted. It is also anticipated that those exemptions will, once granted, take retroactive effect.

Lisa Penn-Lettsome, President of the BVI Bar Association, said that the ability of BVI-domiciled companies to act as trustees of trusts was integral to the provision by an offshore financial centre of a comprehensive range of financial services.

Sovereign Comment

Despite being a world leader for Incorporations, BVI has rather belatedly legislated for private trust companies. Sovereign has been setting up these structures in other jurisdictions for many years. For clients who dislike the loss of control entailed by putting their assets into trust, a trust company ensures that the trustee remains under the control of the settlor and his family. This can remove much of the anxiety. Sovereign has particular expertise in this area and can advise upon request.

India draws up tax haven black list for foreign funds

A negative list of tax havens, countries that levy very low or no tax, is being prepared in India to reduce the vulnerability of equity markets in the country to foreign funds, according to the Finance Ministry on 7 November 2006.

A panel chaired by Ashok Lahiri, chief economic advisor in the Finance Ministry, with members drawn from the Reserve Bank of India (RBI) and the Securities & Exchange Board of India (SEBI), recently suggested that such a list be drawn up.

The National Security Council (NSC) under the Prime Minister's Office had also warned that without proper checks, Pakistani or Chinese investors could route their investments into India through tax havens like Mauritius, Cayman Islands or Cyprus.

Fear were raised when the Council was told that more than 85% of foreign fund inflows into India in 2005-06 were through participatory notes (PNs) – an anonymous instrument. In 2003-04, PNs accounted for a little over 20% of foreign fund investments in India, but the proportion rose to 42% the next year.

The NSC said: “Billions of rupees come into India as foreign investment but hardly any money leaves our shores as open taxable returns on investment or the repatriation of principal amounts. This raises suspicion that some other clandestine method is used for this purpose.”

The Council suggested that existing legislation be not only strengthened but also extended to cover flow of funds into India from tax havens in order to check money laundering.

The move could also be a negotiating stance to increase pressure on Mauritius, the largest source of foreign direct investment (FDI) to India, to amend the current tax treaty. Reserve Bank of India figures for FDI in 2004-2005 show Mauritius as the lead external investor into India with US$820m out of a total US$2,320.

The Indian government has been unsuccessful in convincing Mauritius to amend the treaty. But the Mauritius government announced in October that it is to tighten up rules on the issuance of Tax Residence Certificates, and in future will issue them for only one year at a time.

Pressure on India to re-negotiate the Mauritian tax treaty has increased; particularly after stronger residence qualifications were included in a similar treaty signed recently with Singapore.

Sovereign Comment
Indian GDP continues to grow at around 9% p.a. Both our Mauritius and Dubai offices are active in this increasingly important market. The proposed changes serve to illustrate the importance of using carefully planned structures when investing into India. Contact details for both offices are given on the inner back page of this issue.

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Australia to expand TIEA network

The Australian Taxation Office (ATO) plans to expand the number of tax information exchange agreements (TIEAs) with offshore financial centres in a bid to restrict corporate tax avoidance.

A TIEA with Bermuda was finalised last November and similar agreements with nine other countries are well advanced, said ATO Commissioner Michael D'Ascenzo. Preliminary discussions are also being held with several countries in the Pacific Region.

"We also want to extend our comprehensive treaties so that they will cover information exchange not just on direct taxes but also GST (goods and services tax), and other indirect taxes," D'Ascenzo said.

The Commissioner said the majority of tax avoidance by Australian companies occurred through transfer pricing by companies selling their own goods and services to overseas divisions of their company, so that most of a company's profit could be booked in a country with low taxes. Since 1998, the ATO had garnered more than A$1.7 billion in tax and penalty adjustments from audits of transfer pricing, together with disallowed losses of around A$1.9 billion.

He also said the ATO was seeing evidence of "aggressive" moves to avoid royalty and interest withholding, and currently had a number of cases under audit.

Bahrain enacts new trust law

The Trust Law, to govern trustees and trust administration in Bahrain, was enacted on 16 August 2006. Bahrain is one of the first countries in the Middle East to put in place such a legal framework. The Dubai International Financial Centre enacted a trust law last year.

