Tax and structuring challenges for 2020?

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What are some of the key tax and structuring challenges on the horizon in 2020?

We've obviously got the Common Reporting Standard that continues to be implemented, and that's obviously now up and running with exchange of information now taking place between signatories to that regime. So that's the first point. Secondly, we've got the BEPS regime, the 'Base Erosion and Profit Shifting' regime, that is again now taking effect, and that's really posing substantive challenges, I think, for private clients as well as corporates. Because unlike CRS, which is simply concerned with the exchange of information, BEPS has actually substantively changed the provisions in double tax agreements; we're now actually seeing those provisions bite.

Gradually, when we're doing tax treaty planning for clients, we're now having to actually look at the changes that have been introduced as a result of BEPS. And as I say, it's affecting both private clients and corporates because of those substantive changes in the treaties. So, we've obviously got CRS up and running, BEPS is beginning to bite, and then along comes the economic substance rules. They have been born out of European Union, along with the OECD, that obviously is also behind BEPS and CRS.

With the economic substance rules, they're focusing on the crown dependencies - specific jurisdictions include Isle of Man, British Virgin Islands, Guernsey - and what they're really saying at a high level is that you can't anymore set up a company in those jurisdictions, pay tax at 0% but have effectively no activity there, which is what has gone on for many years. What they're now saying is that if you want to set up in those jurisdictions, you're going to have to actually have a proper physical presence there. You're going to have to have staff there, and sufficient expertise there in order to not be blacklisted effectively, those jurisdictions, by the EU and these onshore states.

So in order to be able to continue to preserve their status within the international financial regime, they're going to have to implement these measures, which they are actually in the process of doing. I think, again, at a fairly high level, if you've got a passive structure that tends to be equity holding, then you're probably still okay. The real problem is for trading companies, where they expect you to physically have staff and engage in trade in these jurisdictions.

Now obviously, in places such as the Isle of Man, how much business is actually carried out in the Isle of Man when you set up an Isle of Man company? Very, very little. So I think for trading companies it does actually

pose real threats and challenges to those jurisdictions that are affected. At a fairly high level, they're three of the challenges that we're going to be facing in 2020 in our world of tax planning for high net worth individuals.

In relation to CRS - how have clients adapted?

We need to distinguish between CRS, BEPS, and the economic substance rules. They're obviously part of the same overall project, if you like, which is an attack on shell structures, and plate parking money in an offshore shell company and not paying tax on it, at a very, very high level. But CRS, in essence, is simply just concerned with reporting, so it's bare bones. I suppose you could trace it back to the European Savings Directive, where what it's really concerned with is: you've got, Michael - you're a resident. Let's say you live in the UK, but you have a bank account in Hong Kong. If you're a UK resident, you're taxed on your worldwide income, so you need to be reporting the interest that accrues to that bank account on your UK tax return and paying tax accordingly. If you don't do that, that's tax evasion.

Now, in the past, it was very hard for HMRC (HM Revenue and Customs) in the UK to determine that you had a bank account in Hong Kong. What CRS has done is that it's meant that the bank in Hong Kong, that's the financial institution, to give it its technical term under CRS, is now under an obligation to report your details, because the bank have your address, of course; under the anti-money laundering regime, they know where you live, they know that's in the UK. They pass those details on to the Hong Kong Revenue, who then subsequently pass that onto HMRC, and they can then go and check your tax return to check that the interest is being reported on the return. If it's not being reported, you'll get an inquiry and you'll have to pay back the tax plus severe penalties, which can now be as high as 200% in the UK, in that example.

So that's essentially what it's designed to do. Note, though, it's not actually a mechanism for charging taxpayers. It doesn't mean that they're subject to new taxes, and it doesn't provide a regime for collecting taxes. All it does is (act as) a mechanism for reporting account holders in other jurisdictions where they're not resident. Finishing in on CRS, it's not just limited to bank accounts. It extends to companies which hold bank accounts and the beneficial owners of those companies.

And finally, it also extends to trusts. And that's where it's given us real problems, is in the trust context, because to try and determine who the beneficial owner of a trust is can be quite difficult. And under CRS, they effectively say a settlor, or the protector, or the beneficiaries can all be beneficial owners. That's meant for those of us who are involved in the trust world, the trust planning world, it's caused us a real headache.

And you'll probably find if you speak to one person and you say, "well is this trust, is it caught by CRS? Do the trustees need to make a report?" They'll say, well no, this is exempt because it's a trading structure. You speak to someone else and they'll say, no, it's reportable. So it's almost how long is a piece of string, CRS. Hopefully, as the regime beds in over time, then things will settle down and we'll get a better idea in the trust context of what needs to be done. But at the moment, there's quite a lot of uncertainty still.

