LEGAL ASPECTS OF INTERNATIONAL TAX PLANNING FOR SPORTSPEOPLE AND ENTERTAINERS: A Critical Examination from a UK Perspective, with Comparative Analysis from a US Perspective, of the Degree to which Offshore Financial Centres Can Provide Effective Tools for International Tax Planning for Sportspeople and Entertainers

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Contents

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ABSTRACT

LEGAL ASPECTS OF INTERNATIONAL TAX PLANNING FOR SPORTSPEOPLE AND ENTERTAINERS: A Critical Examination from a UK Perspective, with Comparative Analysis from a US Perspective, of the Degree to which Offshore Financial Centres Can Provide Effective Tools for International Tax Planning for Sportspeople and Entertainers

No consolidated published work exists on the subject matter of this research. In 1983 a UK doctoral thesis stated that academic research into international tax law was in its early stages of development. Today, with the increasing globalisation of finance, the growth in offshore financial centres and the unprecedented mobility of capital and labour, the need for such continued research is compelling. This thesis seeks to increase the body of knowledge and analysis in that area international revenue law concerned with the use of offshore financial centres in international tax planning. The specific focus for the study is sportspeople and entertainers, arguably the most mobile business individuals in the world.

Offshore financial centres, by virtue of their low tax regimes and their provision of offshore companies, offshore trust and offshore limited partnerships, are widely considered to provide opportunities for tax avoidance for high earning and high net worth individuals in the developed world. The hypothesis tested in the thesis is whether offshore financial centres provide effective tools for international tax planning for sportspeople and entertainers from a UK perspective (with a comparative analysis from a US perspective).

Three themes weave themselves through this work. There is the theme of the taxation of sportspeople and entertainers, together with the relevant domestic and international anti-avoidance provisions. There is the theme of comparative tax law, between the UK and the US, and between Jersey (offshore UK) and the Cayman Islands (offshore US). The third theme involves an analysis of offshore financial centres themselves, their history and characteristics, and their corporate, trust and partnership vehicles.

This thesis has been researched and written up during the current debate within the OECD, the G7 countries and the EU on 'unfair tax competition'. The thesis consequently joins the debate on whether offshore financial centres by driving down the effective tax rate levied on income from mobile activities cause harm on a global scale.

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INTRODUCTION

The aim of this research is to provide a critical examination from a UK perspective, with comparative analysis from a US perspective, of the degree to which offshore financial centres can provide effective tools for international tax planning for sportspeople and entertainers, individuals referred to collectively in this work as 'performers'.

Professional sport and entertainment is today very big business and global in nature. It has been asserted that it is entertainment (for these purposes including sport), more than defense spending, automobiles, steel and financial services, that is fast becoming the driving wheel of the new world economy.[1] In the UK popular music "has outperformed the UK's economic output by 2% a year since the early 1980s."[2] In the United States alone entertainment is a $480 billion industry.[3] It ranks above clothing and health care as a percentage of household spending.[4] In twenty years to 1993, consumer spending in the sport, media and entertainment sector of the US economy rose at twice the rate of overall consumer spending.[5] The $340 million spent in 1993 may be broken down into passive, active and hardware entertainment. In the passive category, $13 billion was spent

[1] Wolf M.J. The Entertainment Economy: How Mega-Media Forces Are Transforming Our Lives New York, Random House (1999) p. 4
[2] J. Harlow 'Breaking Records' The Sunday Times, 31 October 1999, p. 21
[3] Wolf M.J., op. cit.

on movie tickets and film-video rentals, $19 billion to watch cable television, and $10 billion for recorded music. In active category, $12 billion was spent to see sporting events, musical concerts, and other kinds of live entertainment, $14 billion to attend amusement and theme parks, and some $28 billion on gambling.[6] The largest element of the total money spent on entertainment is in the hardware category: toys and sporting equipment accounting for $65 billion, VCRs, televisions, CD players, and videotapes $50 billion, and $50 billion on books, magazines, and newspapers.[7]

So dominant a force is entertainment in the economies of the developed countries that a seminal[8] article in the Harvard Business Review in 1998 has suggested that the companies that succeed in the future will be those that incorporate entertainment into the products they provide to their consumers, thereby creating an 'experience economy'.[9] The argument runs that first there was agriculture, then manufactured goods, and eventually services, each change representing a step up in economic value, and a way for producers to distinguish their products. Now, as services are themselves becoming standardised, companies are looking for the next higher value in an economic offering. Leading-edge companies, the argument concludes, are finding that it lies in staging experiences, drawing

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[4] Ibid.
[5] Vogel H.L. Entertainment Industry Economics Cambridge, Cambridge University Press (1994)
[6] Ibid.
[7] J.P. Kraft 'American entertainment in the 1990s' Business & Economic History, Winter 1997, Vol. 26, No. 2, p.805
[8] The article has given rise to much subsequent academic comment and its thesis is developed by Wolf M.J., op. cit.
[9] J.H. Gilmore 'Welcome to the Experience Economy' Harvard Business Review, July, 1998 / August, 1998, p. 97

lessons from the pioneer experience providers, the Walt Disney Company.[10]

The growth of the entertainment industry is reflected in the rise in the income and wealth of the performers themselves. From a UK perspective, the Sunday Times 'Rich List 1998',[11] which featured Britain's wealthiest 1,000 richest individuals in 1998, included sports figures such as golfer Nick Faldo,[12] boxer Lennox Lewis[13] and formula one racing driver Nigel Mansell,[14] alongside entertainers such as singer-songwriter George Michael,[15] guitarist Eric Clapton[16] and Noel and Liam Gallagher of the rock band Oasis.[17] The wealth of former Beatle, Sir Paul McCartney, was estimated by the Sunday Times to be £500 million, making him the 29th wealthiest person in Great Britain.

Though substantial, the earnings of UK sportsmen and entertainers are dwarfed by the earnings of performers in the US. In 1997 alone the comedian Jerry Seinfield earned £140 million, the film director Steven Spielberg earned £109 million and the TV host Oprah Winfrey earned £78 million.[18] The highest earning US sportsman was the basketball player Michael Jordan with £53 million, followed by the boxers Evander Holyfield (£36 million) and Oscar De La Hoya (£26

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[10] Iibd.
[11] 'The Sunday Times Rich List 1998: Britain's Richest 1,000' CD Rom
[12] Estimated wealth in 1998: £50 million; ranked joint 428th wealthiest individual in Great Britain.
[13] Estimated wealth in 1998: £25 million; ranked joint 769th wealthiest individual in Great Britain.
[14] Estimated wealth in 1998: £35 million; ranked joint 617th wealthiest individual in Great Britain.
[15] Estimated wealth in 1998: £50 million; ranked joint 428th wealthiest individual in Great Britain.
[16] Estimated wealth in 1998: £75 million; ranked joint 294th wealthiest individual in Great Britain.
[17] Estimated wealth in 1998: £25 million; ranked joint 769th wealthiest individual in Great Britain.
[18] Source Forbes Magazine as quoted in M. Watson 'Stand up and be counted, £140m-a-year Seinfield', Evening Standard, 8 September 1998

million).[19] It is notable that most of these performers are self-employed,[20] but salaries for performers in employment can also be substantial. Schumacher's £52 million three-year contract with Ferrari sustains his position as earning, at £17.33 million a year, one of the highest salaries in sport.[21]

The earning potential of international performers serves to make them substantial business entities in themselves. Established international businesses have traditionally used offshore financial centres in their tax planning structures. Unsurprisingly, international performers have followed a similar route, though in doing so they have attracted a large degree of hostile attention from the popular media.

Much anti-avoidance tax legislation has been passed in the UK, aimed at taxpayers generally and, specifically, at non-resident sportspeople and entertainers. Both the UK and the US apply withholding tax to the earnings of non-resident performers.[22] Double taxation treaties invariably contain a specific Article denying to sportspeople and entertainers the benefit of not being subject to tax in the Contracting State in which they perform, a benefit granted under the same treaties, in general terms, to business people engaged in virtually every other endeavour. This denial is increasingly extended to the performer's service company. Moreover, the ever-expanding anti-treaty shopping provisions, notably

[19] A.Henry 'Motor Racing: Bait of pounds 52m for Schumacher', The Guardian (London), March 13, 1998, p.10

[20] Michael Jordan was employed Chicago Bulls, but the majority of his income was generated by sponsorships, endorsements and personality merchandising.

in US treaties, serve to limit the degree to which offshore financial centres may be successfully incorporating into the tax planning structure of taxpayers generally. The judiciary too, with varying waves of intensity, have been active in striking out tax saving benefits from tax minimisation schemes adjudged to contain elements of artificiality.

In their 1987 report on the taxation of income derived from entertainment, artistic and sporting activities the Organisation for Economic Cooperation and Development (the OECD) commented as follows on the problems of taxing sportspeople and entertainers:

> *"Sophisticated tax avoidance schemes, many involving the use of tax havens, are frequently employed by top-ranking artistes and athletes. Whilst some countries do not consider such activities of major importance, given the limited number of persons involved in international activities of this sort and the relatively small amount of revenue involved, there is general agreement that where a category of – usually well-known – taxpayers can avoid paying taxes this is harmful to the general tax climate, which therefore justifies co-ordinated action between countries."*[23]

Warming to their theme, the OECD painted a somewhat unflattering portrait of performers and their advisors:

> *"The problems of effectively taxing artists and athletes are rooted in the diverse forms their activities take. Success can be sudden but ephemeral. Relatively unsophisticated people - in the business sense - can be precipitated into great riches, income sources can be many and varied. Travel, entertainment and various forms of*

[21] A.Henry 'Motor Racing: Bait of pounds 52m for Schumacher', op. cit.
[22] See Chapter 1, section 1.6.5.4; and Chapter 2, section 2.3.
[23] OECD Taxation of Entertainers, Artistes and Sportsmen Paris, OECD (1987), para. 7

ostentation are inherent in the business and there is a tendency to be represented by adventurous but not very good accountants."[24]

This view, unsurprisingly not wholly shared by many advisors to the sport and entertainment industry,[25] does find a strong resonance in the popular press.[26] Where the press credit the sports person or entertainer with a sophisticated approach to business and financial affairs, reference to his or her use of a tax haven or offshore financial centre is seemingly *de rigueur*, however inaccurate the accompanying analysis. Of rock musician David Bowie, the UK Daily Express has written:

> *"Bowie's wealth ... is attributed to a keen business brain. He decided to take control of his purse strings and invest much of his fortune overseas to avoid crippling tax demands... Bowie, with his supermodel wife Iman, made the shrewd move of uprooting all his companies to Switzerland where there is no tax payable on net profits."*[27]

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[24] Ibid., para. 8

[25] In their 'Sportlight' article on 'International Taxation of Entertainers and Athletes: Report by Organization for Economic Cooperation and Development', Legal Affairs Section, Entertainment Law Reporter, Vol. 10, No. 4, September, 1988, V. Abrams, C. S. Andersson, et.al. note, quite reasonably, "...there is also a growing tendency for entertainers and athletes to be sophisticated in business matters and to be represented by non-adventurous, highly qualified accountants."

[26] From a domestic perspective, one need only turn to the recent obituary of the children's entertainer and puppeteer Rod Hull to read the familiar morality tale of 'simple man wins fame - overspends - poor advisor - Inland Revenue - bad end': *"'It was a wonderful time. Life could not have been better,' remembered Hull, who, at the time [the 1970's], could command £5,000 per show... However, he soon experienced difficulties similar to that of his fellow entertainer Ken Dodd. [In 1986 he] bought Restoration House, a 32-roomed Elizabethan mansion in Rochester, Kent, which he hoped to restore to its original splendour... However, the Eighties property boom bubble burst and, by the turn of the Nineties, Hull's £350,000 investment became an albatross around his neck. An unscrupulous accountant didn't help. 'I didn't realise how bad things were until I received a buff envelope from the taxman saying I hadn't paid tax for five years. Ever since I'd started in show business, I'd had the same person to manage my money. It was someone I trusted absolutely,' he said... The house was eventually requisitioned by the Receiver to help pay a huge tax bill and in October 1994, Hull was declared bankrupt."* The obituary concluded that Rod Hull "fell from grace because of over-exposure, mismanagement and his own naïve nature." See P. Perrone Obituary: Rod Hull, The Independent (London), 19 March 1999, p.6

[27] J Chapman 'Singing all the way to the bank' The Express, 29 October 1997, p. 16

In fact Swiss resident companies are liable to corporation tax on all sources of income and capital gains.[28] From 1 January 1998, the federal direct tax is levied at a flat rate of 8.5% on taxable income.[29] The cantonal and municipal tax rates, which are levied in addition to the federal rate, can vary between 17% and 32%. The company residency rules in Switzerland are similar to those in the UK, explored in Chapter 3, section 3.3.2. A company is treated as Swiss resident if it is incorporated in Switzerland or if its place of management is in Switzerland. Thus a foreign incorporated company may be treated as by the Swiss Revenue authorities as resident in Switzerland if it is managed there. Even if Bowie's 'uprooting all his companies to Switzerland' did not result in them becoming Swiss resident, becoming instead domiciliary companies,[30] thereby potentially escaping cantonal and municipal taxes on income derived from abroad,[31] they would still fall in charge to Swiss federal taxation.

However, technical accuracy is all too often sacrificed by the popular media in order to reinforce a preconceived picture of the life of a star, full of high income, consumptive excess, and low tax liabilities through the advice of sharp tax lawyers and accountants making use of offshore financial centres. This is not to

[28] This rule applies wherever the profits arise, unless specifically exempted, such as profits of a foreign branch.

[29] The effective rate is 7.8% because the federal tax is itself tax-deductible; i.e. 8.5/108.5 = 7.8.

[30] The definition of a domiciliary company varies depending on the canton in which it is registered. In broad terms, a domiciliary company:

- is registered in a particular canton and has no more than a registered office with a local agent (for example, law firm, trustee company or service company) in that canton;
- is managed from abroad;
- does not have Swiss offices (apart from the registered office), or staff in Switzerland or carry out business activities in Switzerland; and
- only receives foreign source income

suggest that sportspeople and entertainers do not frequently attempt to use offshore financial centres in their tax minimisation strategies. The issue taken with the media is that they portray such plans as going unchallenged by the tax authorities. The OECD report highlighted several tax minimisation schemes and arrangements which it sought to develop techniques to curtail.

> *"In a typical case of a 'slave agreement', the performer receives a salary from a foreign employer for services undertaken in the country of performance. There is no legal relationship between the domestic promoter of an event and the entertainer. The foreign company enters into a contract with the promoter. This provides for a lump-sum payment which represents the fee for the entertainer's appearance as well as a fee for the company for planning and organization. This payment is usually made abroad, often before the performance is given. As contracts are signed and other business is done abroad, it is not possible to contend that the company is carrying on a trade or business in the country of performance. Many of these foreign employers are companies controlled by the performers themselves and are based in tax havens (rent-a-star companies)."*[32]

The report also made mention of arrangements by which resident – usually well-known – performers endeavour to take themselves out of the self-employed status into a dependent one for the purpose of accumulating income abroad "by setting up a sham company in a tax haven ."[33]

International tax planning for athletes recognises their short career and is often concerned with spreading their income to even the tax burden, rather than eliminating the tax burden altogether. In this sense, tax planning is a constituent part of the athlete's financial planning, the absence of which would be evidence of

[31] The degree of exemption depends on the canton in which the companies are registered.
[32] Op. cit., para. 26

imprudence and neglect. There is a poignant reminder of the consequences of inadequate tax planning in the press coverage of the 1998 boxing context of the former world boxing champion Roberto Duran.

> *"After 31 years in the ring, Roberto Duran's 'Hands of Stone' crumbled to dust as William Joppy gave him a fierce two-fisted beating before, in the third, referee Joe Cortez rescued the poor, dazed veteran, who was stumbling about like someone caught in an earthquake... Roberto took this fight because he owed America's Internal Revenue Service $300,000. His purse was $250,000, so he was back fighting for nothing, just like he had so many years before in the dusty streets of Panama until some laughing tourist would toss him a dime... There is something genuinely tragic about a gifted, poverty-stricken kid who can make $50 million, only to end up fighting as a sad slow-moving grandfather because he can't pay his tax bill."*[34]

In the Chapter I of his 1983 PhD thesis on tax havens,[35] Michael Grosh noted that research into international tax law is in its early stages of development. "Academic research into tax law ... has been conducted primarily at the local level. Research in Britain is mainly conducted for British Tax law, while research in Canada is done on Canadian law."[36] He continued:

> *"Why has more academic research not been undertaken? The answer to this query arises from the inherent nature of the required research. To effectively research tax law, one must possess a good understanding of the operation of tax law in general. This understanding is patiently applied on an international scope. On an international scale, more countries are considered with more complications and constant changes. The scope of international tax law is volatile in its changing nature, which requires the utmost care being taken for efficient analysis.*

[33] Op. cit., para. 39
[34] 'Duran Can't Cheat Hands Of Time' Boxing News, September 4, 1998, pp. 18-19
[35] Grosh M.H. A Simulation of Tax Haven Selection Procedures Unpublished PhD thesis, University of Bradford (1983)
[36] Ibid., p. 8

Expertise in all aspects of international law is an impossibility, a consultant must choose a particular sector as the object of his abilities."[37]

The 'sector' of international tax law examined in this thesis is the use of offshore financial centres in international tax planning. In the process three themes weave themselves through this work. There is the theme of the taxation of sportspeople and entertainers, from a domestic and an international perspective. There is the theme of comparative tax law, primarily between the UK and the US, but also between Jersey and the Cayman Islands. The third theme involves an analysis of offshore financial centres, their history and characteristics, and their corporate, trust and partnership vehicles.

Underlying these themes is the premise that the use of offshore financial centres in international tax planning for sportspeople and entertainers is a legitimate activity in a moral, jurisprudential, political and economic sense. This premise is presently being challenged by the debate on 'harmful tax competition', which this thesis joins in Chapter 3, section 3.7.

This thesis addresses international tax planning as it relates to taxes on income, profits and gains. Taxes on inheritance, capital transfers, sales and value added are not considered, except in passing.

The thesis does not address the crime of tax evasion, rather it focuses on international tax planning; that is, tax avoidance, the lawful process whereby

[37] Ibid.

taxpayers arrange their affairs so as to minimise their exposure to taxation. Similarly, whilst acknowledging that offshore financial centres have been used in the crime of money laundering, this issue is not addressed in this work. In focusing on offshore financial centres, the thesis is concerned solely with their legitimate use in international planning.

Chapter 1 examines the taxation of sportspeople and entertainers from a UK perspective and Chapter 2 makes a similar examination from a US perspective, drawing comparisons and highlighting contrasts with the UK tax system. These chapters deal with the taxation of performers, resident and non-resident, their service companies, resident and non-resident, and their trust structures, resident and non-resident. This forms the basis for the discussion in the subsequent chapters on the comparative effectiveness from a UK and US perspective of the use of offshore companies, offshore trusts and offshore limited partnerships in international tax planning for sportspeople and entertainers.

Chapter 3 explores the offshore financial centre, both from an historical perspective and from a current legislative perspective. Maintaining the UK/US comparative study, the review of the historical development of offshore financial centres focuses on Jersey, representing 'offshore UK', and the Cayman Islands, representing 'offshore US'. The current legislative enactments in Jersey and the Cayman Islands, as they pertain to offshore companies, offshore trusts and offshore limited partnerships, are analysed in detail, and the potential uses of these offshore vehicles in international tax planning for sportspeople and entertainers are set out, together with the relevant anti-avoidance provisions in the UK and the US.

Chapter 4 is a study of how double taxation treaties affect the taxation of sportspeople and entertainers. The relevance of this chapter rests on the fact that the offshore vehicles discussed in Chapter 4 will be used for tax minimisation purposes by performers in countries that have a developed sports and entertainment industry, for such countries also have an established network of double taxation treaties. In addition to studying the OECD Model Treaty, the relevant provisions of the current UK:US treaty are examined in detail. The issue of treaty shopping, whereby a person seeks to obtain benefits under a double taxation treaty between the two countries though being a resident of neither, is explored with emphasis on persons resident in offshore financial centres.

Chapter 5 exemplifies and expands on the analysis in chapters 1, 2, 3 and 4 by means of four original case studies. Each case study explores the efficacy of using offshore financial centres in international tax planning for a sportsperson or entertainer, both from a UK and US perspective. In so doing they address a range of tax issues including residence, ordinary residence, domicile, the recognition of offshore companies, the determination of sham corporations or transactions, anti-avoidance measures in the UK and the US, withholding tax in the UK and the US, the recognition of royalty income, double taxation treaties, treaty shopping, offshore service companies, offshore licensing companies, offshore limited partnerships and offshore trusts. The case studies involve an actress, a boxing champion and a four-piece UK rock band.

This research is based principally on primary sources of information; references to secondary sources have been made where pertinent. Finally, throughout this thesis, as regards to application of the laws of taxation to individuals, references to the male gender include the female gender, and vice-versa, unless this is clearly not so by reference to the context.

CHAPTER 1

THE SYSTEM OF TAXATION AS APPLIED TO SPORTSPEOPLE AND ENTERTAINERS IN THE UK

1.1 INTRODUCTION

This chapter examines the UK tax regime as it affects sportspeople and entertainers, both from a resident and non-resident perspective.

In common with other jurisdictions, resident sportspeople and entertainers do not have a special tax regime in the UK. They are taxed according to the same general principles as other self-employed or employed individuals. There are special factors that apply to performers, including allowable deductions under Schedule D, Case II,[1] and the nature of emoluments under Schedule E,[2] and these have been addressed in this chapter. Non-resident performers are subject to special withholding tax rules in the UK,[3] and these are set out in section 1.6.5.4 below.