"The establishment of a trust, in a well-regulated environment, will broaden the available options for the transfer of business, property or other assets from one generation to another. It will also enable the Bahrain-based wealth management industry to develop and extend more innovative products and solutions," said Abdul Rahman Al Baker, executive director of Financial Institutions Supervision at the Bahrain Monetary Authority (BMA).

The new trust law provides that trusts must be registered with the BMA. Trusts may be established for a maximum of 100 years and trust property may comprise any form of property, moveable or immoveable, tangible or intangible.

A trust may have one or more trustees and the trust law sets out the obligations on a trustee to provide adequate protection to the beneficiaries and ensure that the trust is managed in accordance with the terms and conditions of the settlor.

The law provides for high levels of confidentiality for the execution and administration of the trust fund. It also provides for the establishment of a register of financial trusts by the BMA and obliges the BMA to maintain complete confidentiality of all information recorded in the Register.

Trusts are a relatively recent structure in the Middle East but the potential for growth is great. The region boasts the world's highest concentration of high net worth individuals, whose collective wealth is estimated at over $1.3 trillion.

Sovereign Comment
This is an exciting new development and should be of interest to anyone looking to establish trust structures in the region. Sovereign is represented in Bahrain and our local manager, Hadi Daou, will be able to assist with any trust or related enquiries hdaou@SovereignGroup.com.

New ruling hits "tax exiles" over days spent in the UK

The Special Commissioners ruled, on 31 October 2006, against British-born businessman Robert Gaines-Cooper, who sought to establish he was resident and domiciled in the Seychelles for the tax years 1992/93 to 2003/2004. If upheld on appeal, the ruling means that many wealthy business people may be stripped of their non-resident status.

In *Robert Gaines-Cooper v. Revenue & Customs*, the appellant, who had business interests across the world, purchased a house in the Seychelles in 1975 and obtained a residency permit in 1976. He indirectly retained a house and assets in England and latterly his wife and son resided in England. He often visited his family in the UK at weekends, but he judged he was not liable to tax because he had moved his domicile to the Seychelles and spent fewer than 90 days a year on average in the UK.

Since 1993, days of entry and departure have been disregarded when calculating whether an individual has spent an average of more than 90 days in the UK during four consecutive tax years - or more than 183 days during any single year. Anyone who exceeds either limit is liable to income tax.

The Special Commissioners acknowledged that Gaines-Cooper had based his assessment of the days spent in the UK on Revenue guidance, but agreed with Revenue & Customs that ignoring both the dates of arrival and departure would create a distorted picture. It therefore adjusted the time spent in the UK to include nights spent in the UK.

The tribunal rejected Gaines-Cooper's claim that he had moved his domicile on the grounds that he retained connections with the UK. As well as educating his son in the UK and visiting his wife who was mainly based in the UK, he visited regularly for pheasant shooting, Royal Ascot and the Rolls-Royce Enthusiasts Club rally. It held that Gaines-Cooper was resident and ordinarily resident in the UK.

Sovereign Comment

It is understood that Gaines-Cooper, whose businesses ranged from a jukebox company in Henley-on-Thames to a medical equipment supplier incorporated in the Netherlands Antilles, intends to appeal the decision. The ruling may affect a lot of people who avoid tax by carefully limiting their time spent in the UK. It also raises wider concerns about the reliability of the Revenue guidance. But the change in how residence and domicile status are determined for tax purposes means, conversely, that many wealthy foreigners who live and work in the UK are now less likely to be forced to pay UK tax.

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ECJ rules against Azores' tax breaks

The European Court of Justice (ECJ) dismissed, on 6 September 2006, the Portuguese government's challenge to a 2002 European Commission decision which found that the reduced income tax rates applied in the Azores Islands were contrary to EC rules.

Dismissing the action, the ECJ said: "The court finds that the Portuguese government has not proved that the adoption of the measures at issue was necessary for the functioning and effectiveness of the general tax system."

