

ALAN PINK TAX

International Businesses: Your Guide to Saving Tax

We're all becoming much more internationally mobile these days, and so are the businesses we run. The interesting thing is: rapid advances in technology, and changes in the emphasis of the average business from using large fixed establishments to being lighter on their feet, hasn't been matched by a comparable advance in the tax rules.

So the question this article poses is quite a simple one: how do you avoid paying UK tax on your business profits by exploiting, or introducing, an international element in the business?

Avoiding the Fixed Base

It's only fair to say that those carrying on certain types of business should probably stop reading now. These are businesses which not only have a fixed base in the UK, but all of whose profits must necessarily come from that fixed base: for example, hotels, nursing homes, and those manufacturing products suitable only for the UK market.

The reason for this is that any business, to escape UK tax, needs to avoid having all its profits made in a "permanent establishment" in this country.

If you have a fixed base in the UK, then no matter where you are personally resident, or your company is set up, HMRC are still going to want their pound of flesh on the UK based profits. A permanent establishment in the UK can be such a thing as an office, a shop, a factory, or even the premises of somebody who acts as a dependent agent for your business. Even if your business doesn't own any fixed establishment, or indeed even rent it, use of an establishment owned by somebody else is just as liable to bring your profits into the UK tax net.

So, apart from the obvious answer of setting up your fixed base somewhere else, here are two thoughts for chiselling some profits out of the grasp of the UK Inspector:-

- Minimise the amount of the total business profits which he can attribute to the UK establishment. This is obviously easiest where you have some international element already in your business, perhaps sales offices somewhere outside the UK. The sales made outside this country result in profits some or all of which can be taken out of the grasp of the fixed UK base, even if that base is central to the operations of the business.
- If you make use of an agent's premises in the UK, rather than your own, find, if you can, someone who can be described as an "independent" agent. Generally speaking, an independent agent is somebody who has lots of clients or customers other than you, and operates independently in the sense that he does not just obey your orders all the time. The premises of an independent agent are not a "permanent establishment".

Where you've got fixed bases both in the UK and outside, then inevitably the question of "transfer pricing" is going to arise. Let's take an example.

Your business might be, for example, the provision of specialist software. This software was developed in an office in the UK which qualifies as a permanent establishment. However, it is sold to various clients all over the world, and supported on the clients' premises. If the sale is concluded from somewhere outside the UK, and the support is provided and administered outside the UK **even if not from a permanent establishment outside the UK**, then you have the possibility of taking some of the overall profits of the business outside the UK tax net.

The question, however, of course, is how much? This is where transfer pricing comes in.

If the UK base grants a licence of the software to the non UK part of your business, and that non UK part is the one that then transacts with the offshore clients, the amount the UK charges the non UK part is obviously crucial in determining how much of the overall profits are taxed here and how much are not. Unsurprisingly, HM Revenue & Customs take a keen interest in this question! The cheaper the onward sale price to your non UK branch, the less profits you make in the UK and the more you make outside the UK.

So be prepared to justify your transfer price as being that which you would charge if you were dealing with somebody outside the UK who wasn't connected with you.

So much for the "permanent establishment" hurdle. There are two others we need to surmount in order to get our profits outside UK tax.

Company Residence

Most businesses which look to avoid UK tax on their profits make use of limited companies set up outside this country. Limited companies aren't the only business vehicle you could choose, but to avoid complicating matters we'll assume in what follows that you are talking about a non UK company.

So you've got the sort of business where at least some of the profits can be "siphoned off" (to use a rather provocative term) into say a Guernsey incorporated company. Will that company avoid UK tax on the profits?

You would have thought that the answer should be an obvious "yes". Here are profits made outside the UK by a company which is incorporated outside the UK. How could HMRC argue that those profits could be within their grasp?

Easy, says the taxman. You need to look at a very important distinction: the distinction between where a company is incorporated, and where it is resident.

The place of incorporation is all about whose law the company was formed under, and is linked in with questions like where its registered office is, where it needs to make annual returns and send any accounts etc. This is usually a very straightforward question of fact where there can be no doubt.

The country of a company's **residence**, on the other hand, can admit of considerable doubt in practice.

The concept of company residence, if you think about it, is actually a very odd one indeed. Companies have no physical existence, they are just a legal concept, whose physical manifestation is a few bits of paper. How can that company be resident anywhere?

Well, we all know how lawyers go on in these situations. They invent an idea, which results in them having to ask themselves an impossible, meaningless question: where is this imaginary legal “person” resident?

And the way they answer it is by making up rules that nobody had suspected before. This happened in a series of cases which were heard by the English courts in the 20th Century, and those courts had to decide the question of where a company was resident which carried on business in foreign parts, but was controlled from this country. In these cases, board meetings were regularly held in London, for example, and fundamental decisions relating the company’s business were made there. Result: according to the judges, the company was UK resident.

Traditionally English tax law uses the phrase “central management and control”, to determine where the company should be treated as resident, and a term more often used in international tax law is “place of effective management”. Wherever that is, there is the company’s residence, even if the company is actually incorporated in a different country completely.

So, by definition, a company can only be resident under the central resident and control criterion in one country. It’s the country where the most fundamental decisions relating to the company are made: not where its day to day business, or even administration takes place, but where the directors actually make their key decisions like opening and closing branches, changing the nature of the company’s trade, hiring and firing board members etc.

So let’s get back to the basic question: how do I ensure that my Guernsey incorporated company is not caught for UK residence?

In what you might call the “good old days”, people seem to have got away with being very casual about this question. The orthodoxy was that, all you needed to do was hold board meetings once a year in some non UK location.