No discussions of the taxation of any group of individuals within the UK can properly take place without first setting out the UK's schedular tax system. In short, for tax purposes income is classified in the UK by reference to its source,

[1] See section 1.3 of this work.
[2] See section 1.4 of this work.
[3] ICTA 1988 s. 555

be it from within the UK or from overseas. The rules for computing the tax charge differ depending on the schedule (and case) into which it falls. The six schedules, and relevant cases, are as follows:

Schedule A	Rents or receipts from land in the UK.
Schedule B	The annual value of woodlands in the UK managed on a commercial basis (abolished for 1988–89 onwards).[4]
Schedule C	Profits from public dividends in the UK and abroad (abolished from 1996–97 onwards).[5]
Schedule D	
Case I	Trade profits.
Case II	Profits of a profession or a vocation.
Case III	Interest, annuities and other annual payments.
Case IV	Income from foreign securities.
Case V	Income from foreign possessions.
Case VI	Profits of an income nature not charged under any other Schedule or Case and certain income specifically charged under this Case.
Schedule E	
Case I	Income from offices, employments and pensions.
Case II	Foreign employment income
Case III	Foreign employment income.
Schedule F	Dividends and other distributions of companies resident in the UK.

This chapter deals with Schedule D (Cases II, V and VI) and Schedule E. These are the schedules of most direct applicability to those tax issues that are most relevant to performers. From the domestic perspective, one of the most important

[4] FA 1988, s. 65 and Sch. 6
[5] FA 1996, s. 79

issues is the classification of their trading status; namely, whether they are employed or self-employed.

1.2 EMPLOYED v SELF-EMPLOYED

The employed/self-employed distinction for performers was recently summarised by the author in a published article for tax practitioners:[6]

> *"The Schedule E and Schedule D [Case II] distinction for income tax purposes is very relevant to sportsmen and entertainers whose short contracts often have characteristics of both employment and self-employment. The standard distinction between a contract of service (employment) and a contract for services (self-employment) must be applied to each case... Most full-time professional entertainers are now taxed under Schedule D [Case II]. This applies today even under standard equity contracts following the 1993 successful appeal by [two] actors ... against the Revenue's classification of their income under Schedule E. The main exception to this rule is where the entertainer operates under a specific long term contract with his orchestra or, as in the case of* Fall v Hitchen,[7] *a dancer's contract with an opera company. In these and similar circumstances, the entertainer is taxed under Schedule E. The employed/self-employed distinction for professional sportsmen and women is, in many respects, easier to determine. Those engaged in team sport, such as football and cricket, are employees of their clubs; whereas those engaged in individual sports, such as boxing and golf, are self-employed."*[8]

Even where a performer is classified as an employee in respect of his 'performing' income,[9] the sponsorship, personality merchandising and

[6] T.L. Thomas *'Focus on Sportspeople and Entertainers'* Tolley's Practical Tax Supplement (October 1997) p.168
[7] [1973] STC 66
[8] T.L. Thomas, op. cit., p.168b
[9] In this contest an individual's 'performing' income refers to the income he enjoys directly from the exercise of his sporting or entertaining activity.

endorsement income he enjoys from activities not directly connected with and not regulated by his employment will arise in his capacity as a self-employed individual. Thus in the current highly commercialised world of sport and entertainment it is not uncommon for a performer to enjoy sources of income within a fiscal year which fall to be taxed under Schedule E and Schedule D(II). This section however specifically focuses on the degree to which 'performing' income itself can be said to arise from an employment or self-employment.

The effect of the distinction between Schedule E and Schedule D(II) is significant. Individuals taxed under Schedule E (employees) are subject to pay-as-you-earn ('PAYE'). That is, their income is taxed at source by their employer and paid over to the Inland Revenue on their behalf. In contrast, under the current self-assessment legislation those taxed under Schedule D(II) (the self-employed) are responsible for their own tax affairs and pay their tax semi-annually on 31 January and 31 July. But the timing of the payment of tax is not the key distinction for the taxpayer. The key distinction lies in the allowable deductions of expenditure for tax purposes. Under Schedule D(II) a taxpayer may deduct from his income all expenditure "wholly and exclusively laid out or expended for the purposes of the trade, profession or vocation."[10] Whereas individuals taxed under Schedule E may only deduct expenses "expended wholly, exclusively *and necessarily*[11] in the performance of the duties of the office or employment."[12]

[10] ICTA 1988 s.74(1)
[11] Emphasis added

The inclusion of the word 'necessarily' in the provisions relating to the deductibility of expenditure for tax purposes under Schedule E serves to restrict severely those expenses qualifying for tax relief. A recent case is illustrative. In *Fitzpatrick v IRC* [13] five employed journalists were seeking tax relief on monies laid out for newspapers and journals. The Special Commissioners rejected the claim and their decision was upheld by the Court of Session.[14] In the Case Stated, the Special Commissioners, referring to the narrow nature of the test to be applied under Schedule E, set out the following:

> *"We find that the 'wholly and exclusively' test is satisfied in this case. To succeed, however, the taxpayers [as employees] also have to satisfy the further requirements of the subsection [ICTA 1998 s.198(1)], that they were 'necessarily obliged' to incur the expenditure 'in the performance' of' the duties of their employment, that is to say in the course of performing those duties. Those requirements impose an objective test which is notoriously rigid and difficult to satisfy."* [15]

The rigidity of Schedule E in respect of allowable expenses has led most performers to seek a Schedule D(II) classification whenever possible. The Inland Revenue, for their part, concerned over a potential loss of tax revenue to the Exchequer, have sought to challenge the D(II) status of performers, preferring a Schedule E classification.[16] The view of the Inland Revenue has been (and continues to be) that often what a performer views as self-employment, with a succession of different clients, is in fact a series of different employments with a

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[12] ICTA 1988 s.198(1)
[13] [1992] STC 406
[14] Lord McCluskey dissenting
[15] [1992] STC 406, at p.423
[16] See R. Harvey and R. Baldwin Tax and Financial Planning for Sportsmen and Entertainers, London, Butterworths (1994) pp.19-20

succession of different employers. The Revenue are keen to prevent the expansion of Schedule D(II) status at the expense of Schedule E. This was highlighted at the conclusion of Nolan's LJ's judgment in the 1993 case of *Hall v Lorimer*,[17] where referring to Peter Goldsmith QC for the Crown, he stated that:

> *"Mr Goldsmith told us that in pursuing this appeal the Revenue were not trying to extend the scope of the Sch. E charge but were concerned to prevent it from being eroded in the case of casual employments."*[18]

This case concerned a vision mixer whose role was to select the images to appear on the screen in the making of television programmes. He had a client list of some twenty-two production companies and his engagements usually lasted for one day or two. Filming usually took place in a studio with the production company providing the expensive equipment required. The Inland Revenue contended that these were a series of employments. Mr Goldsmith relied on the most useful test in support of his contentions, being that formulated by Cooke J in *Market Investigations Ltd v Minister of Social Security:*[19]

> *"... the fundamental test to be applied is this: 'Is the person who has engaged himself to perform these services performing them as a person in business on his own account?' If the answer to that question is 'yes,' then the contract is a contract for services. If the answer is 'no,' then the contract is a contract of service. No exhaustive list has been compiled ... of the considerations which are relevant in determining that question... [t]he most that can be said is that control will no doubt always have to be considered ...*

[17] [1994] STC 23
[18] [1994] STC 23, at p.32
[19] [1969] 2 QB 173

[together with] ... such matters as whether the man performing the services provides his own equipment, whether he hires his own helpers, what degree of financial risk he takes, what degree of responsibility for investment and management he has, and whether and how far he has an opportunity of profiting from sound management in the performance of his task."[20]

In applying this test Mr Goldsmith argued that the taxpayer was not self-employed because the production companies always controlled the time, place and duration of each programme. They also provided all of the equipment. The taxpayer hired no staff to assist him in his work; he ran no financial risk other than the risk of bad debts; he had no responsibility for investment in or management of the programmes he worked on; and, consequently, he had no opportunity of profiting from the manner in which he carried out his individual assignments.

Such a test, though supported by no less a jurist than Lord Griffiths in a Privy Council judgment,[21] would, if adopted in an unrestricted manner, have had a major impact on the employment status of sportspeople and entertainers whose services do not have the characteristics of a business. This was recognised by Nolan LJ who expressed the position thus:

"[T]he special feature specified in the ... list would be found in the case of many individuals who exploit their talents in the theatrical, operatic, or sporting fields but who are nonetheless independent contractors... A self-employed author working from home or an

[20] [1969] 2 QB 173 at pp. 184-185

[21] As stated by Nolan LJ in Hall v Lorimer at p. 27: "In Lee Ting Sang v Chung Chi-Keung & Anor [1990] 2 AC 374 Lord Griffiths delivering the judgment of the Privy Council said at p. 382 that 'the matter had never been better put' than by Cooke J in the passage in question."

actor or a singer may earn his living without any of the normal trappings of a business."[22]

In providing an effective rebuttal to the case made by applying the factors set out by Cooke J, Nolan LJ quoted with approval from the opinion of the Special Commissioner who first heard the case and who found in favour of the taxpayer.[23] However, Nolan LJ expressed a preference for avoiding the application of the test or indicia set out by Cooke J, preferring to agree with the "views expressed by Mummery J in the present case", namely:

> *"In order to decide whether a person carries on business on his own account it is necessary to consider many different aspects of that person's work activity. This is not a mechanical exercise of running through items on a check list to see whether they are present in, or absent from, a given situation. The object of the exercise is to paint a picture from the accumulation of detail. The overall effect can only be appreciated by standing back from the detailed picture which has been painted, by viewing it from a distance and by making an informed, considered, qualitative appreciation of the whole. It is a matter of evaluation of the overall effect of the detail, which is not necessarily the same as the sum total of the individual details. Not all details are of equal weight or importance in any given situation. The details may also vary in importance from one situation to another. The process involves painting a picture in each individual case."*[24]

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[22] [1994] STC 23, at p. 30

[23] [1994] STC 23, at p. 29: "... Mr Lorimer [the taxpayer] provides no equipment (i.e. he has no tools), he provides no "work place" or "workshop" where the contract is to be performed, he provides no capital for the production, he hires no staff for it. No; he does not. But that is not his business. He has his office, he exploits his abilities in the market place, he bears his own financial risk which is greater than that of one who is an employee, accepting the risk of bad debts and outstanding invoices and of no or an insufficient number of engagements. He has the opportunity of profiting from being good at being a vision mixer. According to his reputation so there will be a demand for his services for which he will be able to charge accordingly. The more efficient he is at running the business of providing his services the greater is his prospect of profit."

[24] [1994] STC 23, at p. 29

In the *Hall* case the picture painted was one of self-employment and the Inland Revenue's appeal was dismissed. This case is today the leading case on the employed/self-employed distinction and has been relied on in the most recent cases in this area. In *Barnett v Brabyn (1996)*[25] the picture painting approach was followed to the letter,[26] and in the following year Lightman J opined in *McManus & Anor v Griffiths*[27] that:

"It is common ground that the test to be applied in determining whether in providing such services [the taxpayer] was acting as an employee or was self employed is to be found in such cases as Hall (HMIT) v Lorimer and Barnett v Brabyn (HMIT)."[28]

The problem for the performer is that a test involving an 'evaluation of the overall effect of the detail' is uncertain in nature. That said, the various *obiter dicta* in the employment/self-employed distinction cases, including that of Nolan LJ in *Hall v Lorimer* quoted above, regarding the Schedule D(II) status of singer, actors and authors, lends persuasive authority to the view that self-employment status of 'independent' performers could not be successfully challenged by the Inland Revenue.[29] Moreover, it is clear that the courts are resisting the attempt by the

[25] [1996] STC 716

[26] Lightman J at p. 724: "The difference between an employee and a self-employed independent contractor has long been formulated as follows: an employee is engaged and serves under a contract of service, whilst an independent contractor is engaged under a contract for services and performs the services as a person carrying on business on his own account. But there is no one test which is conclusive for determining into which category a particular engagement falls. There are a number of badges of one or other of the relationships and these badges depending on the context may carry greater or lesser weight. The proper course for the court in each case, no doubt after first identifying the individual badges of potential significance, is to form an overall view giving due weight to the relative significance of the various badges in the particular context: see *Hall (HMIT) v Lorimer...*"

[27] [1997] STC 1089

[28] Ibid., at p. 1099

[29] This does not mean, however, that *Fall v Hitchen* [1973] STC 66 would be decided differently today. In that case the taxpayer was a professional dancer. After finishing his training he was

Revenue to erode the Schedule D(II) status of those who have a series of different engagements. This should provide some comfort to performers who are one of the primary targets of the Inland Revenue in this area.

1.3 SCHEDULE D(II): ALLOWABLE DEDUCTIONS AND THE RECOGNITION OF INCOME

As discussed in 1.1, those taxed under Schedule D(II) may deduct from their income all expenditure "wholly and exclusively laid out or expended for the purposes of the trade, profession or vocation."[30] In contrast, those taxed under Schedule E may only deduct expenses "expended wholly, exclusively and necessarily in the performance of the duties of the office or employment."[31] This section explores the tax allowable deductions for performers under Schedule D(II). The more restrictive regime of Schedule E is explored in section 1.4.

There are no legislative provisions entitling performers to tax deductions denied to other professionals, such as accountants and lawyers. However, the special nature of a performer's trading activity sometimes entitles him or her to deductions for items that would not satisfy the 'wholly and exclusively' test for

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engaged by Sadler's Wells under a standard form of contract providing, inter alia, (a) that the engagement should last for a minimum period of rehearsals plus 22 weeks, and thereafter until determined by a fortnight's notice on either side; (b) that he should work full-time during specified hours for a regular salary; (c) that during the engagement he should not perform elsewhere without the consent of the management, such consent not to be unreasonably withheld; (d) that with one exception the management should provide and retain the property in the costumes used by him on the stage. The High Court upheld the Revenue's tax assessments raised under Schedule E. It is submitted that the picture painting approach would have led to the same conclusion.

[30] ICTA 1988 s.74(1)(a)

other sole traders. These may include deductions for expenditure on hairdressing and make-up, wardrobe and 'props', travelling to interviews and auditions, gratuities to dressers and call boys, the purchasing of records and cassettes and theatre and cinema tickets, and various physical treatments including chiropody (mainly for dancers), physiotherapy, cosmetic dentistry and trichology. This list, which is by no means exclusive, reproduces, in an abbreviated form the guidance notes from the actors' union Equity. They have no force in law, though they represent common practice on the part of accountants and tax advisors acting for performers. From a strictly legal perspective, there is a problem with most items on the list. In short, they fail the 'exclusively' test, for most of the expenditure listed has a personal benefit element. Moreover, section 74(1)(b) ICTA 1988 expressly prohibits the deduction from profits of "any disbursements or expenses of maintenance of the parties, their families or establishments, or any sums expended for any other domestic or private purposes distinct from the purposes of the trade, profession or vocation."

Taking subsections 74(1)(a) and 74(1)(b) together, any domestic or private element to expenditure (s. 74(1)(b)) would create a duality of purpose which would lead to a disallowance of the whole expenditure under the wholly and exclusively test (s. 74(1)(a)). Yet in practice the Revenue often accept expenditure with a dual purpose, simply disallowing that part of the expenditure estimated to be for private use. Indeed, it is this practice that encourages Equity to assert the tax deductibility of expenditure on hairdressing, records, cassettes,

[31] ICTA 1988 s.198(1)

theatre and cinema tickets, physiotherapy, cosmetic dentistry and trichology, each of which would usually have a domestic (i.e. personal) benefit to the taxpayer.

This is an important and under-researched area, namely that of determining why in certain areas, notably duality, revenue law and Revenue practice digress. The Revenue have to some degree formally embraced the principle of allowing (at least in part) expenditure with a dual private and business nature, as evidenced by the advice given to Inspectors of Taxes in the Inland Revenue Guidance Manuals:[32]

> *"Where an expense is such that a definite part or proportion of it is wholly and exclusively laid out or expended for the purposes of a trade, profession or vocation, that part or proportion should not be disallowed on the ground that the expense is not as a whole so laid out or expended. Examples of expenses part of which may be regarded as allowable are the running etc costs (including hire-purchase interest) of a car used partly for business and partly for private purposes and the cost of rates, lighting and heating of premises used partly as business and partly as private accommodation (see* Copeman v William Flood and Sons Ltd., 24 TC 53 *and* Wildbore v Luker, 33 TC 46*). In the same way, it may sometimes be possible, where there is a genuine business purpose in undertaking a journey for mixed purposes, to apportion the travelling expenses on the basis of the time spent on business during the period away."*[33]

[32] The Inland Revenue Manuals provide Revenue staff with guidance on the interpretation of tax law and the operation of the tax system. The manuals have been made available to the public as part of the government's code of practice on access to government information. The publishers CCH, infra, state:
"The guidance contained in the manuals will usually be applied in the normal case, unless the Revenue consider that there has been the avoidance of tax. However, the Revenue stress that it should not be assumed that the guidance is comprehensive nor that it will provide an answer in every case. Revenue staff are expected to use their own judgment, based on training and experience, to apply the guidance to the facts of a particular case. In particularly difficult or complex cases they are able to obtain further information from specialists at the Revenue's head office."

The case law relied on for this statement does not in fact support the breadth of circumstances to which this practice is applied. In *Copeman v William Flood and Sons Ltd,*[34] for example, the Revenue sought to disallow high directors' remuneration paid to young directors for fairly simple administrative tasks. The High Court remitted the case back to the Commissioners "to find as a fact whether the sums in question were wholly and exclusively laid out for the purpose of the Company's trade, and if they were not, to find how much of such sums was wholly and exclusively laid out for the purposes of the Company's trade."[35] It is submitted that there is a material difference between determining an appropriate level of remuneration for a director in order to determine the 'wholly and exclusively' element of the salary and apportioning travelling expenses on a trip taken for both business and pleasure.

It is against this somewhat uneasy backdrop of revenue law and Revenue practice that the deductibility of specific expenditure of interest and relevance to the performer is examined, followed by a brief analysis of the recognition of income under ScheduleD(II).

1.3.1 Allowable Deductions: Clothing

The deductibility, maintenance and cleaning of clothing constitutes an area of special interest for the performer. The 'wholly and exclusively' test is plainly

[33] The Inland Revenue Manuals, 'Apportionment of expense', para 601e, HMSO (as published by CCH Editions Ltd, Bicester, 1998

passed in respect of distinctive clothes worn by a performer in the course of his or her performances. These include, for example, sport kits, uniforms and costumes. Problems arise, however, where the clothes worn by a performer are not distinctive but ordinary and capable of being worn generally by the performer whilst not actively engaged in professional sport or entertainment.

It has been suggested in a professional tax publication, for example, that "the cost of [an actor's] ordinary clothing that is also worn outside the theatre will be subject to some restriction for private use, even where it is necessary for, say, a TV personality or actor to buy particularly expensive clothing for his public image."[36] This is an overly generous interpretation of the duality principle. It is far more likely that the entire cost would be disallowed under *ratio* established in *Mallalieu v Drummond*.[37] The *Mallalieu* case addressed quite specifically the general legal principles regarding the deductibility of expenditure on clothing under Schedule D(II), as emphasised by Lord Brightman at the commencement of his judgment:

> *"My Lords, the immediate issue in this appeal concerns the right of a female barrister, in computing the profits of her profession, to deduct the cost of upkeep of a wardrobe of clothes of a design and colour suitable to be worn under her gown during court appearances. But during the course of the argument this issue was found to resolve itself into a far more general and fundamental question: whether any person carrying on a trade, profession or vocation on his own account is entitled to a similar deduction if he*

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[34] [1941] 1 K.B. 202

[35] Ibid., at p. 206

[36] B. Laventure <u>Taxation of Specialised Occupations and Professions</u> London, Institute of Chartered Accountants (1992) p.46

[37] [1983] BTC 380

chooses to set apart clothes, underclothes and footwear for use only at his place of work, and when proceeding to and from his place of work."[38]

Lord Brightman, supported by three other Law Lords, Lord Elwyn-Jones dissenting, found no merit in the reasoning of the High Court and Court of Appeal which allowed the tax deduction by relying on the Commissioners' findings that the only object present in the mind of the taxpayer when making the clothing purchases was the requirements of her profession. This his Lordship viewed as insufficient to satisfy the 'wholly and exclusively' test. He considered that in the purchasing the ordinary, if subdued, clothing a second object in the mind of the taxpayer, though not conscious, would be the provision of clothing that she needed as a human being. Lord Brightman concluded by approving the following observations of Goulding J. in *Hillyer v Leeke*,[39] which he regarded as "appropriate in their entirety" to the *Mallalieu* case.

> *"The answer that the Crown makes is that where the clothing worn is not of a special character dictated by the occupation as a matter of physical necessity but is ordinary civilian clothing of a standard required for the occupation, you cannot say that the one purpose is merely incidental to the other. Reference is made to what Lord Greene M.R. said in Norman v. Golder (1944) 26 T.C. 293, at page 299... referring to the food you eat and the clothes that you wear: 'But expenses of that kind are not wholly and exclusively laid out for the purposes of the trade, profession or vocation. They are laid out in part for the advantage and benefit of the taxpayer as a living human being.' In my judgment, that argument is conclusive of the present case, and the expenditure in question, although on suits that were only worn while at work, had two purposes inextricably intermingled and not severable by any apportionment that the Court could undertake."*[40]

[38] [1983] BTC 380, at p. 383
[39] (1976) 51 TC 90
[40] [1983] BTC 380, at p. 387

This House of Lords decision provides powerful authority for the Inland Revenue to disallow in their entirety the costs relating to the ordinary clothing of performers even if they have a duality of purpose. Thus rather than suggesting that the Inland Revenue may restrict such expenditure to take account of the private use element, it is more appropriate to advise that there is no right to any such deduction, but that the taxpayer may be able to agree by negotiation a concession from the Revenue to allow the tax deduction for a proportion of such costs.

1.3.2 Allowable Deductions: Health and Grooming Products and Services

Expenditure on health and grooming products and services, including health club and gym subscriptions, hair and beauty products, vitamins and tonics, and physiotherapy and cosmetic dentistry, is common to most performers. Such expenditure invariably contains an element of duality, a personal as well as a business benefit. There exists litle judicial guidance in this specific area other than the other than the cases discussed under the 'Clothing' section, 1.3.1, above.