Portugal had permitted the regional assembly of the remote, mid-Atlantic islands to set their own income and corporate tax rates well below those of the mainland, with cuts of as much as 30% in corporate income tax. It argued that the tax cuts were a matter of sovereignty and motivated by the geographical isolation, difficult climate and economic dependence.

The Commission ruled in December 2002 that the tax cut was prohibited state aid because it gave the Azores an economic advantage at the expense of other EU areas. It ordered the region to raise its rates. Portugal appealed.

The ruling was being closely watched for implications by the UK and Spain, which both intervened on the side of Portugal. The UK said a decision against the tax cuts would raise "regional autonomy issues of considerable constitutional importance".

Spain also said the decision could affect the special tax powers granted to its northern Basque Country and Navarre regions.

In October 2005, the ECJ Advocate General Leendert Geelhoed of the Netherlands said the purpose of the tax reductions was to compensate for disadvantages of doing business in the Azores, but that did "not constitute a valid justification based on the nature and economy of the Portuguese tax system".

Sovereign Comment

This ruling is of importance not only to the Azores but also for the implications this may hold for another similar case presently before the ECJ involving Gibraltar. The decision in this latter case is expected shortly; the outcome and implications for Gibraltar will be reported in a future edition.

Ruling in Deutsche Morgan Grenfell

In a landmark decision of 25 October 2006, the House of Lords reversed the Court of Appeal's decision and found in favour of the taxpayer in the *Deutsche Morgan Grenfell* (DMG) case.

The ruling considered whether a claim to recover tax paid more than six years ago could be based on a mistake of law – in this case, when UK rules are in breach of European law. The decision enables DMG to recover tax paid more than six years ago – the six-year time limit for claiming running not from the date on which the tax was wrongly paid but when the mistake was, or could reasonably have been, discovered.

This decision has wide implications. It will not only impact upon claims under European legislation, such as taxpayers currently challenging the UK's group relief rules, CFC rules or taxation of overseas dividends rules as being contrary to the provisions of the EC Treaty, it also applies generally to claims for repayment of tax brought against HM Revenue & Customs (HMRC).

The level of concern shown by the UK government as to the implications of this case is clear from the fact that it introduced blocking legislation in the Finance Act 2004 to remove a taxpayers' right to reclaim from HMRC tax paid under a mistake of law.

The effect of the law change is to restrict claim time limits for claims brought after the introduction of the blocking legislation, which took effect retrospectively from September 2003, to six years. The legality of the blocking legislation is itself currently being challenged in the courts.

Hong Kong signs new tax treaty with China

The People's Republic of China (PRC) and the Hong Kong Special Administrative Region signed their first comprehensive income tax treaty on 21 August 2006. The new treaty extends the scope of the existing 1998 agreement, which was limited to business profits and income from personal services, and will strengthen Hong Kong's competitiveness as the investment gateway to the Chinese mainland.

Based on the OECD model, the new treaty covers direct income earned by businesses and individuals, such as operating profits and employment income, as well as indirect income, such as dividends, interest and royalties. It also contains new administrative provisions, including an exchange of information article.

Under the new treaty, China-sourced passive income – including dividends, interest, royalties and capital gains – received by Hong Kong investors will derive preferential treatment by way of reduced withholding tax rates or, if specific conditions are satisfied, a tax exemption.

This compares favourably with China's domestic tax law and many of China's bilateral income tax treaties, including those with Macao and Singapore, and is particularly attractive because the items of income covered are not subject to Hong Kong tax, resulting in a net benefit to the Hong Kong investor.

A CGT exemption will facilitate cross-border restructuring, and merger and acquisition activities, because capital gains derived from the disposition of shares in a Chinese company by Hong Kong investors would otherwise be subject to a 10% withholding tax. This exemption will not apply if the Chinese company is mainly a property holding company or the ownership interest disposed of represents an interest of at least 25% in the Chinese company.

China does not currently tax dividends paid by foreign investment enterprises in China to foreign investors, but that exemption may be curtailed. If this is the case, the new treaty's 5% withholding tax rate on dividends will be preferential to a possible 10% or higher rate.