Like a lot of tax mythology, this was never actually true, but passed muster as if it were. HMRC have got a lot cuter to this sort of practice now, though. They tend now to go beneath the surface of the nicely produced annual board minutes, and ask searching and often embarrassing questions about where the decisions of the directors actually were made. It’s no good flying out to the Cayman Islands to minute a decision that you and you fellow directors have already made in London.

This problem is particularly acute in cases where there is really only one dominant individual personality on the scene. The taxman sneers cynically at your suggestion that that individual waits until he lands in Cayman before deciding what to do next with his company. Actually, of course, the Inspector will say, he must have already decided what he was going to do with his company long before he got there, and that decision was actually probably made in his bath in England. (Does any of this sound to you completely absurd? Well, if it's any comfort, it does to us as well, but the rules are the rules.)

So it's essential to have the situation where the real decision making process is outside this country. Where you have a UK individual involved, as you usually will in these cases, make sure you have another individual, preferably non UK resident and who doesn't come here very often, involved as well. Make sure that fundamental decisions relating to the company's future direction etc have to be made by a consensus of the individuals, and above all, keep careful evidence of actual decisions made and the location of those decisions.

This is one of those areas where tax law is still, frankly, stuck in the 19th Century. With communications such as email, video conferencing, or even the old fashioned telephone, a question such as "where was this decision made?" can become a complete nonsense question. But you should obviously avoid one of the potential candidates for the answer to that question being the United Kingdom.

Because of the increasing concentration of HMRC on questions of company residence in recent years, the key word, that cannot be emphasised strongly enough, is Evidence. Even if you've played the game completely according to the rules, this won't get you home and dry unless you have solid evidence of the control of the company taking place physically abroad.

Where should the company be treated as resident? Presumably a company has to be resident somewhere? The answer to this question in practice is usually some tax haven jurisdiction such as the Channel Islands, The Isle of Man, or wherever suits the geographical convenience of the individuals concerned. Most tax havens have a rule that companies resident in their territory are not chargeable to their local tax on certain criteria, usually that the beneficial owners of the company are not resident in the tax haven concerned, and the company carries out no physical business in the tax haven concerned.

Transfer of Assets Abroad

And now we come to what may be the most difficult hurdle of the three.

Let's suppose that you have established profits which are not being made in a UK fixed base, and those profits are going through the books of a company which you have successfully established as not being centrally managed and controlled in the UK. So far so good. But you also have to avoid the UK "transfer of assets abroad" legislation.

Like most of our tax law, these rules have recently been re-written in a new "clear" format. The effect of the re-write, interestingly, is that three or four sections of the old Taxes Act have now found their way into thirty-eight sections of the new Act! So we'll paraphrase brutally, here.

Basically, we are talking about some fairly wide ranging anti-avoidance rules. Where a person who is UK resident has made arrangements as a result of which income is received by a non UK resident person, and that income is expected to go to the UK resident at some point in the future, or actually goes to any other UK resident in the present, then the UK resident individuals concerned end up paying tax as if the foreign person's income was theirs.

To explain that rather convoluted sentence by way of an example, let's say you have a web based business, and you set up the file server in the Isle of Man, through an Isle of Man incorporated company. You yourself are UK resident, though. But for the transfer of assets abroad legislation, your Isle of Man company's income would be outside the UK tax net, providing you make sure that it is centrally managed and controlled outside the UK. That is, you've passed both the fixed establishment test (because there's no fixed establishment in the UK for this business) and the company residence test, (because you successfully established that the Isle of Man company isn't UK resident). But the company is one in which you, or a trust you've set up for your own benefit, own all of the shares. Therefore the expectation is that you will ultimately benefit from the income, either by payment of dividends to yourself or by ultimate sale or wind up of the company. So the Isle of Man company's profits are treated as taxable directly on you.

If you are caught by these rules, this is definitely a case of shooting yourself in the foot, because the alternative, of putting the income through a UK company, would have at least have meant that you would be paying tax at the corporate rates of 21% to 28%. Being clobbered under the transfer of assets legislation means that you pay personal income tax at 40%, or indeed 50% from next year.

So how do you get out of this apparently all embracing regime?

There are two ways: either you can establish that there are commercial reasons, to the effective exclusion of tax planning reasons, why you set things up the way you did, or you can be a non UK domiciliary who claims the “remittance basis” of taxation.

One powerful argument for having a commercial motive is if the local jurisdiction, wherever you have set up the business, actually requires you to set it up through a locally incorporated company. If you have an important business partner located in the non UK country, this is also a strong reason for having a non UK based person and business. You might even succeed with the Isle of Man, tax haven though it is, if you can convince the Revenue that the reason your file server is there because of the particularly good internet cable connections between the Isle of Man and countries such as the United States.

The other get out clause, available for non UK domiciliaries, is much easier to establish. If you are non UK domiciled, it doesn't matter if your sole reason for setting up the arrangements in this way was the most blatant tax avoidance: the rules exclude you from tax providing you don't remit the money to the UK and providing, if you have been long term resident here, you pay up your £30,000 on the nail every year, which is now a condition of enjoying the “remittance basis”.

So those are the three hurdles, fixed base, corporate residence, and transfer of assets abroad, that you need to get over to escape UK tax on your business profits. The question of what offshore jurisdiction to use, and also the question of how to get the profits ultimately to yourself as a UK resident in a tax efficient manner, are separate questions, and we have already gone on long enough here without turning this piece into a complete treatise on offshore tax planning. This is, after all, intended to be “O level” international tax planning, and not some kind of degree course. But avoiding UK tax on business income in the first place is an obvious first requirement in order to do any effective tax planning. For the complete

picture, keep reading our lines, and, before doing anything major and irrevocable, bounce your initial ideas off a suitably qualified tax adviser. Without wanting to be too obvious, you will find the contact details for one of these immediately below!

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