Interestingly, the area of health and grooming products and services has received more attention in value added tax cases, of which two of the more recent decisions are analysed below. The analysis, however, must be tempered by caution, because the rules for the tax deductibility of expenditure for Schedule

D(II) purposes are different from the rules for the recovery of VAT input tax. The VAT legislation refers to input tax being recoverable if incurred "in the course or furtherance of the business."[41] This is to be contrasted with the 'wholly and exclusively' test under Schedule D(II).[42] Moreover, VAT legislation specifically provides for the apportionment of input tax relating to expenditure that has both a personal and business element.[43] Thus the cases serve only to acknowledge that expenditure on health and grooming are accepted as having a business purpose for performers (an acknowledgement that would be denied to most general traders).

In *Collie (1991)*[44] the Commissioners had refused to allow deduction of input tax on a wig purchased by the taxpayer, a professional jazz musician with a worldwide reputation. The taxpayer had began to lose his hair and decided after professional advice to acquire a wig so that his image could be maintained and because photographs, posters, record covers, press releases and artwork upon which he relied would need to be renewed entirely if his appearance changed. The tribunal decided that the wig had been purchased for the purpose of the

[41] VATA 1994 "26(1) The amount of input tax for which a taxable person is entitled to credit at the end of any period shall be so much of the input tax for the period (that is input tax on supplies, acquisitions and importations in the period) as is allowable by or under regulations as being attributable to supplies within subsection (2) below.
26(2) The supplies within this subsection are the following supplies made or to be made by the taxable person in the course or furtherance of his business–
(a) taxable supplies;
(b) supplies outside the United Kingdom which would be taxable supplies if made in the United Kingdom;
(c) such other supplies outside the United Kingdom and such exempt supplies as the Treasury may by order specify for the purposes of this subsection."

[42] *See section 1.1.2.*

[43] VATA 1994 "26(3) The Commissioners shall make regulations for securing a fair and reasonable attribution of input tax to supplies within subsection (2) above, and any such regulations may provide for– (a) determining a proportion by reference to which input tax for any prescribed accounting period is to be provisionally attributed to those supplies..."

taxpayer's business and allowed his appeal and the full deduction of the input tax on the wig.

In the earlier case of *Anholt (1989)*[45] the taxpayer, an actor, successfully appealed the Commissioners' decision that he was not entitled to the input tax on membership and annual fees paid to a health club. The Commissioners had contended that the expenditure was "inessential" to his acting profession. The taxpayer argued, however, that the club's fees were a business expense as its facilities gave him the physical fitness and confidence necessary for a dynamic role he was playing in 'Howards' Way', a BBC television series. In addition, he argued that the club was a useful place for making professional contacts with producers and directors. The VAT Tribunal allowed the actor's deduction of input tax without apportionment.

Given the absence of apportionment in both these cases they may serve as persuasive authority for a tax deduction in like circumstances under Schedule D(II). A general rule for Schedule D(II) deductions for expenditure on health and grooming products and services is difficult to establish. Inland Revenue practice, however, is apparently in line with the foregoing VAT authorities. [46]

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[44] [1991] BVC 1394 (LON/90/1382) No. 6144
[45] (1989) 4 BVC 1416 (LON/89/487) No. 4215
[46] Though anecdotal, it is not inappropriate to mention that the author who for ten years has run a tax consultancy specialising in sportspeople and entertainers, which at one point acted for more

1.3.3 Recognition of Income

Income falls in charge to tax under Schedule D(II) when it becomes receivable by the performer.[47] This raises the question of whether tax is payable on income received before it is technically receivable. In the context of performers, the main case in point is an advance paid out by a record company or a publisher to an artiste or author on the condition that the advance will be repaid by out of future royalties. In these circumstances monies will have been received by the artiste or author before he or she has actually earned the royalties; that is, before the royalties are receivable. It could be argued from the taxpayer's perspective that the advance is simply a loan and that taxable income only arises when the loan is repaid from the royalties earned.

The courts have dealt with this issue only partially. In *Taylor v Dawson*[48] a record company made an advance to the taxpayer who contended that the sum advanced was a loan from the company to him, repayable out of future royalties. Macnaghten J held that the advance was taxable in the fiscal year in which it was received by virtue of the terms of the agreement. He said that:

> *"The question of the construction of the agreement is, of course, a question of law, and the case seems to me to be a perfectly plain one. [Counsel for the taxapayer] has said everything that could be*

boxing champions than any other firm in the UK, was never challenged on tax deductions for boxers in respect of gym fees, vitamins, trainers and other sportswear.

[47] It is possible to prepare accounts on a cash basis, whereby only amounts actually received and expenditure actually laid out fall to be recorded in the accounts. The Revenue accept such accounts as the basis for taxation, particularly for those self-employed individuals enjoying relatively small amounts of income and expenditure.

[48] (1935-1939) 22 TC 189

> *said in support of the contention that the £1,500 was a loan: but he has to admit that it was a loan which nobody was liable to repay, that it could only be repaid out of the royalties earned in future years, and, if sufficient royalties were not earned, then it would have to be written off, so far as the company was concerned. In these circumstances it cannot properly be called a loan. It was in fact a payment in advance of royalties to Mr. Dawson. There is no ground whatever for saying that it was a loan. Mr. Dawson never could be called upon to repay it."*[49]

This case is clear authority for the taxing of non-refundable advances in the fiscal year in which there are receivable. Where, however, the advance is repayable by the artist out of his own resources should the future royalties not cover the amount of the advance (or not cover the amount of the advance within a stipulated timeframe), it would appear that there is a reasonable argument at least for the proposition that the advance should be treated as a loan and not subject to tax. Interestingly, the specialist professional books on the taxation of sportsmen, sportswomen and entertainers seem reluctant to make this point directly, preferring merely to lead to this position by implication. Laventure[50] writes: "Non-repayable advances of fees or royalties are, however, assessable when received, even if they are recouped against future royalties"[51] He does not however go on to state specifically that repayable advances are not assessable when received. Harvey and Baldwin[52] adopt the same approach. They state: "If the performer's accounts are being prepared on an earnings basis, non-repayable advances will be

[49] (1935-1939) 22 TC 189 at 194
[50] B. Laventure Taxation of Specialised Occupations and Professions London, Institute of Chartered Accountants (1992)
[51] Ibid., p. 42
[52] R. Harvey and R. Baldwin Tax and Financial Planning for Sportsmen and Entertainers, London, Butterworths (1994)

attributable to the year on which they are receivable."[53] The reluctance on the part of Laventure, Harvey and Baldwin to state the converse of the only position on which there is case law authority probably stems from their view, shared by this author, that the Revenue would seek to resist such a contention. The anticipated Revenue's position, however, should not serve to prevent the setting out of the correct statement of the law as it is understood at this present time. Indeed, it would be appreciated if the Inland Revenue were to state clearly their position on this issue in a Statement of Practice.

1.4 SCHEDULE E

From the exploration of the employed v self-employed distinction in section 1.2, it may be broadly asserted that sportsmen and women in team sports, and entertainers subject to specific long term relationships with one principal, are most likely to be classified as employees. Moreover, the Inland Revenue actively seek to reclassify self-employed performers as employees where the nature of their work and their relationship with the other contracting party, such as a theatre company, has the characteristics of employment. This section starts with a brief discussion of the legal position of allowable deductions under Schedule E, already introduced above, and is followed by a thorough examination of the nature of emoluments, the income under Schedule E that is subject to taxation.

[53] Ibid., p.36

1.4.1 Allowable Deductions under Schedule E

As set out in 1.2, individuals taxed under Schedule D(II) may deduct form their income all expenditure "wholly and exclusively laid out or expended for the purposes of the trade, profession or vocation,"[54] whereas individuals taxed under Schedule E may only deduct expenses "expended wholly, exclusively and necessarily in the performance of the duties of the office or employment."[55] The restrictive nature of the Schedule E rules for tax allowable expenditure,[56] as discussed above,[57] effectively means that only the expenditure the employee is obliged to lay out as part of his conditions of employment will be allowable for tax purposes, though even this condition is not always sufficient. On this point *Brown v Bullock*[58] is illustrative. The case concerned the deductibility under Schedule E of a bank manager's subscriptions to a club. Even though it was accepted, as set out in the Case Stated, that club membership was virtually a condition or requisite of managerial appointment, Lord Evershed MR felt unable to allow the deductions for tax purposes. He expressed the opinion that when the subscription for the club was paid by the taxpayer and when he visited the club to have lunch and entertain customers there, he was not really acting in the performance of his duties as manager of the bank.

[54] ICTA 1988 s.74(1)(a)
[55] ICTA 1988 s.198(1)
[56] See *Fitzpatrick v IRC* [1992] STC 406
[57] See section 1.1.2
[58] [1961] 3 All E. R. 129

This case highlights the restrictive nature of the Schedule E rules for tax allowable expenditure for all employees, including employed performers. There is, however, a specific provision for employed entertainers to tax deductions denied to other professionals. By virtue of section 201A ICTA 1988, an entertainer may deduct from his emoluments for tax purposes fees paid to an agent, subject to a ceiling of 17.5% of the emoluments falling in charge to tax in that fiscal year. This provision, introduced in the 1991 Finance Act, though no doubt welcome to employed performers,[59] emphasises again the narrowness of the wording of section 198(1). A deduction that would be wholly uncontentious under Schedule D(II) requires legislative authority for Schedule E cases.

1.4.2 Emoluments

Those performers who are employees are taxed, like all other employees, on their 'emoluments', a word defined by section 131(1) ICTA 1988 to includes "all salaries, fees, wages, perquisites and profits whatsoever". This serves to include, for example, that part of a transfer fee paid to a footballer by the club that employs him. It has also been held recently to include a payment to a player to induce him to move to another club. The case in question is *Shilton v Wilmshurst*,[60] and it deserves detailed study, for the issues it raised are of relevance to most employed sportspeople who play for professional teams.

[59] Though s. 201A is headed 'Expenses of entertainers', the detailed wording of the provision, which only makes reference to "the employee", is such that it would also apply to sportsmen and women.
[60] [1991] STC 88

1.4.2.1 Inducement Payments

In 1982 the taxpayer, Peter Shilton, a professional footballer employed by Nottingham Forest FC, was transferred to Southampton FC. There were three parts to the transfer. Nottingham Forest agreed with Southampton to accept a transfer fee of £325,000 for the taxpayer to play for Southampton. Nottingham Forest paid the taxpayer £75,000 to induce him to agree to the transfer so that they would receive the transfer fee. The taxpayer agreed with Southampton that he would play for the club for four years at an agreed salary if Southampton paid him £80,000, a further inducement payment, which they did. The Revenue assessed the taxpayer on £155,000,[61] the aggregate of the sums of £75,000 and £80,000, taking the view that both sums were emoluments 'from' the taxpayer's employment with Southampton. The taxpayer agreed the assessment so far as it applied to the £80,000 paid by Southampton but disputed it so far as it applied to the £75,000 paid by Nottingham Forest. He claimed that the £75,000 was not an emolument 'from' his employment with Southampton. Rather, he felt that it was a 'golden handshake' taxable under s. 148 ICTA 1988 and attracting termination payment relief.[62]

Section 181 of the Act of 1970, as amended and now replaced, so far as material, by s. 19 of the 1988 Act provided that tax under Sch. E: "...shall be charged in

[61] Under ICTA 1970, s. 181(1), now ICTA 1988 s. 19(1)

respect of any office or employment on emoluments therefrom which fall under...Case I: where the person holding the office or employment is resident and ordinarily resident in the United Kingdom..."

The High Court and Court of Appeal held that the payment of £75,000 was an emolument 'for' but not 'from' the taxpayer's employment with Southampton and therefore not taxable under the aforementioned provision.[63] The House of Lords disagreed. Lord Templeman opined:

> *"Section 181 [now ICTA 1988 s. 19] is not limited to emoluments provided in the course of employment; the section must therefore apply first to an emolument which is paid as a reward for past services and as an inducement to continue to perform services and, secondly, to an emolument which is paid as an inducement to enter into a contract of employment and to perform services in the future. The result is that an emolument 'from employment' means an emolument 'from being or becoming an employee'. The authorities are consistent with this analysis..."*[64]

Thus, Lord Templeman found, the £80,000 paid by Southampton and the £75,000 paid by Nottingham Forest to be taxable as emoluments under Schedule E as they were both inducements to the taxpayer to enter into a contract of employment

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[62] Payments chargeable to tax under s. 148 are exempt in respect of the first £30,000. The details of the relief are to be found in s. 188.

[63] The Court of Appeal upholding the decision of Morritt J found that to be chargeable under s. 181(1) an emolument had to be referable to the performance of services by the employee under his contract of employment. An emolument paid to an employee by someone other than the employer would only be an emolument 'from' the employment if the payer had some interest in the performance by the employee of his contract with the employer. Nottingham Forest had no interest in the taxpayer's performance of his contract with Southampton. Once he had been transferred it made no difference to Nottingham Forest whether the taxpayer fulfilled his contractual obligations to Southampton. This view was rejected by Lord Templeman in the House of Lords judgment. He found: "There is nothing in sec. 181 or the authorities to justify the inference that an 'emolument from employment' only applies to an emolument provided by a person who has an interest in the performance by the employee of the services which he becomes bound to perform when he enters into the contract of employment." [1991] STC 88 at p.94

[64] [1991] STC 88 at p.91

with Southampton. The motive of Nottingham Forest to obtain a transfer fee did not alter the fact that the £75,000 was paid as an emolument 'from the employment' because it was an emolument 'from becoming an employee', indistinguishable from the £80,000 paid by Southampton.

To place this decision in context it is worth noting that Lord Templeman himself made reference to the Revenue's anxiousness regarding the point of law and the effect of the decision going against them. He stated at the beginning of his judgment, "The Crown takes the view that the result of this appeal will have substantial repercussions on the ambit of s. 181 and may have repercussions on other taxing provisions."[65] In short, the Revenue were concerned over a potential loss of tax arising in similar circumstances which are not at all uncommon in team sports. The House of Lords firmly closed the door on any tax advantages arising from such arrangements. A related area, however, that remains open to employed sportsmen and women (less so for entertainers) is the testimonial.

1.4.2.2 Testimonials

The question of whether income received by employed sportsmen and women from testimonials held in their honour falls within Schedule E is not capable of a simple answer. Much turns on the facts of each case. The most established authority supporting non-taxable nature of testimonial income is the 1927 House

[65] Ibid.

of Lords case decision in *Seymour v Reed.*[66] In that case the Committee of a Cricket Club in the exercise of their absolute discretion granted a benefit match to the taxpayer, one of the Club's professional cricketers. The proceeds of the match, together with certain public subscriptions, were invested in the names of the Trustees of the Club and the income therefrom, and thereafter the proceeds of the realised investments, were paid to the taxpayer in accordance with the rules of the Club. The House of Lords held that the award of the proceeds of the benefit match to the taxpayer was not a profit accruing to him in respect of his office or employment, but rather was in the nature of a personal gift and not assessable to income tax.[67]

It is instructive to contrast the facts and decision in *Seymour v Reed* with those of *Moorhouse v Dooland.*[68] The latter case also concerned a cricketer in receipt of 'testimonial' income. The taxpayer was employed by a professional cricket club. The terms of his employment were governed by a written agreement which provided, inter alia, that "...collections shall be made for any meritorious performance by the Professional with bat or ball...in accordance with the Rules for the time being of the Lancashire Cricket League." One of these rules provided that a collection was to be taken from spectators for any player scoring 50 runs or more in any one innings. The taxpayer enjoyed income from collections for

[66] [1927] AC 554
[67] The degree to which this was a difficult area even in the 1920, when the judiciary took a strict literal approach to legislative interpretation may be seen from the decisions in the case as it proceeded through the appeal process. The commissioners found for the taxpayer, as did the High Court (Rowlatt J). The Court of Appeal (Sargant LJ dissenting) found for the Revenue, and the House of Lords (Lord Atkinson dissenting), reversing the decision again, found for the taxpayer.
[68] [1955] 1 All E.R. 93

meritorious performances, and argued before the commissioners that the collections were given as testimonials to his abilities and were not profits arising from his employment. The Court of Appeal, however, distinguishing *Seymour v Reed* on the grounds that unlike Seymour, Dooland had a contractual and repeated entitlement to receive the testimonial income,[69] held that the collections were part of the earnings of the taxpayer's employment and not mere personal presents distinct from his earnings.

Clearly, there is no reason why the rules as they pertain to cricket should not apply equally to football and other team sports. The issue of contractual entitlement to testimonial income and the reward for services rendered as an employee has come before the courts in cases concerning footballers and have been similarly resolved. In *Davis v Harrison*[70] the taxpayer had been employed as a professional footballer by the Everton FC under rules which permitted a club to pay to him "as a reward for 'loyal and meritorious service'" a benefit every five years. Everton FC paid the taxpayer a benefit under these terms shortly after he had been transferred to another football club. The Revenue sought to tax the payment under Schedule E, but the taxpayer argued that the payment was really

[69] Sir Raymond Evershed MR, distinguishing *Seymour v Reed,* emphasised three distinguishing factors. First, though Dooland qualified for the collections by excellencies of performance on his part, they were excellent performances of his professional duty as a cricketer, and they arose in the ordinary course of his service while playing professional cricket. Second, though the performances were exceptional in the sense of being outstanding, they were not exceptional in the sense of being very rare and unlikely to be repeated. Third, it was a term of Dooland's contract of service that, on each occasion on which he performed his service with the requisite degree of skill, he should be entitled to invite subscriptions for himself from bystanders. It was a right capable of enforcement at law. The right, in other words, was part of the consideration for his services flowing from his employers.

[70] (1926-27) 11 TC 707

compensation for loss of office. The High Court, which referred to and distinguished *Seymour v Reed*, held that the payment to the taxpayer was remuneration for services rendered in his employment and assessable to income tax.[71]

In *Moore v Griffiths*,[72] England's 1966 World Cup winning captain, Bobby Moore, the taxpayer, was assessed by the Revenue under Schedule E in respect of bonus from the Football Association of £1,000 for winning the World Cup and prize money from an unrelated trading company which manufactured Radox Bath Salts of £500 for being the best player in the competition and of £250 for being the best player for England. The taxpayer was assessed to income tax under Schedule E for the year 1966-67 in a sum which included the bonus and prizes. He appealed, contending that the bonus and prizes were gifts in the nature of testimonials and therefore not assessable.

It was clear that Mr Moore was employed by West Ham United FC. In his judgment, Brightman J spent some time establishing the exact nature of Mr Moore's contractual relationship with the Football Association, the body who made the bonus payment.

[71] Rowlatt J found it difficult even to appreciate that there was anything contentious in this case. He saw it as a case of a professional football player who had received a payment. It was not the result of direct subscriptions by the public or indirect support to a fund by the public attending at a match at which the gate money goes to the professional, contrasting *Seymour v Reed*, op. cit. The payment simply represented an extra sum of money given by the club to the professional.

[72] *Moore v Griffiths, Griffiths v Moore, Hurst v Griffiths, Griffiths v Hurst* [1972] 3 All E.R. 399

> *"To sum the matter up, the taxpayer was under contract to the club, which was his employer. The International Committee of the Association was entitled to select a player for an international event; the club was bound to place a player so selected at the disposal of the Association; and a selected player would be in breach of the rules of the Association and therefore in breach of contract if, without sufficient cause, he failed to play in an international match."*[73]

Then, turning to the Case Stated, Brightman J observed:

> *"Whenever the Association wish to call upon players to represent England the usual procedure is for them to inform the Club and ask for the player's release. The player is told all that is necessary. A player is paid a match fee plus expenses. These are paid to the Club and in turn the player receives the money after tax has been deducted under PAYE."*[74]

Turning to the point of law at issue in the case, Brightman J declared that there was no dispute that the bonus and prizes were 'emoluments' as defined by the legislation.[75]

> *"The problem before me, therefore, is to decide whether the payments in question were 'emoluments therefrom'; that is to say, emoluments from the employment of the taxpayer."*[76]

As regards the payment from the Football Association, Brightman J said,

> *"I think it would be wrong to regard the payment to the taxpayer as being something in the nature of a reward or remuneration for services. The true purpose of the payment was to mark his participation in an exceptional event, namely, the winning of the World Cup Championship – exceptional because the Cup is open for competition only every four years and has never before been*

[73] [1972] 3 All E.R. 399, at p. 405
[74] Ibid.
[75] "[I]ncluding 'all salaries, fees, wages, perquisites and profits whatsoever", then defined by Sch. 2 to the Finance Act 1956. The same definition, as discussed in section 1.3.1, is now found in s. 131(1) ICTA 1988.
[76] [1972] 3 All E.R. 399, at p. 406

won by this country. In other words, the payment had the quality of a testimonial or accolade rather than the quality of remuneration for services rendered."[77]

In reaching this conclusion, Brightman J took the following factors into consideration:

1. The payment had no foreseeable element of recurrence.
2. There was no expectation of reward. The taxpayer was totally unaware of the prospect of the payment prior to the services which he performed and the terms of his contract with his club did not contemplate that gratuitous payments of that or any type would be made.
3. The payment was not made or even announced by the Football Association until after the World Cup had been won; that is to say, until after the Association had already dispensed with the taxpayer's services.
4. The principal function of the Association is to promote the sport of football, and not to derive a benefit from the services of footballers.
5. The Football Association made the payment to mark its pride in a great achievement rather than to remunerate the meritorious execution of the employee's services.
6. Each member of England's 1966 football squad, regardless of the number of times that he played, received precisely the same sum of £1,000. The sum therefore was not in any way linked with the quantum of any services rendered.