The new treaty's 7% withholding tax rates on interest and royalties received by Hong Kong investors from Chinese sources compare favourably with the standard 10% rate under China's domestic law and the PRC-Macao income tax treaty. These rates should further encourage "capital exports" by Hong Kong investors to the mainland.

If ratified before 31 December 2006, the new arrangement will take effect with respect to Hong Kong taxes from the year of assessment beginning on or after 1 April 2007, and with respect to PRC taxes from the taxable year beginning on or after 1 January 2007.

Sovereign Comment
With an exchange of information provision in the new treaty, taxpayers should seek to manage their cross-border business transactions and tax affairs in a consistent manner and maintain proper records to support the commercial objectives that underlie the business transactions. Readers are reminded that Sovereign specialises in China Entry Services from our Hong Kong office. Such support is vital when considering doing business in China; advice should be obtained sooner rather than later – email hk@SovereignGroup.com.

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Chinese Protocol with Mauritius

The People's Republic of China and Mauritius signed, on 5 September 2006, a protocol amending the existing 1994 treaty to provide for an expanded exchange of information article.

Mauritius has become a popular jurisdiction for multinational companies seeking to establish holding companies for their Chinese operations because a Mauritian company will only be subject to Mauritius income tax on gains arising from the transfer of its interest or shares in a PRC company, provided that the assets do not consist primarily of immovable property. But the Chinese revenue believed the inability of the source country to tax capital gains on the transfer of a significant shareholding in a Chinese company allowed scope for tax avoidance. Under the new protocol, China has followed the UN model and added a clause that permits the source country to tax capital gains on the transfer of a 25% or more shareholding of a company resident in the source country.

The protocol with Mauritius also incorporates the changes in the 2005 OECD model to expand the scope of the treaty's exchange of information article. The information exchanged can include particulars about non-residents and can be applied to the administration or enforcement of taxes other than income taxes. China will probably seek to include broader exchange of information articles, based on the 2005 OECD model, in future bilateral tax treaties and protocols.

Malta-Spain tax treaty comes into force

The Malta-Spain tax treaty, signed on 8 November 2005, was brought into force on 12 September and came into force on 1 January 2007. The treaty, which follows the OECD model, applies to residents of one or both contracting states, except for tax-exempt entities formed under the Maltese Merchant Navy Act of 1973.

In Spain, the treaty applies to the individual and corporate income tax, non-resident income tax and local income taxes. In Malta, the treaty applies only to the income tax.

Dividends paid by a company that is a resident of Spain to a resident of Malta, will be subject to Spanish withholding tax at a maximum rate of 5% of the gross amount of the dividends. Spain will further exempt from withholding tax dividends that are paid to a company that is a resident of Malta, provided that the company holds at least 25% of the capital of the company paying the dividends. Interest and royalties are taxable only in the payee's state of residence.

Malta is currently included on Spain's 'black-list' of tax havens but, under Spanish law, a country is automatically scratched when it signs a tax treaty or exchange of information agreement. Thus, the new tax treaty should exclude Malta.

Sovereign Comment
With the accession of 10 new states to the EU in 2004, and two more (Bulgaria and Romania) joining in 2007, the tax treaty network is sure to be extended over the next few years. Each treaty must be studied to consider the implications for existing structures as well as for proposed new arrangements. Corporate tax rates differ across the extended EU and Sovereign is well placed to advise.

Life insurance provides tax planning cover

It is a truth universally acknowledged, that due to ever increasing amounts of anti-avoidance legislation, most straightforward offshore company or trust arrangements are no longer effective in reducing tax for residents of high tax countries.

Onshore countries attack these offshore structures in slightly different ways but by the same basic principles. Attribution rules apportion the income of an offshore structure to the beneficial owners of that structure in proportion to their interests. For example, a UK resident and domiciled individual who owns, directly or indirectly, 50% of an offshore structure will be required to report that interest and will be taxed on 50% of the income within that structure whether he receives it or not. Additionally, if the same UK client exercises control over the management of that company – either as a director or by issuing instructions to the directors – then that will make the structure itself tax resident in the UK and liable to UK tax as a result.