What are the consequences of (Base Erosion and Profit Shifting) BEPS?

Again, BEPS is another project that was born out of the OECD. The fact that, in BEPS speak, they look back at what a tax treaty should do, Michael. And originally, if you read what a double tax agreement says on the tin, it's designed to prevent double taxation. So to give you an example, if you've got some interest accruing in Singapore, let's just say, and Singapore taxed that interest, because it's Singapore-sourced income, but you live in the UK and you'll be taxed on it in the UK, a double tax agreement is designed to determine which in this example out of Singapore and the UK has the right to tax you on that interest.

And what it does is that it ensures that the interest in this example is not taxed in both jurisdictions, so to prevent double taxation, being taxed twice. What BEPS is designed to combat is treaty abuse, as they refer to it under the BEPS Project. Others involved in tax planning wouldn't regard it as abuse, they would say it's tax planning. But what they don't like is this thing called double non-taxation. It means that you're using a treaty and you're not being taxed either in your country of residence, which is where you live, or the country of source, which is where the income comes from.

To give you an example of where this has come in in the past, a treaty was used in the Isle of Man for UK land development in the past. It's all been closed down now, partly under the implementation of BEPS, but effectively you could trade in UK land through an Isle of Man company. The treaty would block the UK's taxing rights, but then the Isle of Man would tax it at 0%. So in that example you can see that you're generating profit from UK land by buying and selling it for a gain, but it's not taxed in the UK, not taxed in the Isle of Man. It's that type of arrangement that BEPS is designed to combat, double non-taxation.

And you'll see now what's been inserted into treaties is effectively targeted anti-avoidance rules, so you've got things like where a treaty is being used for the purposes of avoiding tax, then you won't get the treaty benefits anymore. Obviously, these type of provisions do create uncertainty, and I think what it's meant is that more and more treaties are only going to be used for commercial purposes rather than for private client planning, where it's going to be more and more difficult, I think, to be able to say that the main purpose of using the treaty is the tax benefits and not for, say, setting up a company in Hong Kong because you need to use a Hong Kong company for commercial reasons.

Economic Substance Rules - what does in mean in practice for the average HNW client?

For the average client, they probably need to determine whether they still want to use the jurisdictions that have been caught by these economic substance rules, because frankly, it's going to be quite difficult now, I think, particularly as we said earlier in the trading context, to be using one of these companies going forward.

So I think if you're based, say, in the Isle of Man and you've got a trading company, you probably want to consider moving the business, say, to Hong Kong or a jurisdiction that's not actually caught. Also, Singapore is a good example, as well. Why are those jurisdictions attractive? Well, they're not per se tax havens. They have a source-based tax system, and that means that you are actually taxed, but only on local-sourced income. And it's normally possible to structure a company that's based in Hong Kong or Singapore to ensure that it's not actually taxed there, because the income that's accruing to the company is not sourced in Hong Kong or Singapore. But the point for present purposes is that they're not tax havens. They have a source-based tax system. So if you're trading, you probably want to move out of Guernsey and the Isle of Man to one of these type of places, Singapore or Hong Kong.

The other point is, offshore companies have often been used as shell companies, and you'll often see, say, a BVI, a British Virgin Island company that's registered in the BVI, but trust companies, we're not excluded from that, will often manage the BVI company from, say, their Isle of Man office where they've got their main center. Well, what the economic substance rules have necessitated is that registration and management now have to be in the same place. So you've actually seen sort of a consolidation, if you like, of offshore companies in certain centers.

You're now going to see, if you've got an Isle of Man company, an Isle of Man in actual fact, you would always classically have the directors based in the same place as registration. But it's particularly affected by these rules of the Caribbean jurisdictions, where as I've said, you would set up in the Caribbean but you would have your place of management, and your banking particularly, outside of the Caribbean.

So what you're seeing now with these Caribbean-registered companies is a re-domiciliation taking place. And what does that mean? Well, it effectively means that the registration of, say, a British Virgin Island company is now being re-domiciled over to the Isle of Man, for example, and the company will now effectively become, in this example, an Isle of Man company. It will have its directors based there, and it will have its banking based there.

Now, for certain economic substance purposes, that will be sufficient. However, in certain other instances, I keep on mentioning trading, it won't be, and it will probably be a step too far, what you now need to do to ensure that a trading company has substance in one of these jurisdictions that are affected. And as I've said, you probably want to shift the trade, the business to a source-based tax center, which isn't ostensibly a tax haven, such as Singapore or Hong Kong. ■

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