Brightman J continued,

[77] Ibid., p. 411

> *"So far as the payments by Nicholas Products Ltd. are concerned, I find some difficulty in appreciating the basis on which they are said to be taxable under Schedule E. The taxpayer performed no services whatever for that company. The company was wholly disinterested, in any realistic sense, in the quality of the services performed by the taxpayer or by any other player. It did not matter to the company how well or how ill the members of the team played. The prizes were plainly offered in order to publicise the company's products. I do not see how it can reasonably be suggested that the payments were in the nature of a reward for services rendered by the taxpayer to the Association or to the club, or indeed to anyone else."*[78]

Brightman J thus held that neither the bonus nor prizes fell in charge to taxation.

This case pre-dates the case of *Shilton v Wilmshurst*[79] discussed above. *Moore v Griffiths* was not distinguished or even referred to in the Shilton, yet there is an argument that applying the opinion of Lord Templeman to the facts in *Moore v Griffiths* would have yielded a different result. Lord Templeman held that an emolument 'from employment' meant an emolument 'from being or becoming an employee', irrespective of who makes the payment. Brightman J was in no doubt that the payment by the Football Association was an emolument, he simply held that it did not arise from the employment. This question is: did it arise from being an employee? The two examples given by Lord Templeman of emoluments that did not arise from being an employee were emoluments attributable to a desire on the part of the provider of the emolument to relieve distress or to provide assistance to a home buyer. Such emoluments are fundamentally different in

[78] Ibid.
[79] [1991] STC 88

nature to a reward for playing well; that is, performing one's duties as an employee well.

1.5 INCOME FROM WRITING

As explained in Chapter I, when this work refers to 'entertainers' the term includes authors. That said, this section is not only concerned with the taxation from authors exercising a profession, but also the taxation of other sportsmen, sportswomen and entertainers who increasingly pen, directly or indirectly, newspaper and magazine articles and their biographies.

1.5.1 Schedule D(II) v Schedule D(VI)

As set out above in section 1.1, Schedule D(II) is the taxing schedule for individuals carrying on a profession or vocation.[80] This clearly applies to professional writers. In contrast, Schedule D(VI) is the taxing schedule for "any profits or gains not falling under any other Case of Schedule D and not charged by virtue of Schedule A or E."[81] This is the schedule under which the income enjoyed by non-professional, i.e. casual, writers are taxed.

There are significant differences between the two schedules. As regards trading losses, s.380 ICTA 1988 permits losses incurred under Schedule D(II) to be the

[80] ICTA s. 18(3)
[81] ICTA s. 18(3)

set-off against the taxpayer's other income (that is, income under the same or other schedules) of the current year or preceding year. Section 381 provides for trading losses incurred under Schedule D(II) in the first four years of trading to be carried back and offset against his income (under the same or other schedules) of three years earlier.[82] These reliefs are not available for losses incurred under Schedule D(VI). Under Schedule D(VI) an individual who sustains such a loss may utilise it in one of two ways:

- he may set it against other income charged under Case VI in the tax year in which the loss is incurred; and
- in so far as any balance remains unrelieved, he may carry it forward and set it against income charged under Case VI in subsequent tax years.

Unlike Schedule D Case II losses, Case VI losses may not be set against income chargeable under any other Case or Schedule, whether in the current year or in future years. This renders the Case less attractive for the taxpayer than Case II.

As regards allowable deductions under the two Cases, Schedule D(II) is also the more favourable Case from the taxpayer's perspective. There is no provision which specifically permits the deduction of expenses incurred in earning a Case VI profit; that is, no equivalent to s. 74 ICTA 1988 (see section 1.3). The Revenue, however, in practice, apply the same 'wholly and exclusively' test to

[82] The rationale of this relief is that losses incurred in the early years of a trade are sustained by savings of the trader out of his taxed income in the years immediately before the commencement of self-employment.

deductions under Case VI.[83] This concession does not extend to pre-trading expenditure. The legislation provides that business expenditure[84] incurred up to seven years before self-employment commences may be treated as incurred on the first day of trading.[85] This relief is specific to Schedule D Cases I and II and does not extend to Case VI.

1.5.2 Sale of Copyright: Capital or Revenue

A writer, whether professional or not, creates a copyright in the work he produces.[86] Copyright is an intellectual property right that protects the author from the unauthorised copying of his work. The copyright may be assigned by the author to another in return for royalties, usually based on the number of copies of the work sold. It may be assigned, in whole or in part, for a fixed consideration, whether payable in advance or by instalments. Finally, it may be sold outright for a lump sum. This section focuses on the outright sale of copyright and addresses the question of whether this gives rise to a capital receipt, subject to capital gains tax, or a revenue receipt, subject to income tax.

The relevance of the capital revenue distinction is two-fold. First, the tax regimes are different. Now that capital gains are taxed as the highest slice of an individual's income, it is less favourable to be subject to capital gains tax than it

[83] Inland Revenue, Inspector's Manual, vol. 1, 1724

[84] *Clearly, the expenditure must be such as would have been allowable as a deduction in computing profits under Schedule D(I) or II had it been incurred after the commencement of the business.*

was in the past. Furthermore, the allowable deductions under capital gains tax are less generous than under income tax. Secondly, and providing a counter balance to the foregoing, a non-UK resident individual is exempt from UK capital gains tax.[87]

It may be safely asserted that a professional author, taxable under Schedule D(II), will be subject to income tax on the sale of his interest in his copyright. This is supported by all relevant authorities. In *Glasson v Rougier*[88] the taxpayer, who was carrying on the vocation of an authoress, transferred outright to a publishing company her copyright in three books on which she had previously been receiving royalties, in consideration of a lump sum payment. She contended that the lump sum payment was a capital receipt and not a sum received in the ordinary course of carrying on her vocation and should be excluded in computing her profits. The High Court rejected this contention. Macnaghten J said that:

> *"Whatever [the taxpayer] receives, whether by way of royalty or by payment for the sale of her copyright, each and all are profits earned by her in her vocation which must, in accordance with the Income Tax Acts, be included in the assessment."*[89]

[85] ICTA 1988 s. 401
[86] Copyright, Designs and Patents Act 1988 s. 1
[87] This has been modified by the Finance Act 1998 s.127, which inserts a new section 10A in the Taxation of Chargeable Gains Act 1992, which removes this capital gains tax exemption from 'temporary non-residents'.
[88] [1944] 1 All E R 535
[89] [1944] 1 All E R 535 at p. 536

This rule of law even extends to the sale of film rights based on the books subject to copyright. In *Howson v Monsell*[90] the taxpayer was a writer of historical novels. She retained the copyright in her books, earning royalties on their sale. On the sale of the film rights in two of her books she contended that the profits of her vocation as a writer were derived by exploiting the copyright in her books through royalties and that the sums received for the sale of the film rights did not relate to her vocation and were thus of a capital nature. Again, the High Court rejected this contention. In his judgment Danckwerts J said that he often thought hard that authors should have to pay income tax on capital sums which are the result of the sale of products of their own brain, but he was bound to administer the law relating to income tax as he found it.

The situation is potentially different for a non-professional writer whose income from writing is assessed under Schedule D(VI). The distinction is based of the case of the *Trustees of Earl Haig v IRC*.[91] The late Earl Haig, by his trust disposition and settlement, authorised his trustees to publish his War Diaries. A biography of the Field Marshal was written by Mr Duff Cooper who made full use of the material in the diaries. The trustees and the author agreed that all profits resulting from the book and from the sale of any rights connected with it were to be equally divided. It was held that the sums received by the trustees were capital payments in return for a partial realisation of an asset, the whole asset being the diaries themselves. The Lord President opined:

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[90] (1946-1950) 31 TC 529
[91] 1939 SC 676

> *"Here, the finding that the Appellants did not carry on a trade or adventure is important. If it had been found that Mr. Duff Cooper was the Appellants' agent or associate in a trade or adventure, the case would have worn a very different aspect. But if the Appellants were outside the region of trade or adventure it is difficult to give a positive answer to the question whether they overstepped the line of realizing a capital asset for a capital payment, and unless that line was passed the transaction is not brought within the scope of Schedule D, Case VI."*[92]

Though this case remains a precedent for disposal of a copyright interest being capital for individuals taxed under Schedule D(VI), the application of this principle of law to performers who write has proved somewhat elusive. This is because the performer who writes has usually been held to be providing a service, the income of which is taxable under Schedule D(VI), rather than disposing of a copyright interest.

In *Housden v Marshall*,[93] the taxpayer, a racehorse jockey and trainer, made available his reminiscences of his racing career to a ghost writer provided by a newspaper under an agreement which granted the newspaper the first British serial rights. The taxpayer contended that the agreement provided predominantly for a sale of publication rights and that the sums received therefrom were capital. It was held that the payments made to the taxpayer by the newspaper were for services and thus fell in charge to income tax under Schedule D(VI). Harman J asked,

[92] 1939 SC 676 at p. 678

> *"What was he paid for? He was paid for making available his reminiscences and for producing certain documents if called on, and, I think, for nothing else. It is true that by clause 4 he is expressed to grant the British serial rights in the reminiscences. But no reminiscences were in existence when he so purported to grant the rights, and the reminiscences were never his copyright; they were the copyright either of the man who wrote them, (i.e. the 'ghost'), or of the 'ghost's' employers. There was nothing for the taxpayer to grant."*[94]

This case, which applied the ratio in *Hobbs v Hussey*,[95] and distinguished that of *Trustees of Earl Haig v IRC*,[96] was itself followed in *Alloway v Phillips*,[97] discussed in 1.6.5 below.

1.5.3 The Spreading of Income

Self-employed professional writers, in common with other self-employed performers, often lack even and regular annual income. The preparation of a literary work may cover many fiscal years, during which time no income is earned, leading to the loss of personal allowances[98] and the loss of the benefit of

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[93] [1958] 3 All E.R. 639

[94] [1958] 3 All E.R. 639 at p. 641

[95] In *Hobbs v Hussey* [1942] 1 KB 491, a newspaper paid the taxpayer for the serial rights of his life story, which was then written up by a ghost writer. It was held that the payment was taxable under Schedule D(VI). At pp. 496–497 Lawrence J stated: *"Does then the fact that the present transaction involved the sale of the copyright in the appellant's series of articles, constitute the profits therefrom capital, or is such sale merely subsidiary to what was in its essence a performance of services by the appellant? In my opinion, the true nature of the transaction was the performance of services. The appellant did not part with his notes or diaries or his reminiscences. He could re-publish the very articles themselves so long as they were not in serial form, and, on the whole, I am of opinion that the profits he received were of a revenue nature and not the realization of capital."*

[96] The *Trustees of Earl Haig* case was distinguished on the basis that the trustees had the diaries, already subject of copyright, in their possession, and they sold a part of that pre-existing right.

[97] [1979] STC 452. One point at issue was whether the sale of the reminiscences of the wife of one of the 'Great Train Robbers' to a newspaper capital or revenue transaction. The courts held it was revenue.

[98] Unused personal reliefs cannot be carried forward from earlier years

the lower and basic rates of taxation. The sale or assignment of the copyright in the work produced may, in contrast, give rise to a large income in one fiscal year only. Thus an author may find himself subject to higher rate tax in one year on income it had in reality taken him several years to produce. Had the income been spread over the years to match the actual writing and researching process, the aggregate tax liability would have been lower, reflecting the utilisation of the personal allowances and the annual application of the lower and basic tax bands.

The legislation seeks to alleviate this tax inequity by allowing authors and certain other artists[99] to spread their income over more fiscal years than the fiscal year(s) in which they received their income. By s. 534 ICTA 1988, where an author assigns the copyright of his work (wholly or partially) or grants any interest in the copyright by licence, and the consideration for the assignment or grant consists wholly or partially of a payment which would otherwise be assessed in a single tax year, then provided the author was engaged on the work for a period of more

[99] The legislation refer only to an 'author' but this term is given a wide meaning by specifying "an author of a literary, dramatic, musical or artistic work…" (ICTA 1988 s.534(1)). The provision also stipulates that the term " 'author' includes a joint author." (ICTA 1988 s.534(7)). The term 'author' is further widen by the definition of 'literary, dramatic, musical or artistic work' contained in the Copyright, Designs and Patents Act 1988 (see s. 3(1), 4) whereby:

- "'literary work' means " any work, other than a dramatic or musical work, which is written, spoken or sung, and accordingly includes a table or compilation and a computer program;
- 'dramatic work' includes a work of dance or mime;
- "'musical work' means " a work consisting of music, exclusive of any words or action intended to be sung, spoken or performed with the music;
- "'artistic work' means" :

(a) a graphic work (including a painting, drawing, diagram, map, chart, plan, engraving, etching, lithograph, woodcut or similar work), photograph (but not part of a film), sculpture (including a cast or model made for the purposes of sculpture) or collage, irrespective of artistic quality;
(b) a work of architecture being a building or part of a building or a model for a building, etc.; or
(c) a work of artistic craftsmanship.

than 12 months he may make a claim for the income to be spread over more than one fiscal year.[100] In the case where the author was engaged on the work for no more than 24 months, only one-half of the payment is treated as having become receivable when it was actually receivable and the remaining half is treated as having become receivable 12 months before that date. In the case where the author was engaged on the work for more than 24 months, only one-third of the payment is treated as having become receivable when it was actually receivable, one-third is treated as having become receivable 12 months before that date, and the remaining one-third is treated as having become receivable 24 months before the date on which it became receivable.[101]

There is a similar relief for authors who dispose of their copyright interest ten or more years after the first publication of the work. In these circumstances the author may claim for the lump sum he receives to be treated as equal yearly instalments. By s. 535 ICTA 1988, where an author assigns the copyright in a work wholly or partially, or grants any interest in the copyright by licence, not less than ten years after the first publication of the work and the consideration received consists wholly or partially of a lump sum payment, which would otherwise be assessed in a single tax year, then provided the copyright or interest is not assigned or granted for a period of less than two years he may make a claim for 'forward-spreading relief'. Where the assignment or grant of the copyright is

[100] A claim under s.534 may only be made provided that a claim has not already been made under ICTA 1988 s. 535 (see below).

for less than six years, the amount of the payment is treated as received in equal instalments at yearly intervals over the period of whole years spanned by the assignment or grant.[102] Where the assignment or grant of the copyright is for more than six years, the amount of the payment is treated as received in equal instalments at yearly intervals over the period of six years.[103]

1.6 RESIDENCE, ORDINARY RESIDENCE AND DOMICILE

The issues of residence, ordinary residence and domicile are very important to sportspeople and entertainers because of the potential international nature of their earning capacity. Indeed, it was recently remarked at an international tax seminar that "entertainers and athletes are probably the most mobile individuals in the business world."[104] They earn income from their principal performing activity, which may be generated in many different jurisdictions. In addition, worldwide income may also be generated by royalty sales and the exploitation of their popularity through sponsorships, endorsements and personality merchandising. Opportunities often exist to reside in tax advantageous territories, but even where this is not the case the extensive foreign travel may create complex questions over which jurisdiction has the right to tax the income generated by the performer.

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[101] A claim under this section may be made at any time within one year from the 31st January following the latest (or only) year of assessment in which a qualifying payment is receivable. ICTA 1988 s. 534(5A)

[102] ICTA 1988 s. 535(3)

[103] ICTA 1988 s. 535(2)

[104] International Fiscal Association Taxation of Non-resident Entertainers, The Hague, Kluwer Law International (1996) p. 3

The UK's fiscal jurisdiction extends to England, Wales, Northern Ireland and Scotland. It includes the Scilly Isles, but does not extend to the Channel Islands or the Isle of Man.[105] Income tax is only levied by the UK where either the individual is resident in the UK or the income is generated in the UK. This is a long established principle. Over one hundred years ago Lord Herschell remarked in *Colquhoun v Brooks*,[106]

> *"The Income Tax Acts, however, themselves impose a territorial limit, either that from which the taxable income is derived must be situate in the United Kingdom or the person whose income is to be taxed must be resident there."*[107]

There is no statutory definition of the terms 'residence', 'ordinary residence' and 'domicile'. In very broad terms, 'residence' refers to the jurisdiction in which an individual resides or lives (see 1.6.2), ordinary residence refers to habitual residence (see 1.6.3) and domicile refers to the jurisdiction in which the individual has his permanent roots (see 1.6.4). Whilst it is possible for an individual to be resident in more than one country, it is not possible for him to have more than one domicile for UK tax purposes.

In general terms, a UK resident, ordinarily resident and domiciled individual is taxed in the UK on his worldwide income, whereas an individual who is not resident in the UK is only liable to UK tax on his UK income. Again, in general terms, an individual who is resident but not ordinarily resident in the UK is liable to UK tax on income from foreign possessions only to the extent that the income

[105] Interpretation Act 1978, Sch. 1.

is remitted to the UK. An individual who is resident, ordinarily resident but not domiciled in the UK is liable to UK tax on his UK income but not on his overseas income unless it is remitted to the UK. These issues will be examined in more detail in section 1.6.5.

1.6.1 A Question of Law or Fact?

As mentioned above, there is no statutory definition of the terms 'residence', 'ordinary residence' and 'domicile'. In providing a common law definition the courts, applying the accepted principles of statutory interpretation, have relied on the ordinary meaning of the terms. Were statutory definitions to exist it would clearly be a question of law to determine whether an individual (or his circumstances in a given fiscal year) fell within that definition. However, in the absence of a statutory definition, the determination of an individual's residence or domiciliary status is principally one of fact. This is crucially important for questions of fact are decided by the Commissioners and appeals to the courts only lie on questions of law.[108] Indeed, the courts can only disturb a finding of fact by the Commissioners if, based on the material before them, their findings were so unreasonable[109] that no reasonable commissioners could have arrived at them.[110] As Lord Sands observed in *Reid v CIR*:[111]

[106] (1889) 14 App Cas 493
[107] (1889) 14 App Cas 493, at p. 504
[108] TMA 1970 s. 56(6)
[109] See *Steiner v IRC* [1973] STC 547 in which Foster J expressed the opinion, in a case concerning the Commissioners' findings of fact regarding an individual's domicile, that he could not substitute his own view for those of the Special Commissioners unless he thought that no reasonable tribunal could have come to the conclusion which they did.

"In this case the Commissioners have found that the Appellant was a person ordinarily resident in the United Kingdom. That is prima facie a finding in fact, and upon questions of fact the Commissioners are final. But when there is involved in a finding in fact the interpretation of an expression in an Act of Parliament it is within our jurisdiction to determine as a matter of law whether the statute has been misinterpreted. It is clearly our duty to intervene when the expression in the statute is one which is defined by statute or by judicial decision, or is one, the meaning of which is capable of clear judicial definition, and, in our view, the Commissioners have not properly construed the Act. But when a statute uses ordinary non-technical language describing a certain person or thing in general or ambulatory terms, and it becomes merely a matter of impression or opinion whether, in relation to the special circumstances, a person or thing falls within the expression, the tendency of the law is to treat a finding upon the matter as a finding in fact."[112]

Thus, even if the courts would have reached a different decision based on the evidence presented as to the residence or domiciliary status of a taxpayer, the Commissioners decision on this point will stand unless the courts could find no evidence to support the Commissioners' decision. Lord Blackburn found himself in such a position in *Reid v CIR*:

"As your Lordships have pointed out, the finding of the Commissioners is really one of fact which we must accept as final

[110] This state of affairs was adversely comment on by Viscount Sumner in *Levene v CIR* [1928] A.C. 217. In robust language he asserted, at p. 227 *"The words 'resident in the United Kingdom', 'ordinarily' or otherwise, ... guide the subject remarkably little as to the limits within which he must pay and beyond which he is free... [N]or can I confidently say that the decided cases have always illuminated matters. In substance persons are chargeable or exempt, as the case may be, according as they are deemed by this body of Commissioners or that to be resident or the reverse, whatever resident may mean in the particular circumstances of each case. The tribunal thus provided is neither bound by the findings of other similar tribunals in other cases nor is it open to review, so long as it commits no palpable error of law, and the Legislature practically transfers to it the function of imposing taxes on individuals, since it empowers them in terms so general that no one can be certainly advised in advance whether he must pay or can escape payment. The way of taxpayers is hard and the Legislature does not go out of its way to make it any easier."*

[111] (1926) 10 TC 673

[112] (1926) 10 TC 673 at p. 681

unless we are prepared to say either that there is no evidence to justify them in returning the finding they did, or that they have misdirected themselves as to the legal meaning of the words 'ordinarily resident'. While I am not prepared to hold that there is no evidence to justify the finding that the Appellant was still 'ordinarily resident' in the United Kingdom for the two years ending in April, 1921, I feel bound to say that I should not have reached the same conclusion as the Commissioners have done upon the evidence as led."[113]

There is a significant and current problem with this state of affairs. The Commissioners, seeking a level of consistency in determining the residence or domiciliary status of individuals, are faced with a formidable array of case law. The Revenue, however, has developed its own code of practice[114] which reads like a codification of the case law (which it is not).[115] Nonetheless, perhaps in a quest for the aforementioned consistency or simply because a codified law is easier to follow and apply, the code of practice, "though of no legal standing, is generally applied with a degree of inflexibility normally accorded only to statutory instruments."[116]

Thus for practical purposes the Revenue's code of practice has an importance greater than that to which it is entitled. Reference will be made to the code as part of the detailed analysis of the concepts of residence (1.6.2), ordinary residence (1.6.3) and domicile (1.6.4). The principal emphasis, however, will be on the law as laid down by judicial decisions. For though in this area the judges must accept the finding of fact of the commissioners, they have nonetheless established

[113] (1926) 10 TC 673 at p. 681
[114] IR 20 (1996) 'Residents and non-residents – liability to tax in the UK'
[115] See sections 1.2.1.2, 1.2.1.3 and 1.2.1.4

principles and approaches to the questions of residence, ordinary residence and domicile that the commissioners are obliged to follow. Sections 1.6.2, 1.6.3 and 1.6.4 explore these principles.