Fortunately all developed countries recognise the importance of encouraging people to take out life insurance and pensions so that they can look after themselves and their family without becoming a burden on the state. For this reason considerable tax breaks are still available for those who wish to save for their retirement or those who wish to insure their lives to the benefit of their dependents. And these offer great potential for creating tax efficient structures.

Having an offshore structure owned by an offshore life insurance contract will generally mean that the attribution rules referred to above no longer apply. Income and capital gains can be generated offshore, and remain outside the scope of onshore taxation, until withdrawn from the structure. In short, indefinite tax deferral – and sometimes complete tax avoidance – can be achieved. This occurs because the asset owned by the client is transformed from shares in a corporation to a life insurance contract that just happens to invest in the shares of an offshore company. As a result a very different tax regime applies.

The large insurance companies recognised these possibilities long ago and created what they call “offshore bonds”. In this scenario investments can be held by an offshore life insurance “wrapper”. Cash injected into the offshore bond is invested into a range of mutual funds offered by the insurance company and selected by the owner of the contract. Under current rules, 5% of the premium paid into the life insurance contract can be withdrawn tax free every year for 20 years. This is not particularly generous as it represents a return of the invested capital, but at least it clarifies that the withdrawal will be treated as capital rather than income. The underlying capital gains and income will not be taxed unless and until withdrawn at a later date.

The disadvantage of using the services of these insurance companies is that they place restrictions on what investments the wrapper can hold. They will rarely allow private assets to be held within the structure and normally insist upon the whole of the capital being invested into a limited range of mutual funds that often carry quite high entry and annual charges. They are also expensive to set up – insurance brokers who sell these products will normally earn up to 8% of the capital value in commissions. This is not always immediately apparent at point of sale.

“In other words, these contracts work rather like an offshore piggy bank.”

But smaller insurance companies are more flexible and much cheaper. Bespoke insurance contracts can be written for each client and used, for example, solely to own the shares of an offshore company which can then undertake a whole range of trading or investment activities free from the high charges and restrictions imposed by larger competitors. The insurance companies normally allow the assets of each insured to be held within a segregated ‘protected cell’. The return on the insurance contract is thus directly related to the value of the underlying assets of each insured and assets of one contract are not mingled with assets of another.

This system has the added advantage that if the insurance company itself has financial problems, the assets within the individual cells would be protected.

The actual level of insurance within the contract can be quite small and generally the insurance will promise to return only whatever that particular cell of assets is worth upon the death of the life insured. In other words, these contracts work rather like an offshore piggy bank. They can be used as private investment vehicles that have the necessary characteristics to be classified as insurance and give the same tax advantages as pure insurance contracts. They are highly effective tax deferral vehicles.

While we have used the example of a UK resident and domiciled client we know that similar principles would apply to clients resident in most countries of the world, including the US, Australia, Spain, Portugal, France, Sweden and many others.

In the UK the Revenue has tried to remove some of these advantages by creating rules that attribute 15% of the initial life insurance premium as an annual capital gain taxable upon the owner of the insurance policy. The 15% deemed gain is then taxable in the hands of the policyholder. But if the policy itself is owned by an offshore company and that company is owned by an offshore trust, the 15% charge would not apply and a tax free structure is created. This can be used to defer tax indefinitely, even when the beneficial owner of the structure is a UK resident and domiciled individual.

The tax advantages provided by life insurance products were tested by the House of Lords. In the case of *Willoughby*, the Law Lords ruled that Parliament had created a specific tax regime for life insurance contracts and their tax treatment should therefore remain unchanged until Parliament legislates otherwise. This would seem to mark the end of the attempts by the UK Revenue to tax life insurance contracts at a point before the distribution of funds.

Sovereign has taken opinion from leading experts on the tax efficacy of these arrangements and can arrange for such opinions to be written to clients upon request. Contact your nearest Sovereign office for further details.

information

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