1.6.2 An Individual's Residence

There is no statutory definition of the word 'residence'. In providing a common law definition the courts, applying the accepted principles of statutory interpretation, have relied on the word's ordinary meaning. In the leading case of *Levene v IRC*[117] Viscount Cave observed:

> *"[T]he word 'reside' is a familiar English word and is defined in the Oxford English Dictionary as meaning 'to dwell permanently or for a considerable time, to have one's settled or usual abode, to live in or at a particular place'. No doubt this definition must for present purposes be taken subject to any modification which may result from the terms of the Income Tax Act and Schedules; but, subject to that observation, it may be accepted as an accurate indication of the meaning of the word 'reside'."*[118]

It is in keeping with this view that the occupation of a house or other accommodation[119] in the UK has been held by the courts to be indicative of residence.[120] This is so whether or not the taxpayer owns the accommodation. In

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[116] D. Davies Booth: Residence, Domicile and UK Taxation London, Butterworths (1997) p. 8
[117] *Levene v IRC* [1928] A.C. 217
[118] Ibid., p. 222
[119] In *Bayard Brown v Burt* (1911) 5 TC 667 the Appellant was an American citizen who, during the year of assessment (and for many years previously), had lived on board his yacht, which was moored in the port of Colchester. It was held that the Appellant is liable to Income Tax as a person residing in the United Kingdom.
[120] 'Indicative of residence' only. In the same case, albeit at first instance, Rowlatt J said *""The words 'resident' and 'residence' are in the first place quite clearly intended to describe, as I think I*

Lowenstein v De Salis[121] a Belgian citizen who had a residence in Brussels, visited the UK each year, and occupied a hunting box belonging to a company of which he was a director. He could, without obtaining formal permission, use the hunting box at any time. Though in no year was he in the UK for a total period of six months or more, it was held that he was UK resident for tax purposes. According to Rowlatt J:

> *"He has got this house to come to when he likes; he does not own it; he has got no proprietary interest in it, but it is just as good as if he had for the purpose of having it for a residence, and there it is. I am bound to say that I do not think there can be any question upon the facts as clearly found in this case, giving the Appellant the benefit of anything that may be doubtful upon the case or unsatisfactorily stated."*[122]

This decision provokes controversy in that the court seems to have taken a somewhat strict approach toward a taxpayer who did not even have a place of business in the UK. However this case remains good law. Indeed access to property in the UK has been held to be indicative of residence even where the taxpayer only spends short periods at the accommodation. In *Cooper v Cadwalader*,[123] the taxpayer, an American ordinarily resident in New York, with no place of business in the United Kingdom, rented a house and shooting rights in Scotland on a three year lease, though he only spent about two months continuously in each year on the property. It was held the taxpayer was a person residing in the United Kingdom. This case also serves as authority, together with

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have said before, the attribute of the person. One must get out of one's mind altogether the use of the words 'resident' and 'residence' as applying to a building or anything of that kind."

[121] (1926) 10 T.C. 424

[122] (1926) 10 T.C. 424 at 437

Lloyd v Sulley,[124] for rule that an individual can be resident in the UK even though he has accommodation available to him in other countries.

This general common law approach is still applicable today, unaffected by the abolition of the 'available accommodation rule' in the Finance Act 1993. The abolition of the 'available accommodation rule',[125] inserted by s. 208(1) FA 1993 into what is now s. 336(3) ICTA 1988, served to remove any automatic determination of UK residence of individual in the UK for temporary purposes simply by virtue of his having accommodation available for his use in the UK.

The frequency or regularity or duration of visits to the UK, as well as general ties to the UK, are factors to be considered in determining residence. In *Levene v*

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[123] (1904) 5 T.C. 101

[124] *Lloyd v Sulley* (1884) 2 T.C. 37. In this case the taxpayer carried on business in Italy where he ordinarily resided, but he also owned a place of residence in the UK, at which he lived with his family for several months in the year. It was held that he was resident in the UK, and liable to tax in respect of the profits of the business carried on abroad.

[125] ICTA 1988, s. 336 provides:

"(1) A person shall not be charged to income tax under Schedule D as a person residing in the United Kingdom, in respect of profits or gains received in respect of possessions or securities out of the United Kingdom, if–

(a) he is in the United Kingdom for some temporary purpose only and not with any view or intent of establishing his residence there, and

(b) he has not actually resided in the United Kingdom at one time or several times for a period equal in the whole to six months in any year of assessment, but if any such person resides in the United Kingdom for such a period he shall be so chargeable for that year.

(2) For the purposes of Cases I, II and III of Schedule E, a person who is in the United Kingdom for some temporary purpose only and not with the intention of establishing his residence there shall not be treated as resident in the United Kingdom if he has not in the aggregate spent at least six months in the United Kingdom in the year of assessment, but shall be treated as resident there if he has.

(3) The question whether–

(a) a person falls within subsection (1)(a) above, or

(b) for the purposes of subsection (2) above a person is in the United Kingdom for some temporary purpose only and not with the intention of establishing his residence there,

shall be decided without regard to any living accommodation available in the United Kingdom for his use."

IRC [126] the taxpayer, a British subject, sold his property and furniture in the UK and went abroad in December 1919. He did not return until July, 1920, and from that date until January, 1925, he spent between four and five months each year in the UK, the reasons for his visits being to obtain medical advice for himself and his wife, to visit relatives and the graves of his parents, to take part in certain Jewish religious observances and to deal with his tax affairs. During this time the taxpayer had no fixed abode but stayed at hotels either in this country or abroad. The High Court, Court of Appeal and the House of Lords all rejected the taxpayer's contention that for the fiscal years 1920-21 to 1924-25 he was neither resident nor ordinarily resident in the United Kingdom. It will be observed that the courts tend to take a comprehensive view in determining residence by referring to the various relevant factors, each case being considered on the basis of the facts it presents.

The next important case heard by the House of Lords concerning residence was *Lysaght v IRC*,[127] a seminal case in many ways, though, in the view of one eminent commentator, "tainted with uncertainty and stretching the concept of residence almost to breaking point."[128] The case concerned a taxpayer who used to live in the UK, where he was the managing director of a company. In 1919 he partially retired, but retained the post of advisory director of the company. He sold his English residence and his family went to live permanently in Ireland. He

[126] *Levene v IRC* [1928] A.C. 217
[127] [1928] AC 234
[128] D. Davies Booth: Residence, Domicile and UK Taxation London, Butterworths (1997) p. 19

went to Australia in 1919 for the company, and on his return took a furnished house in Somerset, going backwards and forwards to Ireland until 1920, when he went to reside with his family in Ireland, leaving no definite place of abode in England. He returned to England every month to directors' meetings, staying for about a week each time, either at hotels or at his brother's house. The total number of days spent in England for the three years fiscal years 1922/23, 1923/24 and 1924/25 were respectively 101, 94 and 84. It was held that the taxpayer was resident and ordinarily resident in the UK in the years in question.

The principal reason why this case can be described as 'seminal' is because its facts form the basis for the Inland Revenue's code of practice residence ruling based on the frequency and regularity of visits to the UK. The Inland Revenue booklet IR 20 provides that:[129]

> *"You will be treated as resident for a tax year if*
> - *you are in the UK for 183 days or more in the tax year ... or*
> - *you visit the UK regularly and after four tax years your visits during those years average 91 days or more a tax year... You are treated as resident from the fifth year. However*
>
> – *any days spent in the UK for exceptional circumstances beyond your control, for example the illness of yourself or a member of your immediate family, are not counted for this purpose*
>
> – *you are treated as resident from 6 April of the first year, if it is clear when you first come to the UK that you intend making such visits and you actually carry out your intention*
>
> – *you are treated as resident from 6 April of the tax year in which you decide that you will make such visits, where this decision is made before the start of the fifth tax year and you actually carry out your decision."*

[129] Para 3.3

The problem with this 'codification' of the decision *Lysaght*[130] is that the case itself troubled the Law Lords who felt, in large part, constrained from interfering with a determination as to a question of fact by the Commissioners.[131] This had not troubled the Court of Appeal who, by a majority of 2 – 1, had found for the taxpayer.[132] In so doing they sought to re-frame 'residence' as a question of law.[133] In the House of Lords it was recognised that 'residence' was a question of fact. Even Viscount Cave LC, who in his dissenting judgment considered the 'residence' question a mixed finding of fact and law, nonetheless felt compelled to add that, if the Commissioners' decision were to be taken as a finding on the facts only, then it appeared to him that there was no evidence upon which that finding could properly be based. His fellow Lordships were unable to agree, though two doubted that they would have come to the same decision as the Commissioners did on the facts.[134]

Given the rather uncertain judicial foundation of the Inland Revenue's codification in this area, the question does arise as to whether it would be possible

[130] *Lysaght v IRC* [1928] AC 234
[131] See section 1.6.1
[132] The Master of the Rolls, Lord Hanworth, was of the view that a man may come repeatedly to the UK and not acquire residence status if his visits were determined by other considerations than his own desire or volition, but rather by duty or business. This view was rejected by the House of Lords, Lord Buckmaster observing (at p. 248): *"In my opinion this reasoning is not sound. A man might well be compelled to reside here completely against his will; the exigencies of business often forbid the choice of residence, and though a man may make his home elsewhere and stay in this country only because business compels him, yet none the less, if the periods for which and the conditions under which he stays are such that they may be regarded as constituting residence, as in my opinion they were in this case, it is open to the Commissioners to find that in fact he does so reside."*
[133] Lord Hanworth MR was of the opinion that the Court could review the result which the Commissioners had held to follow in law upon the facts found. He felt that the meaning of 'residence' in the Income Tax Act must be a question of law; and upon the facts found by the

for a person falling within para 3.3 IR 20 to appeal successfully to the courts on the issue of the Revenue's determination of his residency status. After all, the taxpayer could contend that IR 20 has no force of law. The problem faced by any such taxpayer would be this. The courts may consider themselves bound to ask: 'Is the application of the rule in para. 3.3 to the facts of this case so unreasonable that no reasonable Commissioners would apply it.' The answer to such a question would invariably be 'no'. In the alternative, the courts may seize the opportunity of deciding whether the rule in 3.3 is a correct statement of the law. That is, it may be, paradoxically, that the Revenue's attempt at codification has in fact turned 'residence' from a question of fact into a question of law.

Finally, returning to the established residence cases, the courts have held that an intention to leave the UK may have no affect on a taxpayer's residence status.[135] Thus a person forced to remain in the UK due to ill health[136] or business[137] (or even imprisonment)[138] may be deemed UK resident. In *Re MacKensie*,[139] the taxpayer, an Australian, was certified to be insane shortly after arriving in the UK and detained in an asylum for 54 years until her death. In holding her to be resident in the UK Morton J said,

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Commissioners the Courts must determine whether the subject has brought himself within the meaning of the term, rightly construed. This view, too, was rejected by the Huse of Lords.

[134] Lord Warrington of Clyffe and Viscount Sumner.

[135] *Bayard Brown v Burt* (1911) 5 T.C. 37

[136] *Re MacKenzie* (1940) 19 ATC 399

[137] See *IRC v Lysaght* [1928] A.C. 234 at 248

[138] This is a point made in D. Davies Booth: Residence, Domicile and UK Taxation London, Butterworths (1997) p. 24 with which, having reviewed the authorities, the author agrees.

[139] (1940) 19 ATC 399

"Her residence in England became permanent, no doubt, by reason of her mental condition and the fact that she required care and attention, but I think it may fairly be said that, in the ordinary course of her life as events happened, she resided in England."[140]

1.6.3 An Individual's Ordinary Residence

The tax consequences of an individual being resident, ordinarily resident and/or domiciled in the UK are set out in section 1.6.5. It is valuable, however, in understanding Parliament's intention in creating the concept of 'ordinary residence' alongside the concept of 'residence', to appreciate at least one consequence of, say, being ordinarily resident but not resident in the UK. Such an individual, for example, though not resident, would remain in charge to UK income tax and capital gains tax, though, in contrast to a UK resident, his income from overseas possessions and securities[141] would only fall in charge to UK tax to the extent that such income were remitted to the UK. Ordinary residence, it can be seen, is a more enduring personal attribute than residence *simpliciter*.[142]

Like 'residence', the term 'ordinary residence' is not defined by the legislation and the courts have interpreted the phrase in accordance with its ordinary meaning. In the House of Lords case of *Lysaght v IRC*,[143] Viscount Sumner said:

[140] (1940) 19 ATC 399 at 404
[141] This is so provided the individual is a British subject or a citizen of the Republic of Ireland. Presumably, the reasoning of parliament was that if the individual were not a British subject or a citizen of the Republic of Ireland he would most likely be not domiciled in the UK and the remittance basis would apply in any event.
[142] See D. Davies Booth: Residence, Domicile and UK Taxation London, Butterworths (1997) pp. 30-31.

"I think the converse to 'ordinarily' is 'extraordinarily' and that part of the regular order of a man's life, adopted voluntarily and for settled purposes, is not 'extraordinarily'."[144]

In essence, an individual is ordinarily resident in the UK if he habitually resides in the UK. Ordinary residence, in the view of Viscount Cave LC, "connotes residence in a place with some degree of continuity,"[145] but no definition of such continuity has been provided by the courts.

The meaning of 'ordinary residence' was more recently before the House of Lords in a non-tax case. In 1983, in *R. v. Barnet London Borough Council, Ex parte Shah*,[146] the meaning of the phrase 'ordinarily resident' was explored in the context of a student's entitlement to receive an educational grant.[147] In delivering the leading speech,[148] Lord Scarman observed that 'ordinary residence' was not a term of art in English law and that in *Levene v IRC*[149] and *Lysaght v IRC*,[150] as noted above, the House of Lords construed those words as bearing their natural and ordinary meaning. His Lordship continued:

"Unless, therefore, it can be shown that the statutory framework or the legal context in which the words are used requires a different meaning, I unhesitatingly subscribe to the view that 'ordinarily resident' refers to a man's abode in a particular place or country which he has adopted voluntarily and for settled purposes as part

[143] (1928) 13 TC 511
[144] [1928] AC at p. 243
[145] *Levene v IRC* [1928] AC 217 at p. 225
[146] [1983] 2 A.C. 309
[147] The case concerned regulations excluding a local authority from being under a duty to bestow an award upon a person who had not been ordinarily resident in the United Kingdom throughout a specified period of three years.
[148] A speech with which Lord Fraser, Lord Lowry, Lord Roskill and Lord Brandon concurred.
[149] [1928] A.C. 217
[150] (1928) 13 TC 511

of the regular order of his life for the time being, whether of short or of long duration."[151]

Lord Scarman did not consider that a settled purpose required an intention to stay indefinitely, "all that is necessary is that the purpose of living where one does has a sufficient degree of continuity to be properly described as settled."[152] This contrasts with the emphasis of Lord Denning MR in the Court of Appeal in the same case,[153] in which he said:

> *"The words 'ordinary resident' mean that the person must be habitually and normally resident here, apart from temporary or occasional absences of long or short duration."*[154]

Notwithstanding the relative weight that should be given to the House of Lords judgment over that of the Court of Appeal, the author finds Lord Denning's formulation of the nature of ordinary residence the more intellectually sound. Lord Scarman's formulation begs two questions: (i) when is it possible to be ordinarily resident without being resident?; and (ii) when is it possible to be resident without being ordinarily resident? The legislation clearly provides for the former circumstance. By the Taxation of Chargeable Gains Act 1992,

> *"...a person shall be chargeable to capital gains tax in respect of chargeable gains accruing to him in a year of assessment during any part of which he is resident in the United Kingdom, or during which he is ordinarily resident in the United Kingdom."*[155]

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[151] [1983] 2 A.C. 309 at p. 343
[152] Ibid.
[153] *R. v. Barnet London Borough Council, Ex parte Shah* [1982] 1 All ER 698
[154] Ibid., at 704
[155] TCGA 1992 s. 2(1)

Lord Scarman's formulation seems to ignore this assumption of the legislature, and is reminiscent of Viscount Cave observation in *Levene v IRC*:[156]

> *"The expression 'ordinary residence'... I think...connotes residence in a place with some degree of continuity and apart from accidental or temporary absences. So understood, the expression differs little in meaning from the word 'residence' as used in the Acts; and I find it difficult to imagine a case in which a man while not resident here is yet ordinarily resident here."*

Turning to the Inland Revenue guidelines, a taxpayer will be treated as ordinarily resident in the UK if he resides in the UK year after year. An example of the distinction drawn by the Inland Revenue in their Practice Statement may be found in paragraphs 3.6 and 3.8. A person coming to work in the UK for two years is treated as UK resident throughout that time. If he intends to remain for three years he is treated as ordinarily resident.[157]

1.6.4 An Individual's Domicile

Unlike residence and ordinary residence, each individual has only one operative domicile at any one time. It is not a concept developed for tax purposes. In the

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[156] *Levene v IRC* [1928] A.C. 217

[157] IR20 states: *"3.4. You will be treated as ordinarily resident if you come to the UK regularly and your visits average 91 days or more a tax year – see paragraph 3.6. Any days spent in the UK for exceptional circumstances beyond your control, for example the illness of yourself or a member of your immediate family, are not normally counted for this purpose.*
For tax years before 1993–94, you were also treated as ordinarily resident if you came to the UK regularly and you had accommodation in the UK available for your use.
3.5. The date from which you are treated as ordinarily resident depends upon your intentions and whether you actually carry them out. You will be ordinarily resident

- *from 6 April of the tax year of your first arrival, if it is clear when you first come here that you intend visiting the UK regularly for at least four tax years*
- *from 6 April of the fifth tax year after you have visited the UK over four years, if you originally came with no definite plans about the number of years you will visit*

UK important personal law consequences flow from the determination of an individual's domicile, for 'domicile' is a general legal concept, a concept independent of nationality.[158] The term 'domicile' refers to an individual's natural or permanent home.[159] The objective of determining a person's domicile is to connect him with some legal system for certain legal purposes.[160]

Five legal principles have been identified which are fundamental to the determination of an individual's domicile.[161] They are:

- no one shall at any time be without a domicile;
- no one can simultaneously have more than one domicile;
- domicile must relate to a territory subject to a single system of law, whether or not the limits of that territory coincide with national boundaries (thus in the UK an individual's could have a domicile relating to England and Wales, or Scotland or Northern Ireland).
- a change of domicile may never be presumed;[162] and
- domicile must be determined according to the English concept of domicile.

Domicile may be (i) of origin; (ii) of dependence; and (iii) of choice.

- *from 6 April of the tax year in which you decide you will be visiting the UK regularly, if that decision is made before the start of the fifth tax year."*

[158] Some other countries, notably the USA, have nationality as the sole determinant of personal law.

[159] *Whicker v Hume* (1858) 7 HL cas 124

[160] J.H.C. Morris The Conflict of Laws London, Stevens (1971) p.14

[161] See Davies D. Booth: Residence, Domicile and UK Taxation London, Butterworths (1997) pp. 98-99

(i) Domicile of Origin

An individual acquires a domicile of origin on birth.[163] This is usually the domicile of his father, unless his parents are unmarried, in which case it the domicile of his mother. A child will also take the domicile of the mother if the parents, though married, are living apart and the child is living with the mother.[164] The domicile of origin, whether operative or dormant, remains with an individual all his life. That is to say, should an individual acquire a domicile of dependency or a domicile of choice, his domicile of origin becomes dormant only to become operative again should the domicile of dependency cease or the domicile of choice be abandoned.[165]

This principle of law was central[166] to the case of *Udny v Udny*.[167] Colonel Udny had a Scottish domicile of origin, having been born in Scotland of Scottish parents in 1779.[168] He spent his childhood and early adulthood in Scotland, moving to London, aged 33, in 1812, following his marriage. He lived in London for the next 32 years. In 1844 Colonel Udny left England, in serious debt, returning

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[162] This simply means that it is difficult to change one's domicile, particularly a domicile of origin to a domicile of choice.

[163] *Henderson v Henderson* [1965] 1 All E.R. 179

[164] Domicile and Matrimonial Proceedings Act 1973 s. 4(1)-(2). See also *D'Etchegoyen v D'Etchegoyen* (1888) 13 PD 132,

[165] It will, of course, be possible for the individual to re-establish a new domicile of choice. In the interim period, however, the individual's domicile will revert to his domicile of origin.

[166] The principal issue was whether the taxpayer's illegitimate child was legitimated by the taxpayer's subsequent marriage to the child's marriage. This, in turn, depended on the taxpayer's domicile.

[167] (1868) LR 1 Sc & Div 307

[168] It should be recognised from the foregoing exposition that had Colonel Udny been born in England (or anywhere else) of Scottish parents, his domicile of origin would still have been Scottish.

briefly to Scotland from where he sold everything he owned in London. He then fled to Bologne. The Lord Chancellor addressed the issue of domicile thus:

> *"The English domicil of Colonel Udny, if it ever were acquired, was formally and completely abandoned in 1844 when he sold his house and broke up his English establishment with the intention never to return... I think that on such abandonment his domicil of origin revived."*[169]

It will, of course, be possible for an individual to establish a new domicile of choice. But the mere intention to create a new domicile of choice is not sufficient. As will be clear from subsequent analysis of cases, establishing a domicile of choice is not an easy task. Thus an individual who has been deemed to revert to domicile of origin may retain that domicile for a considerable period of time. It is, in any event, difficult to abandon a domicile of origin, by adopting a domile of choice in the first place. Even in *Udny v Udny*[170] some doubts were expressed over whether the colonel had ever established an English domicile. In *IRC v Cohen*[171] such doubts formed the substance of the judgment.

The case involved a taxpayer who was born in England in 1860, his domicile of origin being English. He went to Australia in 1878 and remained there continuously till 1910, some 32 years. In 1911 he retired from business on medical advice and came to England with his Australian wife and daughter. From 1911 to 1931 the taxpayer never spent an entire year in England, apart from the war years, and expressed the intention of returning to Australia as soon as his

[169] (1868) LR 1 Sc & Div 307 at 448
[170] (1868) LR 1 Sc & Div 307
[171] (1937) 21 TC 301

health permitted. The taxpayer had no permanent residence in the UK and the whole of his commercial interests were in Australia. He had even reserved a plot of land for himself and his wife in a cemetery in Australian. The issue of his domicile was relevant to the taxation of his unremitted Schedule D(IV) and D(V) income.[172] It was held that there was insufficient evidence to displace the taxpayer's English domicile of origin. In the view of Finlay J:

> *"I think that when one looks at the facts here the dominating fact is this, that this gentleman lived in Australia so long and so long only as his business continued. He was there, I think, because he found a business to go into there. If he had, after his business connection closed by reason of health, remained in Australia, entirely different considerations would have arisen... I cannot but attach the greatest weight to the fact that as soon as his business connection with Australia closed, then at once his physical connection with Australia... closed also... [H]is base ceased to be Australian and it became an English base. That to my mind is the governing consideration in this case, and it leads me to draw the inference that it is not made out that this gentleman intended to abandon his domicile of origin by acquiring a domicile of choice."*[173]

Before coming to his conclusion Finlay J drew attention to an array of supporting precedents, including *Aikman v. Aikman*,[174] *Udny v. Udny*,[175] and, principally, *Bell v. Kennedy*.[176] *Bell v. Kennedy*, a case dating back to 1868, concerned a Mr Bell, born in 1802, of Scottish parents, who had established a domicile of choice in Jamaica. Mr Bell's domicile of origin was thus Jamaican. After completing his education his education in Scotland (to which he had returned at the age of two), Mr Bell returned to Jamaica, shortly after attaining his majority, to cultivate

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[172] See section 1.2.1.5 below.
[173] (1937) 21 TC 301 at p. 315
[174] 3 Macq. (H.L.) 854
[175] 1 S. & D. 441 (discussed above)
[176] 1 S. & D. 307

the estate bequeathed to him by his father. Mr Bell prospered for many years but piqued by the abolition of slavery in 1834, sold the estate in 1837 and left Jamaica for good and returned to the UK. He started to look for a suitable estate, preferably in Scotland, but possibly in England. At this time his wife died and, as she acquired the domicile of her husband on marriage, in order to determine the law under which her estate was to be administered, Mr Bell's domicile at the time of his wife's death had to be determined. It was held that Mr Bell retained his Jamaican domicile of origin. Lord Colonsay observed:

> *"I think it is very clear that Mr Bell left Jamaica with the intention of never returning... But I do not think that his having sailed from Jamaica with that intent extinguished his Jamaican domicile... He could not so displace the effect which law gives to the domicile of origin, and which continues to attach until a new domicile is acquired* animo et facto."[177]

(ii) Domicile of Dependence

The domicile of dependence is also known as the domicile by operation of law. It applies to two categories of individuals: (i) minors (unmarried children under sixteen), and (ii) the mentally disordered. It used to apply to married women until 1 January 1974 when the Domicile and Matrimonial Proceedings Act 1973 became effective. Prior to the Act a married woman took her husband's domicile by operation of law. The Act provided, however, that a the domicile of a woman who marries on or after 1 January 1974 shall "be ascertained by reference to the same factors as in the case of any other individual capable of having an

[177] 1 S. & D. 307 at p. 323

independent domicile."[178] Some vestiges of the previous dependence remained, for the Act also provided that:

> *"Where immediately before [1 January 1974] a woman was married and then had her husband's domicile by dependence, she is to be treated as retaining that domicile (as a domicile of choice, if it is not also her domicile of origin) unless and until it is changed by acquisition or revival of another domicile on or after [1 January 1974]."*[179]

This provision will become less and less relevant as time moves on, but it remains a restriction on the independent domicile of many married women today. As such the oft quoted dictum of Lord Denning, that the Act removed "the last barbarous relic of a wife's servitude,"[180] sounds somewhat optimistic.[181]

The provision formed the basis of the point of law in *IRC v The Duchess of Portland.*[182] The facts, put very briefly, were these. The taxpayer had married her husband who had an English domicile in 1948 and lived in England with him from that time. She was born and had a domicile of origin in Quebec, had always maintained close links with Quebec, had kept a house there and intended to return there should her husband predeceased her. The courts rejected her claim that she was not domiciled in the UK. Referring to s 1(2) of the 1973 Act, quoted above, Nourse J observed:

[178] Domicile and Matrimonial Proceedings Act 1973 s. 1(1)
[179] Domicile and Matrimonial Proceedings Act 1973 s. 1(2)
[180] *Gray v. Formosa* [1963] P 259, at page 267
[181] The author takes issue with Lord Denning in any event. From a tax perspective, surely the removal of "the last barbarous relic of a wife's servitude" was effected by s. 32 FA 1988 which introduced the independent taxation of married women.

"First, it is a deeming provision. Secondly, that which is deemed in a case where the domicile of dependency is not the same as the domicile of origin is the retention of the domicile of dependency as a domicile of choice. I think that that must mean that the effect of the subsection is to reimpose the domicile of dependency as a domicile of choice. The concept of an imposed domicile of choice is not one which it is very easy to grasp, but the force of the subsection requires me to do the best I can. It requires me to treat the Respondent as if she had acquired an English domicile of choice, even though the facts found by the Commissioners tell me that that would have been an impossibility in the real world. In my judgment it necessarily follows that the question whether, after 1 January 1974, the Respondent abandoned her deemed English domicile of choice must be determined by reference to the test appropriate to the abandonment of a domicile of choice and not by reference to the more lenient test appropriate to the abandonment of one of dependency. There can no longer be any doubt as to the test appropriate to the abandonment of a domicile of choice. The leading case on the subject is Udny v. Udny[183]"[184]

Turning to the two types of individuals to whom the domicile of dependence continues to apply in full, the domicile of origin of an unmarried child under 16 will change by operation of law should the parent responsible for his domicile of origin (father or mother) change his or her domicile by choice.[185] On attaining the age of 16 the child retains his domicile of dependence until he acquires a separate domicile of choice. It is considered easier to establish the abandonment of a domicile of dependence than it is to establish the abandonment of a domicile of choice.[186]

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182 [1982] STC 149
183 (1869) 1 LR Sc & Div 441 (and discussed above).
184 [1982] STC 149 at p. 152
185 Domicile and Matrimonial Proceedings Act 1973 s. 3
186 This is clear from the judgement of Nourse J in *IRC v The Duchess of Portland* [1982] STC 149 , as quoted above in the main text, "In my judgment it necessarily follows that the question whether, after 1 January 1974, the Respondent abandoned her deemed English domicile of choice must be determined by reference to the test appropriate to the abandonment of a domicile of choice and not by reference to the *more lenient test appropriate to the abandonment of one of dependency.*" (Italics added)

Before leaving this area, it is appropriate, out of respect for his expertise in this area, to address the view of Clarke who holds that "[o]n attaining 16 the domicile of dependency is retained by the child as a domicile of choice."[187] This is inconsistent with Nourse J's judgment in *IRC v The Duchess of Portland*.[188] If a domicile of dependency becomes a domicile of choice at sixteen, there can be no "more lenient test appropriate to the abandonment of one of dependency", because as soon as it would be possible to abandon the domicile of dependency (at 16) it would have automatically become a domicile of choice and subject to the higher test. This cannot be the case. The author is confident that on attaining the age of 16 a child retains his *domicile of dependency* until he acquires a domicile of choice.[189] The domicile of choice is based on choice.

There is little that need be said about the domicile of mentally disordered individuals. It would appear that where an individual becomes of unsound mind after he has attained the age of 16 he permanently retains whatever domicile he then possessed.[190]

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[187] Clarke G. Offshore Tax Planning (Fifth Edition) London, Butterworths (1998) p. 159

[188] [1982] STC 149

[189] Support for this view comes from an unlikely source. The Inland Revenue's Statement of Practice IR 20: Residents' And Non–Residents' Liability To Tax In The United Kingdom, states at para. 5(5):

"You have the legal capacity to acquire a new domicile (a domicile of choice) when you reach age 16. To do so, you must broadly leave your current country of domicile and settle in another country. You need to provide strong evidence that you intend to live there permanently or indefinitely. Living in another country for a long time, although an important factor, is not enough in itself to prove you have acquired a new domicile."

[190] For a brief discussion of this area see Davies D. Booth: Residence, Domicile and UK Taxation London, Butterworths (1997) pp. 108-109.

(iii) Domicile of Choice

The case law reviewed under the sub-heading 'Domicile of Origin' above shows also the difficult process involved in changing one's domicile by choice. To acquire a domicile of choice an individual must demonstrate a definite determination to abandon the old domicile. The courts have identified two elements which must be present to acquire a domicile of choice. These are *factum* (fact of residence) and *animus manendi* (intention to remain).

It is the need for the presence of both the *factum* and the *animus* that has thwarted many tax planning schemes that were based on changing the taxpayer's domicile. One of the most notable recent cases involved the millionaire industrialist Sir Charles Clore. In *Re Clore (No 2)*,[191] the taxpayer had followed the professional advice he had been given with the long-term objective of his acquiring a foreign domicile, in a country where no tax was payable, by moving to Monaco in 1977. He died in 1979. The courts held that there was no convincing evidence that the taxpayer had formed a settled intention to reside permanently in Monaco, and accordingly he remained domiciled in England. He may have established the *factum* (though this was in doubt), but he had certainly not established the *animus manendi*.

The test for *factum* is not to be confused with the test for residence in tax law discussed in section 1.6.2 above. As Nourse J explained in *IRC v The Duchess of Portland,*[192] "Residence in a country for the purposes of the law of domicile is physical presence in that country as an inhabitant of it."[193] Moreover, although the *factum* and *animus* tests are separate, in certain cases the *animus* may be inferred from the *factum*. This is a long established principle, as evidenced by the 1854 case of *Anderson v. Laneuville*.[194] A testator with an Irish domicile of origin was sent to France for his education in 1787, when he was aged 19. He fled to England shortly after the outbreak of the Revolution and acquiring an English domicile of choice. At the age of 67 he returned to France to live with a woman he had previously known, which he did continuously until his death in 1849, aged 81. It was held he was resident in France at the time of his death, his *animus* may be inferred from his *factum*.[195]

Though the courts may, but not always will, infer an *animus* from a *factum*, a clear *animus* will always defeat a contrary *factum*, as occurred in the comparatively modern case of *IRC v Bullock*.[196] The taxpayer was born in Halifax, Nova Scotia in 1910 where he had his domicile of origin. In 1946 he

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[191] [1984] STC 609
[192] [1982] STC 149
[193] [1982] STC 149 at 155
[194] (1854) 9 Moo. P.C.C. 325.
[195] This case remains good law for the principle for which it has been quoted, but Buckley LJ in IRCv Bullock [1976] 3 All E.R. 353 at p. 360 felt that the decision "must be read in the context of the facts of that case." He was more specific regarding the view expressed in the judgement at p. 334 that "[i]t never can be said that residing in a country until the death of an individual is a residence merely for a temporary purpose." For Buckley LJ it "cannot in my opinion be taken as an enunciation of a rule of universal application." At p. 360
[196] [1976] STC 409

married a lady of English domicile. From 1947 to 1976, the date of the appeal, the taxpayer and his wife lived in England, visiting Canada on a number of occasions. Throughout this period the taxpayer's wife refused to live in Canada, but, as matters stood up to and at the time of the appeal, the taxpayer intended to return to Canada if his wife predeceased him. It was held in the Court of Appeal, that because the taxpayer had always maintained a firm intention to return to Canada in the event of him surviving his wife, he had not, on the facts of this case, acquired an English domicile, despite the matrimonial home continuing to be in England. In reaching this conclusion Buckley LJ said that:

> *"As long ago as 1865 Turner L.J. said in* Jopp v. Wood,[197] *that nothing was better settled with reference to the law of domicile than that the domicile can be changed only* animo et facto; *that is to say, by intention as well as action. The necessary act is that of taking up residence in some country other than the country of the domicile of origin. There is no dispute in the present case about the taxpayer having taken up residence in England. What his intention was in doing so is a question of fact. What we have to determine is whether that intention was such as to clothe his residence in England with the necessary quality to result in his having adopted a domicile of choice in England."*[198]

It should be noted that the burden of proof in domicile cases is on he who asserts that he has changed his domicile. As discussed above, should a domicile of choice subsequently be abandoned, the domicile of origin is revived until another domicile of choice is established. Finally, on inheritance tax matters only, all of the above common law should be read with the Inheritance Tax Act 1984 which provides that a taxpayer is deemed to retain his UK domicile for three years after

[197] (1865) 4 de G.J. & S. 616 at page 621
[198] [1976] 3 All E.R.STC 353 at p. 357

he has acquired a new common law domicile,[199] a discussion of which is beyond the scope of this work.

1.6.5 The Tax Consequences of Residence, Ordinary Residence and Domicile

As mentioned in 1.6 above, an individual who is resident, ordinarily resident and domiciled in the UK is subject to tax on his worldwide income. There are different tax consequences should the individual be resident, but not ordinarily resident and/or not domiciled in the UK. These consequences themselves differ depending on the schedule under which the income falls to be charged.

1.6.5.1 Schedule D(V)

The first to be examined relates to income derived from a trade, profession or vocation, which, because the income is generated wholly abroad, falls to be taxed under Schedule D(V), income from overseas possessions, rather than Schedule D(II). Such income is subject to UK tax if the taxpayer is resident in the UK. However, the liability on such income is limited to the amounts the taxpayer remits to the UK[200] when he is:

- not domiciled in the UK; or

[199] Section 267 Inheritance Tax Act 1984
[200] Income arising in the Republic of Ireland is treated as if it arose in the UK but is nevertheless entitled to the same deductions as if it had been so relieved. ICTA 1988, s. 68.

• a Commonwealth (including a British) citizen or a citizen of the Republic of Ireland and is not 'ordinarily resident' in the UK.[201]

1.6.5.2 Schedule D(VI)

Section 18(1)(a)(iii) ICTA provides that tax under Schedule D shall be charged in respect of annual profits or gains accruing –

> *"to any person, whether a Commonwealth citizen or not, although not resident in the United Kingdom from any property whatever in the United Kingdom or from any trade, profession or vocation exercised within the United Kingdom."*

Such income fall to be taxed under Schedule D(VI), the schedule for "any annual profits or gains not falling under any other Case of Schedule D and not charged by virtue of Schedule A or E."[202]

This provision is very relevant to non-resident performers both in regard to exercising their trade, profession or vocation in the UK (concerts, exhibitions, sporting contests, etc) and in regard to the definition of "property … in the United Kingdom." The case of *Alloway v Phillips*[203] is instructive.

The case concerned the wife of one of the 'Great Train Robbers'. In 1968, while resident in Canada, and pursuing no profession or vocation, she co-operated with the News of the World under contract in the ghost-writing of articles based upon

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[201] ICTA 1988, s. 65

her experiences for the sum of £39,000. The Revenue assessed the taxpayer under Schedule D(VI). On appeal it was contended, inter alia, that the income arose from services rendered in Canada by a non-UK resident and was therefore outside the scope of UK tax. The Court of Appeal held that the income arose from property situated in the UK, the property being the rights under the UK contract with the News of the World. Lord Denning MR, had little difficulty with the case.[204] His Lordship said that:

> *"This case comes under Case VI of Schedule D. It seems to me clear that this wife had property in the United Kingdom. She had a chose in action here. She had a right to receive from the News of the World the sum of £39,000... It was property in England: but she had no property at all in Canada. She had no copyright there. She only had the information in her head which she told to the newspaper reporter. That is not a species of property known to the law of England–nor, I expect, to the law of Canada."*[205]

1.6.5.3 The Cases of Schedule E

Schedule E is divided into Cases I, II and III and liability to income tax is determined by the particular Case under which the employee falls to be assessed. The Cases, in turn, classify the employee according to his residency status. Case I applies where the employee is resident and ordinarily resident in the UK. This is

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[202] ICTA 1988, s. 18(3)
[203] [1980] 3 All E.R. 138
[204] Part of this absence of difficulty, one suspects, was the nature of the case. Lord Denning himself says at the conclusion of his judgment, at p. 143: *"In conclusion I may say that many people regret the practice of such newspapers in paying money to criminals or their wives–so as to get a sensational story to publish. There is nothing illegal in it, so far as I know. But on one point I am clear: If the criminals or their wives get money by relating their stories to newspapers, they ought to pay tax on their profits and gains."* This is all well and good, but the precedent established potentially applies to non-residents contracting to sell perfectly legitimate stories to the UK press. An instance, perhaps, of hard cases making bad law.

the Case under which most UK employees fall. Case II applies where the employee is not resident, or if resident, is not ordinarily resident in the UK. This schedule taxes emoluments which are earned in respect of duties performed in the UK. Such emoluments fall in charge to UK tax in the same manner as under Case I. Where the duties of the employment are performed wholly outside the UK Case II does not apply, but a possible charge may arise under Case III. Case III applies where the employee is resident in the UK, whether ordinarily resident or not. Case III levies tax on a remittance basis only. A charge under Case I or Case II precludes a charge under Case III,[206] leaving Case III to tax those emoluments which would otherwise have escaped UK tax but for the fact that they were remitted to the UK.

Applying these cases to, say, professional footballers, who, as discussed in section 1.2, are employees of their clubs, most footballers in the UK would fall to be taxed under Schedule E, Case I, being resident and ordinarily resident in the UK. A footballer on loan to a UK club from, say, a German club, for one season, would fall to be taxed under Schedule E, Case II, being not resident, or if resident, not ordinarily resident, in the UK. Case III would catch such employment income earned by the German footballer from the UK club on activities performed outside the UK that he chose to remit to the UK.[207]

[205] [1980] 3 All E.R. 138 at p. 143

[206] ICTA 1988, s. 131(2)

[207] This assumes that the footballer would be adjudged resident but not ordinarily resident in the UK.

1.6.5.4 Withholding Tax: Non-resident Entertainers And Sportsmen

There are special tax provisions relating to non-resident entertainers and sportsmen who perform in the UK during a fiscal year. These provisions were introduced by the Finance Act 1986 and became effective on 1 May 1987. In essence the provisions enact a mandatory withholding tax in respect of payments made to non-resident entertainers or sportsmen performing in the UK. Thus, where a payment is made in respect of an appearance by a non-resident entertainer or sportsman in the UK the payer must deduct tax at the basic rate.[208] This rule does not apply if:

- the payments (including connected payments) are below £1,000;[209]
- the recipient has agreed a lower or nil rate of withholding tax with the Revenue;[210]
- the payment has already been subjected to tax deduction at source under the Taxes Act[211] (e.g., on copyright royalties[212] or PAYE);
- the payments are for record sales where the payment is based on the proceeds of sales or is a non-returnable advance on account of future sales;[213] or
- the payments are for ancillary services, on an arm's length basis, to a person who is resident and ordinarily resident in the UK and not connected with or an

[208] ICTA 1988 s. 555
[209] SI 1987/530, para. 4(3)(a)
[210] SI 1987/530, para. 5
[211] SI 1987/530, para. 3(3)(a)
[212] ICTA s. 536
[213] SI 1987/530, para. 3(3)(c)

associate of the performer[214] (e.g., ticket printing, hall and equipment hire, etc.).[215]

For these purposes the definitions of 'entertainers' and 'sportsmen',[216] set out in statutory instrument 1987/530, are broad (and somewhat tautological) in nature. The withholding tax provisions apply irrespective of whether the performer is employed or self-employed.[217] They apply not only to the performer's income but also to sums given to cover expenses (even if the expenses relate to a charity event for which the performer is not getting paid). It also applies to loans to the performer, clearly an anti-avoidance provision, and payments or prizes in kind, motor cars, vintage champagne, etc. Finally, the withholding tax does not only cover the income from a sportman's or entertainer's 'performance'. It even covers income from endorsements, sponsorships and personality merchandising.[218] According to Harvey and Baldwin the UK "is probably the only tax authority in the world seeking to tax visiting performers on merchandising income."[219]

[214] SI 1987/530, para. 3(3)(b)
[215] Examples from FEU 50 para. A8
[216] The Income Tax (Entertainers and Sportsmen) Regulations 1987 (SI 1987/530), para. 2(1): "'entertainer' means any description of individuals (and whether performing alone or with others) who give performances in their character as entertainers or sportsmen in any kind of entertainment or sport; and "entertainment or sport" in this definition includes any activity of a physical kind, performed by such an individual, which is or may be made available to the public or any section of the public and whether for payment or not."
[217] ICTA 1988 s. 555
[218] SI 1987/530, para. 6(3)(b)
[219] R. Harvey and R. Baldwin Tax and Financial Planning for Sportsmen and Entertainers, London, Butterworths (1994) p. 89

Of equal, if not greater, importance is that the payments subject to the withholding tax are not limited to those to the performer.[220] Connected payments to individuals, partnerships, companies or trusts, whether resident in the UK or not, are subject to the withholding tax. The term 'connected' is this context is thus of crucial importance. It is not found in the Taxes Act 1988, but rather in the statutory instrument (SI 1987/530) which provides:

> *"... a payment or a transfer made for, in respect of, or which in any way derives either directly or indirectly from, the performance of a relevant activity, has a connection of a prescribed kind with the relevant activity."*[221]

This is as all encompassing a definition of 'connected' as one is likely to find anywhere.

The withholding tax system is administered by the Inland Revenue's Foreign Entertainers Unit (FEU). The Unit has issued a 'Payer's Guide', FEU 50, to assist those who make payments to non-resident performers. It has no force in law, but not unlike IR20, discussed above,[222] it has become the principal guide to the interpretation of the relevant statutory provisions. This is particularly so in light of the contrast between the opaque and circular language of the statute and statutory instrument and the impressive clarity (in narrative and examples) of the Guide. It is, perhaps not unsurprisingly, skewed in the Revenue's favour. It opens:

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[220] ICTA 1988 s. 555(2)
[221] SI 1987/530, para. 3(2)
[222] See 1.2.1.1.

"Any payer who makes a payment to any person, which in any way arises directly or indirectly from a UK appearance by a non-resident entertainer must deduct tax at the basic rate. There are certain exceptions from the scheme."[223]

The operation of this scheme is returned to in the Case Studies in Chapter 5.

1.6.5.5 Capital Gains

To be within the charge to UK capital gains tax, a person must be either: resident in the UK during any part of the year of assessment; or ordinarily resident in the UK for the year of assessment.[224] The liability to capital gains tax is computed with regard to gains arising on assets wherever situated in the world and, in general, whether the proceeds are remitted to the UK or not. There is an exception to this general rule. In the case of a resident or ordinarily resident individual who is not domiciled within the UK, he or she is liable to tax on gains arising on assets situated outside the UK only to the extent that those gains are remitted to the UK.[225]

Individuals who are not resident and not ordinarily resident are not liable to UK capital gains tax on gains arising on the disposal of assets situated in the UK,[226] subject to one exception. A person who is neither resident nor ordinarily resident

[223] FEU 50 para. A1
[224] TCGA 1992, s. 2(1)
[225] TCGA 1992, s. 12(1)
[226] This is in contrast to the income tax position where non-residents are liable to tax on UK sources of income.

will be chargeable to tax in respect of gains arising on assets used or held for the purposes of a trade carried on in the UK via a branch or an agency.[227]

The 1998 Budget introduced new capital gains tax rules with regard to residence. From 17 March 1998 any individuals who leave the UK for a period of temporary residence abroad, as defined, will remain in charge to UK capital gains tax.[228] A period of temporary residence abroad is defined in the legislation as being less than five complete tax years. Gains realised in the fiscal year of departure will be chargeable in that year and gains made during the period of non-residence will be chargeable in the fiscal year of return.[229] Losses will be allowable on a similar basis. These new rules only apply to individuals who have spent at least four out of seven years immediately preceding the tax year of departure resident in the UK.[230]

1.6.6 Residence, Ordinary Residence and Domicile: Future Developments

The legal concepts of residence, ordinary residence and domicile, and their tax consequences, are ripe for reform. This whole area, as the foregoing analysis has highlighted, is so complex that it gives rise to a high degree of uncertainty to

[227] TCGA 1992, s. 10
[228] TCGA 1992, s. 10A inserted by FA 1998, s. 127(1)
[229] TCGA 1992, s. 10A(2)
[230] TCGA 1992, s. 10A(1)(d)

taxpayers affected by these issues.[231] In 1988 the Inland Revenue issued a consultative paper in which they suggested comprehensive reform whereby residence would be the only determinant of liability to UK taxation.[232] Residence, in turn, would be based on physical presence in the UK for 183 days or more. A new intermediate basis of taxation would apply to an individual's worldwide income depending on the length of an individual's residence in the UK.

In opposition the present Labour government recommended the overhaul of the present system in line with the Revenue's recommendations.[233] Some perceived abuses have been tackled, such as the elimination of the capital gains tax exemption for temporary residence abroad, as discussed in section 1.6.5.5 above. However, the promised overhaul appears to have been shelved, at least for the time being.

This is an area of tax law, however, where the reform required is not solely to tackle perceived abuses. Any reform should also provide much needed clarity, thereby introducing more certainty for the taxpayer, the tax advisor and the Inland Revenue.

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[231] A view supported by Rt. Hon. Denzil Davies, former Minister of State at the Treasury. See D. Davies Booth: Residence, Domicile and UK Taxation London, Butterworths (1997) p. 2
[232] Inland Revenue 'Residence in the United Kingdom, The Scope of UK Taxation for Individuals, a Consultative Document', July 1988

1.7 THE TAX EFFECTS OF INCORPORATION

Many entertainers, sportsmen and sportswomen set up 'one person' companies ostensibly to control their business interests, but principally for the purposes of minimising their exposure to taxation. These companies have been described in various ways, including 'service companies',[234] 'captive employer companies',[235] 'loan-out companies',[236] 'rent-a-star companies'[237] and 'slavery corporations'.[238] For the rest of this section the 'one person' performer company will be referred to by the term 'service company'. Service companies may be UK registered. They may also be offshore companies. This section concentrates on UK resident service companies. The offshore company is explored in Chapter 4.[239]

1.7.1 Tax Deferral

The tax effectiveness of UK service companies was recently commented on by the author in a published article published for tax practitioners:[240]

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[233] Labour Party 'Tackling Abuses – Tackling Unemployment' November 1994

[234] B. Laventure Taxation of Specialised Occupations and Professions London, Institute of Chartered Accountants (1992) p.34

[235] R. Harvey and R. Baldwin Tax and Financial Planning for Sportsmen and Entertainers, London, Butterworths (1994) p.49

[236] D. Sandler The Taxation of International Entertainers and Athletes The Hague, Kluwer Law International (1995) p.131

[237] OECD Taxation of Entertainers, Artistes and Sportsmen Paris, OECD (1987), para. 26

[238] Ibid.

[239] See section 4.2.5 of Chapter 4 for the uses of offshore companies in tax planning for sportspeople and entertainers.

[240] T.L. Thomas *'Focus on Sportspeople and Entertainers'* Tolley's Practical Tax Supplement - October 1997

> *"Many performers are advised to 'incorporate themselves' for tax reasons. This involves the performer in setting up a service company, transferring to it his or her intellectual property rights, and contracting with it only to perform those entertaining or sporting activities directed by the company. In this way, the company contracts on behalf of the individual and all earnings and royalties accrue to the company. Put simply, the service company is a tax minimisation tool. The profits left in the company after the allowable deductions, including the performer's salary to which the normal PAYE rules would apply, is in most instances taxed at the small companies' rate of [20%], rather than the higher income tax rate of 40%."*[241]

Tax deferral is also achieved by a service company even if it is subject to the full corporation tax rate of 30%,[242] applicable for 1999/00 on taxable profits over £1.5 million, as this is still considerably lower than the highest rate income at band of 40%, applicable for 1999/00 on all taxable income over £28,000. There are other advantages to a performer using a UK service company which are examined below.

1.7.2 Defeating Employee Status

A company can never be an employee. It follows that a performer who is concerned that the circumstances of his engagements may lead the Inland Revenue to classify him as an employee may defeat all such arguments by providing his services through a service company. A company, like a self-employed individual, may deduct from its trading income for tax purposes all

[241] Ibid., p.168b

[242] This is a little misleading. The 21% tax rate is applied to taxable profits up to £300,000 and the full rate of 31% is applied to taxable profits over to £1,500,000. On profits of between £300,000

expenditure "wholly and exclusively laid out or expended for the purposes of the trade, profession or vocation."[243] Thus by operating through a service company a performer who would otherwise be employed can enjoy the advantages of the 'wholly and exclusively' rule over the 'wholly, exclusively and necessarily' rule. For a discussion of these advantages see section 1.2.

The service company, however, is sometimes not welcomed by the regulating bodies, particularly in team sports. For example, it is not possible for a footballer in the UK to insist that his Club contracts with his service company. The Football League rules specifically state that a player must be personally contracted to his Club. Matters are more flexible in cricket. The Test and County Cricket Board rules permit the use of players' services companies.[244] In the fast changing world of rugby union the position is not clear. The 'S J Berwin & Co Legal Guide to Rugby Union Players Contracts'[245] clearly envisages that the players will be subject to PAYE as employees,[246] but services companies are not specifically ruled out.[247]

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and £1,500,000 the full rate is used but the tax so computed is subject to a reduction known as the 'small companies marginal relief'.

[243] ICTA 1988 s. 74(1)(a)

[244] R. Harvey and R. Baldwin Tax and Financial Planning for Sportsmen and Entertainers, London, Butterworths (1994) p.53

[245] McInerney P. (Ed) *'S J Berwin & Co Legal Guide to Rugby Union Players Contracts'* Rugby World, IPC Magazines, London (1998)

[246] Ibid., at p. 56 "As a general rule rugby clubs will pay each player a basic wage or salary. Income tax is chargeable under … Schedule E on the emoluments arising from the player's employment with the club…"

1.7.2.1 IR35

In his 1999 Budget Speech the Chancellor announced that changes were to be introduced to take effect from April 2000 aimed at countering tax avoidance by using personal service companies. The Inland Revenue press release accompanying this announcement, IR35,[248] expressed concernover the hiring of individuals through their own service companies so that those individuals can exploit the fiscal advantages offered by a corporate structure, thereby paying substantially reduced tax and national insurance. It announced that the Government would bring forward legislation to tackle this sort of avoidance.

The Government is committed to a consultative process, [249] and, one assumes, the legislation has yet to be drafted. The Government's objective, however, is clear.

> *"The aim of the proposed changes is to ensure that people working in what is, in effect, disguised employment will, in practice, pay the same tax and national insurance as someone employed directly."*[250]

This is a fundamental attack on the use of service companies as part of a tax planning strategy. The ambit is potentially very wide, notwithstanding the Government's stated limited objective:

> *"The proposed changes are aimed only at engagements with*

[247] Service companies are simply not mentioned in the contractual guide. Given that the model of the FA's contracts is in the public domain, the absence of similar provisions in Rugby players contracts would seem to suggest that service companies are permissible (if not encouraged).
[248] IR35 'Countering Avoidance In The Provision Of Personal Services', 9 March 1999
[249] Ibid., para 4: *"[T]he Inland Revenue will over the next few months be working with representative bodies on aspects of the practical application of the new rules and on the production of guidance."*
[250] Ibid., para. 1

> *essential characteristics of employment. They should affect only those cases where these characteristics are disguised through use of an intermediary - such as a service company or partnership. There is no intention to redefine the existing boundary between employment and self-employment."*[251]

The proposals in IR35 have received opposition from an alliance of major professional and business organisations. The Chartered Institute of Taxation, the Law Society, the CBI, the Institute of Chartered Accountants, the Institute of Directors, the Federation of Small Businesses and several computer associations, sent a joint letter to the Paymaster-General expressing serious concerns. The Institute of Chartered Accountants told the Government: 'The operation of the rules will be extremely burdensome, if not unworkable.'[252]

The effect of IR35 on sportspeople and entertainers could be considerable. Its full impact will depend on the drafting of the actual legislation. It should not affect those performers who use a service company because the corporation tax regime is preferable to the income tax regime, performers like golfers and boxers whose status as self-employed traders is unchallenged. It seems likely however to affect all those performers who use a service company partly to defeat employee status. The applicability of IR35 to performers is addressed in Case Study I in Chapter 5.

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[251] Ibid., para. 3

1.7.3 Regularising Income

In section 1.5.3 the statutory provisions regarding the spreading of income[253] were explored in the context of professional writers. These provisions also applied to artists and sculptors, but not to entertainers or sportspeople generally. It will be recalled that the object of the provisions was to spread irregular income evenly over the years of the project giving rise to the income. This ensured that the taxpayers could benefit from the use of personal allowances and lower rates of taxation during those years in which he was working on the project but benefiting from no or little income. Properly administered a service company can achieve similar results for those performers not covered by the income spreading provisions.

Self-employed performers are taxed on the net profits they enjoy in each fiscal year. Companies too are taxed on their net profits in each year of account. However, as set out above, there is a marked difference between the higher income tax rate and the corporation tax rates. Thus through a service company a performer can arrange for his company pay him a regular salary, utilising his personal allowances and the lower and basic rate bands, leaving the surplus income in the company to suffer the lower rates of corporation tax. This surplus can itself be paid to the performer during periods of inactivity or long-term project work, thereby maximising the personal tax reliefs and lowering the

[252] M. Becket 'An Unprecented alliance of major business and professional bodies has come together to oppose personal service company regulations' The Daily Telegraph, June 7, 1999

aggregate tax burden. This has traditionally been an example of efficient and non-contentious tax planning.

1.8 CONCLUSIONS

The future of the taxation of sportspeople and entertainers in the UK will reflect the combination of three factors. First, the present New Labour Government is committed to minimising tax avoidance opportunities, invariably referred to as 'closing tax loopholes'. Secondly, the UK courts are adopting a more purposive approach to the interpretation of tax legislation, resulting in the negation of any benefits deriving from 'artificial' tax planning schemes. Thirdly, sportspeople and entertainers are enjoying unprecedented earnings, largely due to technological advances, not least of which is the advance of satellite broadcasting and the advent of pay-per-view.

The high income, high profile nature of performers will continue to attract the attention of the Inland Revenue, who will be supported by increasing anti-avoidance legislation and a judiciary keen to shake off their previous literal approach to interpreting tax legislation.

CHAPTER 2

THE SYSTEM OF TAXATION AS APPLIED TO NON-RESIDENT SPORTSPEOPLE AND ENTERTAINERS IN THE US

2.1 INTRODUCTION

In contrast to the UK, and most other countries, the US taxes individuals on the basis of nationality. US citizens fall in charge to US tax whether or not they are resident in the United States.[1] The US also taxes residents who are not US citizens. Such individuals are referred to as 'resident aliens'.[2] In addition, the US taxes the US source income of non-residents who are not citizens. These individuals are referred to as 'non-resident aliens'. [3] This section focuses on the taxation in the US of non-resident alien sportsmen, sportswomen and entertainers.

2.2 RESIDENCE

The rules pertaining to residence in the US are different for individuals companies and partnerships. Each is examined in turn.

[1] Non-residents can be exempt on up to $70,000 of foreign earned income.
[2] IRC s. 7701(b)(1)(A)

2.2.1 Residence of Individuals

Since 1 January 1985 there has been two technical tests under the Internal Revenue Code 1986 (as amended) to determine the residence of an individual. First, an alien individual will be treated as a resident alien of the US with respect to any calendar year if, at any time during the year, the individual is a lawful permanent resident of the United States.[4] An individual is a lawful permanent resident of the US at any time if (a) the individual has the status of having been lawfully accorded the right of permanently residing in the US as an immigrant in accordance with the immigration laws (i.e., such individual holds a "green card"), and (b) that status has not been revoked (and has not been administratively or judicially determined to have been abandoned).[5] An alien individual who is issued a "green card" is considered a resident alien of the US for income tax purposes on the first day that the individual is present in the United States as a lawful permanent resident, regardless of the number of days that the individual is present in the United States.[6] This contrasts sharply with the UK where the residence for tax purposes is determined independently of an individual's immigration status. The difference is largely accounted for by the fundamental basis on which individuals are taxed in the two countries. The US approach is consistent with taxing individuals on the basis of nationality.

[3] IRC s. 7701(b)(1)(B)

[4] Sec. 7701(b)(1)(A)(i); sec. 301.7701(b)-1(b)(1), Proced. & Admin. Regs.

[5] Sec. 7701(b)(6); sec. 301.7701(b)-1(b)(1), Proced. & Admin. Regs.

[6] Sec. 7701(b)(2)(A)(ii); sec. 301.7701(b)-4(a), Proced. & Admin. Regs.

The second US test for an individual's residence status, the substantial presence test, is far more similar to the UK approach. An individual meets the substantial presence test with respect to any calendar year if he was present in the US for at least 31 days during that calendar year and for at least 183 days, calculated pursuant to a weighted formula,[7] during the taxable year and the two preceding years.[8] An individual is treated as present in the United States on any day that such individual is physically present in the US at any time during such day.[9] Even if an individual does not meet either of these tests, he may be able to elect to be treated as a U.S. resident for part of the year.[10] There is a concession under the substantial presence test for athletes so as not to discourage them from appearing in charity sponsored tournaments. An individual is not treated as present in the US for the substantial presence test if he is a professional athlete who is temporarily in the United States to compete in a charitable sports event.[11]

There is an important exception to the substantial presence test. Where an individual is present in the United States for fewer than 183 days of the relevant year and establishes that for that year his 'tax home' (as defined in section 911 of

[7] Sec. 7701(b)(3)(A)(ii) provides "...the sum of the number of days on which such individual was present in the United States during the current year and the 2 preceding calendar years (when multiplied by the applicable multiplier determined under the following table) equals or exceeds 183 days:

In the case of days in:	The applicable multiplier is:
Current year	1
1st preceding year	1/3
2nd preceding year	1/6"

[8] Sec. 7701(b)(3)(A); sec. 301.7701(b)-1(c)(1), Proced. & Admin. Regs.
[9] Sec. 7701(b)(7)(A)
[10] Sec. 7701(b)(4); sec. 301.7701(b)-4(c)(3), Proced. & Admin. Regs.
[11] Sec. 7701(b)(5)(A)(iv)

the Code) [12] is in a foreign country and that he has a closer connection to that foreign country than to the United States, the individual shall not be treated as meeting the substantial presence test [13]

Under section 911, an individual's tax home is considered to be located at his regular or principal place of business or, if the individual has no regular or principal place of business, then at his regular place of abode.[14]. (Further, section 911(d)(3) specifically provides that an individual shall not be treated as having a tax home in a foreign country for any period during which his abode is within the United States.) An individual will be considered to have a closer connection to a foreign country than to the US if the individual has maintained more significant contacts with the foreign country than the US. Some of the factors considered include the location of the individual's permanent home and family and personal belongings, the location of cultural or religious organizations to which he belongs, and where the individual votes.[15]

Where an individual is resident in the US under the foregoing rules and resident in another country under the rules of that other country, then if the US has a double taxation treaty with the second country the 'tie-breaking rules' come into effect. Under the tie-breaking rules of the model income tax treaty of the US Treasury

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[12] Sec. 911(d)(3) without regard to the second sentence thereof. At the election of a qualified individual, section 911(a)(1) provides a limited exclusion for foreign earned income. Such exclusion is limited to $70,000 annually (Sec. 911(b)(2)). A qualified individual is a U.S. citizen whose tax home is a foreign country and who meets the bona fide residence test, or resides in a foreign country for a qualifying period (Sec. 911(d)(1)).

[13] Sec. 7701(b)(5)(B)(ii)

Department,[16] when an individual is a resident of two countries under a treaty definition of residence, the individual's residence is where he has a permanent home.[17] An individual having a permanent home in both countries is considered a resident of the country where his personal and economic relations are closer (known as the centre of vital interests test).[18] In situations where an individual's centre of vital interests cannot be determined, he is deemed a resident of the country where he has his habitual abode.[19] Should the individual have an habitual abode in both countries or neither of them, he will be deemed a resident of the country where he is a national.[20] The residence of any individual who is a national in both countries will be determined by mutual agreement between the appropriate authorities of the Contracting States.[21] These rules will be examined in more detail in the Double Taxation Treaty section of this chapter.

2.2.2 Residence of Companies

The services of performers are often supplied by companies, be they long established substantial concerns, the personal service companies of the performers or companies established solely for the purpose of a specific tour or engagement. The residence of companies under US tax law is far simpler to determine than the

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[14] Sec. 1.911-2(b), Income Tax Regs
[15] IRS Field Service Advice FSA 1998-50
[16] US Treasury Department's Model Income Tax Treaty of 16 June 1981
[17] Ibid., Art. 4(2)(a)
[18] Ibid., Art. 4(2)(a)
[19] Ibid., Art. 4(2)(b)
[20] Ibid., Art. 4(2)(c)
[21] Ibid., Art. 4(2)(d)

residence of individuals. A company is a US resident corporation if it is incorporated under the laws of any State in the US. All other companies are treated as foreign corporations. The place of management and control is irrelevant.

There are similarities between these US rules and the post-1988 UK rules on the residence of companies, insofar as all UK incorporated companies are now deemed to be UK resident, as discussed in Chapter 3, section 3.2.2. However, under UK law a company incorporated overseas which maintains its central management and control in the UK would also be UK resident. Under US law a company in comparable circumstances remains a foreign corporation.

A US resident company is liable to corporation tax on all income and capital gains, wherever arising, during its accounting period. A foreign corporation is liable to US corporation tax on income and capital gains if it is engaged in trade or business within the United States during the taxable year. The tax will be levied on that part of its taxable income which is effectively connected with the conduct of a trade or business within the United States.[22]

[22] IRC s. 882(a)(1)

2.2.3 Residence of Partnerships

The rules relating to the residence of partnerships in the US are similar to those relating to the residence of companies. Section 7701 of the Code provides:

> *"The term "domestic" when applied to a corporation or partnership means created or organized in the United States or under the law of the United States or of any State unless, in the case of a partnership, the Secretary provides otherwise by regulations.*[23] *... The term "foreign" when applied to a corporation or partnership means a corporation or partnership which is not domestic."*[24]

This is consistent with the US residence rules pertaining to companies. Again the UK provides a contrast. The residence of a partnership under UK tax law is the jurisdiction in which it has its central management and control. A similarity between the US and the UK in this area can be found in the taxing provisions relating to resident partnerships. Both countries tax the individual partners on their share of the profits rather than the partnership as a separate legal entity, though both countries require the submission of a partnership tax return.

As regards taxation, as discussed above US citizens and resident aliens generally are taxed on their worldwide income. This includes their share of the profits of any domestic or foreign partnership. Non-resident aliens are taxed only on their income from sources within the US and on certain income connected with the conduct of a trade or business in the US. This clearly covers a domestic

[23] IRC s. 7701(a)(4)
[24] IRC s. 7701(a)(5)

partnership, but will only extend to a foreign partnership if its income is from a US source or its business or trade is connected with the US.

The creating of a partnership in the US is as lacking in formal documented procedural requirements as it is in the UK. Under UK law a partnership is defined as "the relationship which subsists between persons carrying on business in common with a view to profit."[25] In the US a partnership is formed when two or more parties intend to act jointly in conducting a business with the intent to share in its profits (and losses). For tax purposes, as set out in the Regulations to the Code, "[t]he term partnership means a business entity that is not a corporation [as defined] and that has at least two members."[26]

This had led to several issues before the Tax Court which have turned on whether the business entity in question is a partnership or not.[27] A detailed review of revenue law cases, however, reveal that the Tax Court has been untroubled by cases turning on whether a partnership is US resident ('domestic') or non-resident ('foreign'). It would appear that determining whether a partnership has been 'created or organized in the United States or under the law of the United States' has proven to be non-contentious.

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[25] The Partnership Act 1890, s. 1

[26] Sec. 301.7701-2(c)(1), Proced. & Admin. Regs.

[27] See *Smith v Commissioner* (1959) 33 T.C. 465 in which commodity markets Funds were held to be associations taxable as corporations, not partnerships; and *South Texas Rice Warehouse Co v Commissioner* (1965) 43 T.C. 540 a new partnership with the same membership as a parallel corporation with which it was trading was held to be not a sham but a bona fide business entity for tax purposes.

2.3 WITHHOLDING TAX

The US operates a withholding tax system in respect of non-resident aliens, foreign partnerships and foreign corporations. This has direct applicability to non-resident sportspeople and entertainers performing in the US, be they employed or self-employed. This section examines the US withholding system as it applies to performers in the US and contrasts it with the withholding tax system operated in the UK. The US system is further explored and applied in Case Studies II and III in Chapter 5.

2.3.1 Non-resident Aliens and Foreign Partnerships

Section 1441(a) of the Internal Revenue Code 1986 (as amended) provides for the withholding at source of Federal income tax at the rate of 30 percent on certain payments made to non-resident aliens or foreign partnerships. The payments covered include 'items of fixed and determinable annual or periodical gains, profits, or income from sources within the United States'.[28] This provision prima facie applies to all non-resident alien performers as income from the performance of personal services, whether on a self-employed or employee basis, is considered by the US to be US source income.[29]

[28] Except as otherwise provided in section 1441(c) of the Code.

[29] IRC ss. 861(a)(3) and 864(b). Section 861(a)(3) of the Code does provide a *de minimus* rule. It provides, in part, that compensation for personal services performed in the United States shall be treated as income from sources in the United States unless such services are performed by a non-resident alien individual who is present in the United States for no more than 90 days during the taxable year, who receives in the aggregate no more than $3,000 for such services, and who

An exemption from the withholding tax is to be found in s.1441(c)(1) of the Code which provides that no deduction or withholding under section 1441(a) of the Code is required in the case of any item of income (*other than compensation for personal services*) which is effectively connected with the conduct of a trade or business within the United States and which is included in the gross income of the recipient under section 871(b)(2) of the Code for the taxable year.

It has been established by the US Revenue authorities that most self-employed non-resident alien individuals who perform in the US are engaged in a trade or business in the United States.[30] Section 871(b) of the Code provides that a non-resident alien individual engaged in trade or business within the United States is taxable at graduated rates under section 1 or section 1201(b) of the Code on taxable income which is effectively connected with the conduct of such trade or business within the United States.

This raises the question as to whether a non-resident alien self-employed performer with an engagement in the US during the relevant tax year could successfully apply for exemption from the 30% withholding tax on the basis (i) that he is effectively connected with the conduct of a trade or business within the

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performs services for a non-resident alien individual, foreign partnership or foreign corporation, not engaged in trade or business in the United States.

[30] See Rev. Rul. 70-543 in which it was stated that a self-employed non-resident alien pugilist who contracts to engage in a prize fight in the United States during the taxable year, a non-resident alien professional golfer who enters various professional golfing tournaments in the United States during the taxable year and a non-resident alien owner and operator of a stable of racing horses in

United States (i.e. under s.1441(c)(1)) and (ii) that his income is taxable at graduated rates under section 1 or section 1201(b) of the Code. The answer to the question would appear to be in the negative. First, self-employed performers earn 'compensation for personal services' which is specifically excluded under s.1441(c)(1) and, in such circumstances, falling in charge to tax under the graduated rates under s.1 or s.1201(b) of the Code does not preclude the operation of the withholding tax.

These issues were addressed by the IRS in their Revenue Ruling 70-543. The IRS were asked to rule, inter alia, on the following situation: *A, a pugilist, is a self-employed non-resident alien individual who has contracted to engage in a prize fight in the United States during the taxable year. A pays the salaries of his handlers, pays commissions to his agent, and has other allowable expenses.* After discussing the relevant provisions of the Code, they ruled as follows.

> *"The purse received by A for participation in the prize fight is compensation for personal services as a self-employed non-resident alien individual. The exemptions from withholding provided by section 1.1441-4(b) of the regulations are not applicable. Accordingly, it is held that the purse received for such prize fight during the taxable year is subject to withholding at 30 percent even though A will be taxable at graduated rates on the amount of his taxable income under section 871(b) of the Code. A may not file Form 4224 or any other statement to claim exemption from withholding of tax."*[31]

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his native country who during the taxable year enters some of his horses races to be held in the United States, were all engaged in trade or business in the United States.

[31] The same conclusion was reached in respect of the prize money enjoyed by *"B, a professional golfer, [who] is a non-resident alien individual who enters various professional golfing tournaments in the United States during the taxable year. B pays the fees of his caddies, incurs traveling expenses, and has other allowable expenses."*

Non-resident alien performers who operate in the US under a contract of employment are also subject to withholding tax under s. 1441 of the Code which specifically makes reference to 'salaries, wages ... remunerations [and] emoluments' among the forms of compensation to which the 30% withholding tax is to be applied.[32] In practice such employees are usually taxed at source at the graduated rates applicable to US citizens under s. 3402 of the Code. This is so because under s. 1.1441-4(b) of the regulations there is an exemption from withholding under s. 1441 for compensation for personal services performed by a non-resident alien individual which is subject to withholding at graduated rates under s. 3402.

These rules may appear somewhat circular on a first reading. It helps to place the rules in a UK context. If the taxpayer is self-employed there is a withholding tax on his gross income applied at the rate of 30%. At the end of the tax year he can submit a US tax return, claim his allowable deductions, and be taxed on his net profits at the graduated rates, giving rise, depending on the circumstances, to a repayment of tax. If the taxpayer is employed then, provided he is subject to the US equivalent of PAYE, withholding tax is not applied. If 'PAYE' is not withheld at source at the normal graduated rates, withholding tax of 30% on his gross income must be applied.

[32] IRC s. 1441(b)

2.3.2 Foreign Corporations

Those circumstances that give rise to a withholding of tax on payments to non-resident aliens and foreign partnerships, also, under s. 1442 of the Code, give rise to withholding tax in respect of foreign corporations. The rate of withholding for corporations is 30 percent.[33] In short, all those withholding agents who must withhold tax under section 1441 must also withhold tax on the same items of income in the same way for foreign corporations subject to taxation.

As with non-resident aliens and foreign partnerships, there are exemptions to the provisions that stipulate the withholding of tax. Withholding will not apply in the case of a foreign corporation engaged in trade or business within the United States where any such withholding would impose an undue administrative burden, provided that the collection of the tax imposed by section 881 on the corporation[34] will not be jeopardized by the exemption.[35]

2.3.3 Withholding Agents

The US withholding tax operates in a very similar way to the UK withholding tax introduced for non-resident sportspeople and entertainers by the Finance Act

[33] IRC s. 1442(a) *"In the case of foreign corporations subject to taxation under this subtitle, there shall be deducted and withheld at the source in the same manner and on the same items of income as is provided in section 1441 a tax equal to 30 percent thereof."*
[34] Section 881 of the Code imposes "for each taxable year a tax of 30 percent of the amount received from sources within the United States by a foreign corporation as (a) interest ... , dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income..."

1986. See Chapter 1, section 1.6.5. In the UK any person who makes a payment to another person, which in any way arises directly or indirectly from a UK appearance by a non-UK resident entertainer, must deduct tax at the basic rate. In the US s. 1441(a) of the Internal Revenue Code of 1986 generally requires all persons having the control, receipt, custody, disposal, or payment of certain items of income from sources within the United States of any non-resident alien individual to deduct and withhold from such items a tax equal to 30 percent thereof. Such persons are known as withholding agents. The income items to which the withholding applies include interest, dividends, rent, salaries, wages, compensations, remunerations, and emoluments.

2.3.4 Central Withholding Agreements

It is possible to reduce the percentage of the withholding tax levied by s. 1441 of the Code by entering into a central withholding agreement.[36] Specifically, non-resident alien performers participating in events in the US may be able to enter into a central withholding agreement with the IRS for reduced withholding tax provided certain requirements are met, though under no circumstance will such an agreement reduce taxes withheld to less than the alien performer's anticipated income tax liability. To obtain the reduction the non-resident alien performer must provide a substantial amount of information regarding his engagements in

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[35] IRC s. 1442(a)
[36] Income Tax Regulations s. 1.1441-4(b)(3)

the US to the IRS,[37] but this administrative burden is usually more than compensated for by the reduced withholding of tax by the withholding agents. The most important of information to be supplied to the IRS is a proposed budget containing itemized estimates of all gross income and expenses for the period covered by the agreement, including supporting documentation. When the IRS approves the proposed budget and the designated central withholding agents, the Associate Chief Counsel (International) will prepare a withholding agreement. The agreement must be signed by each withholding agent, each non-resident alien performer covered by the agreement, and the Assistant Commissioner (International). A request for a central withholding agreement must be made at least 90 days before the agreement is to take effect.

[37] They must provide the following:
1) A list of the name and addresses of the non-resident aliens to be covered by agreement.
2) Copies of all contracts that the aliens or their agents and representatives have entered into regarding the time period and performances or events to be covered by the agreement including, but not limited to, contracts with:
a) Employers, agents, and promoters,
b) Exhibition halls,
c) Persons providing lodging, transportation, and advertising, and
d) Accompanying personnel, such as band members or trainers.
3) An itinerary of dates and locations of all events or performances scheduled during the period to be covered by the agreement.
4) A proposed budget containing itemized estimates of all gross income and expenses for the period covered by the agreement, including any documents to support estimated items.
5) The name, address, and telephone number of the person the IRS should contact if additional information or documentation is needed.
6) The name, address, and employer identification number of the agent or agents who will be the central withholding agents for the aliens and who will enter into a contract with the IRS. A central withholding agent ordinarily receives contract payments, keeps books of account for the aliens covered by the agreement, and pays expenses (including tax liabilities) for the aliens during the period covered by the agreement.

2.4 EMPLOYED V SELF-EMPLOYED

It should be emphasized that performers operating on what they consider to be a self-employment basis may be deemed to be employees in the US if the nature of their relationship with the US contracting party exhibits the characteristics of an employment. The US approach to the employee/self-employed distinction is similar to the UK approach, which was set out in detail in Chapter 1, section 1.2. There is, however, a greater degree of emphasis in the US in determining the employed/self-employed status of an individual on the amount of control the principal exercises over the individual, both behavioral control and financial control. For example, an employee is generally subject to the principal's instructions about when, where, and how to work. Even if no instructions are given, sufficient behavioral control may exist if the principal has the right to control how the work results are achieved. Financial control would include such issues as the right of the principal to control the business aspects of the individual's work including, for example, the extent to which the individual may make his services available to the relevant market place in which he operates.[38] This is a particularly restricting test for those touring performers who consider themselves self-employed but, by virtue of the inevitable control exercised by their principals, find that they are reclassified as employees by the IRS.

[38] See IRS Publication 15-A (1-99) Employer's Supplemental Tax Guide Supplement To Circular E, Employer's Tax Guide (Publication 15)

The recent Tax Court case of *Teschner v Comm*[39] highlights these issues very clearly. This 1997 case concerned the employee v self-employed status of the taxpayer, a professional rock musician who toured with the rock star Rod Stewart during 1991. The taxpayer played various stringed instruments for Stewart's band during most of 1991, while the band was on a tour of the United States, Europe, Asia, and Australia. The practice, travel, and concert schedules greatly influenced the taxpayer's work schedule, and Stewart heavily influenced Teschner's stage dress. Nonetheless the taxpayer considered himself to be self-employed as he could (and, in small part, did) work for others as his schedule allowed. He also purchased his own instruments, clothing and records, and films to familiarize himself with Stewart's songs and performing styles. The IRS rejected his claim for allowable deductions as a self-employed individual, holding instead that the taxpayer was employed by Stewart. The taxpayer petitioned to the Tax Court.

Special Trial Judge Larry L. Nameroff agreed with the IRS. It is valuable to examine his judgment in some detail because it is of wide applicability to sportspeople and entertainers performing in the US. First Judge Nameroff set out the question of law.

> *"The first issue for our consideration is whether petitioner derived income as an employee or as an independent contractor during 1991. Respondent argues that petitioner derived all his income for 1991 as an employee, while petitioner asserts that he was an independent contractor."*[40]

[39] Tax Analysts Citation: 1997 TNT 215-13, Parallel Citations: T.C. Memo. 1997-498

He then set out the common law rules governing the employee/self-employed distinction.

> *"Courts look to several factors to decide whether an employment relationship exists. Among them are the following: (1) The degree of control exercised by the principal over the manner in which work is performed; (2) the individual's investment in the facilities used; (3) the individual's opportunity for profit or loss; (4) whether or not the principal has the right to discharge the individual; (5) the permanency of the relationship; (6) whether the work performed is an integral part of the principal's regular business; and (7) the relationship the parties believe they are creating.* [[41]] *These factors are not weighted equally but must be evaluated according to their significance in each particular case.* [[42]]"[43]

Next, in contrast to the UK approach of 'painting a picture from the accumulation of detail',[44] as discussed in Chapter 1, section 1.2, Judge Nameroff proceeded to weight the control test above the others.

> *Although no one factor is dispositive, the employer's degree of control over the details of an individual's work is the most important consideration in determining the nature of the working relationship.* [[45]] *An employer-employee relationship exists when an employer retains the right to control the manner and means by which an individual performs services.* [[46]][47]

Applying these factors to the present case Judge Nameroff concluded:

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[40] Ibid., para. 13

[41] *United States v. Silk*, 331 U.S. 704, 716 (1947); *Simpson v. Commissioner*, 64 T.C. 974, 984-985 (1975); *sec. 31.3121(d)-1(c)(2), Employment Tax Regs.*

[42] See *Packard v. Commissioner*, 63 T.C. 621, 630 (1975)

[43] *Teschner v Comm* ., Op. cit., para. 15

[44] See *Hall v Lorimer* [1994] STC 23

[45] *E.g., Matthews v. Commissioner*, 92 T.C. 351, 360 (1989), affd. 907 F.2d 1173 (D.C. Cir. 1990) *at 361*

[46] *Nationwide Mut. Ins. Co. v. Darden*, 503 U.S. 318, 323-324 (1992); *Simpson v. Commissioner*, 64 T.C. 974, 984-985 (1975); *Ellison v. Commissioner*, 55 T.C. 142, 152-153 (1970).

[47] *Teschner v Comm* ., Op. cit., para. 16

> *"First, Stewart controlled how, when, and where petitioner was to perform his services. Petitioner was required to tour, travel, and perform according to the band's scheduled performances. Moreover, Stewart had influence over what petitioner wore on and off the stage, which instruments he brought with him and played, and which songs he performed. While it is true that petitioner had some flexibility in choosing which chords to play, his ability to improvise was limited by the framework provided by the Stewart band. Second, petitioner was an integral part of the band while on tour. Th[ese] fact[s] suggests that an employment relationship existed."*[48]

Such reclassification can occur even where the non-resident alien performer uses a service company to provide his services. In the Revenue Ruling 74-331 the IRS were asked to comment on the following situation: E, an entertainer, a resident of the UK and a non-resident alien of the US, was the sole shareholder of CIC, a company resident in the Channel Islands. E signed an exclusive service contract with CIC under which E could veto any arrangements proposed by CIC for the performance of his services. CIC, as agent for E, contracted for the performance of personal services by E with UKC, a UK company. UKC, as agent for CIC, procured a contract with X, a US person, for E's services. The plan is for X to pay UKC for E's services and, after deducting its agency fee, UKC to remit the balance to CIC, who would deduct an agency fee and pay the balance to E as his compensation. The IRS ruled thus, as regards the employment issue:

> *"[I]t is held that E is not an employee of CIC or UKC because neither corporation controls nor has the right to control E in the performance of his services. Moreover, E has the right to veto prospective engagements. In short, CIC is acting merely as E's booking agent and not as his employer... Although E is not an employee of CIC or UKC, he is performing in the United States as an employee of X. E, as an employee of X, is taxable under*

[48] Ibid., para. 17

section 871(b) of the Code. Therefore, X must withhold on E's salary that it pays to UKC pursuant to section 3402, and sections 31.3401(a)(6)-1(a) and 31.3402(a)-1(b) of the regulations."

2.5 ALLOWABLE DEDUCTIONS

Section 62 of the Internal Revenue Code lists the deductions from gross income which are allowed for the purpose of computing 'adjusted gross income' (known as 'above-the-line deductions'). Section 62(a)(1) states the general rule that trade or business deductions are allowed for such purpose only "if such trade or business does not consist of the performance of services by the taxpayer as an employee". Consequently, for employed individuals, section 162 trade and business deductions are ordinarily itemized deductions ('below-the-line deductions).

Section 162(a) of the Code permits the deduction of "ordinary and necessary" business expenses paid or incurred in the tax year, including specifically:

- Salaries or compensation for services actually rendered;
- Travel expenses, including meals and lodging, while away from home in pursuit of trade or business, provided they are not lavish or extravagant; and
- Rents or other payments for use of property used in a trade or business (though the taxpayer may not take a deduction for property if he has title to the property or if he has any equity in the property).

Section 67 limits the allowable expenses available to employees: those miscellaneous itemised (below the line) deductions. Such deductions are allowed only to the extent that they aggregate more than 2 percent of the taxpayer's adjusted gross income.[49] Many of the expenses affected by the 2 percent floor are unreimbursed employee business expenses, including job search expenses, tools used at work, the cost of uniforms, and home office expenses of employees who work at home.

Certain employed performing artists may deduct business expenses from gross income. To qualify, the individual must:

- render services in the performing arts during the tax year for at least two employers;
- have total business deductions attributable to the performance of the services that exceed 10 percent of the income received from the services; and
- have adjusted gross income of not more than $16,000, determined before the provision is applied.[50]

2.5.1 "Ordinary and Necessary"

The term 'ordinary and necessary' is, for British lawyers, an unusual one for tax deduction purposes. Under UK tax law the term 'necessarily', as applied to the

[49] IRC, s. 67(a)
[50] IRC, s. 62(b)(1) and (2)

incurring of expenses within a tax context, is used by statute to restrict the deductibility of expenses under Schedule E as discussed in Chapter 1, section 1.4.1. It will be recalled that under UK law for expenses incurred by an employee to be allowable for tax purposes such expenses must be "expended wholly, exclusively *and necessarily*[51] in the performance of the duties of the office or employment."[52] Furthermore the courts have held that the 'necessarily' element of the provision, absent from the equivalent provision for the self-employed, [53] imposes an objective test on the deductibility of such expenditure which is notoriously rigid and difficult to satisfy. [54]

In the United States Supreme Court decision in *Commissioner of Internal Revenue v Tellier*[55] this meaning of the term 'ordinary and necessary' within the context of the Code was explained as follows:

> *"Our decisions have consistently construed the term "necessary" as imposing only the minimal requirement that the expense be "appropriate and helpful" for "the development of the [taxpayer's] business."* [[56]]. *The principal function of the term "ordinary" in Section 162(a) is to clarify the distinction, often difficult, between those expenses that are currently deductible and those that are in the nature of capital expenditures, which, if deductible at all, must be amortized over the useful life of the asset.*[[57]]"[58]

[51] Emphasis added
[52] ICTA 1988 s.198(1)
[53] ICTA 1988 s.74(1)
[54] See *Fitzpatrick v IRC* [1992] STC 406, at p.423
[55] Tax Analysts Citation: 1994 TNT 241-142; Parallel Citations: 17 AFTR2d Para. 66-194
[56] *Welch v. Helvering,* 290 U.S. 111, 113; *Cf. Kornhauser v. United States,* 276 U.S. 145, *152; Lilly v. Commissioner,* 343 U.S. 90, 93-94; *Commissioner v. Heininger,* 320 U.S. 467, 471; *McCulloch v. Maryland,* 4 Wheat. 316, 413-415.
[57] *Welch v. Helvering, Op. Cit., at 113-116*
[58] Mr. Justice Stewart delivered the opinion of the Court.

For expenses to be allowable for tax purposes solely on the basis they are appropriate and helpful for the development of the taxpayer's business (and not capital in nature), seems at first to be a far more generous test from the taxpayer's perspective than the 'wholly and exclusively' test applied under UK tax law. Section 162(a) of the Code, however, must be read in conjunction with s. 262 which provides, as a general rule, that "no deduction shall be allowed for personal, living, or family expenses."[59] Taken together s. 162(a) and s. 262 approximate to the UK's 'wholly and exclusively' test. This is best illustrated by taking a specific case law review of how the rules are applied in the US. For comparative purposes the area of the tax deductibility of business clothing, so relevant to the entertainer and sportsperson, and examined from a UK tax perspective in section 1.3.1 of Chapter 1, is a valuable area on which to focus.

2.5.2 Clothing as an Allowable Deduction

The applicability of the 'ordinary and necessary' rule to the clothing of a performer is illustrated by the US Tax Court case of *Mella v Comm (1986)*[60] which ruled on whether a professional tennis player could deduct the cost of his tennis clothes and shoes for tax purposes. The taxpayer, a nationally ranked professional tennis player, was the head tennis pro at two clubs in Chicago. The clubs had a rule that no one could play on the tennis courts if he or she was not wearing the proper attire. On his 1980 income tax return, the taxpayer claimed a

[59] Section 262(a)
[60] Tax Analysts Citation: 1986 TNT 253-79; Parallel Citations: T.C. Memo. 1986-594

business expense deduction for the cost of his tennis clothes and shoes. The IRS disallowed the deduction, arguing that the tennis clothes and shoes were a personal expense. The taxpayer appealed to the Tax Court. Judge Simpson set out the question of law to be decided thus:

> *"The issue for consideration is whether the petitioner is entitled to a deduction of $1,350 for tennis clothes and tennis shoes purchased in connection with his job as a tennis professional. The resolution of this issue requires us to reconcile the provisions of sections 262 and 162 of the Internal Revenue Code... The critical question in this case is whether the petitioner's tennis clothes and tennis shoes are suitable for general or personal wear."*

The taxpayer argued they were not.[61] Judge Simpson disagreed.

> *"The Court observes that it is relatively commonplace for Americans in all walks of life to wear warm-up clothes, shirts, and shoes of the type purchased by the petitioner while engaged in a wide variety of casual or athletic activities. The items are fashionable, and in some cases have the name or logo of designers that have become common in America. Indeed, at trial, it was stated that tennis professionals, such as the petitioner, are clothing style setters for their students."*

There is no directly comparable UK case, but there is little doubt that were the tennis player an employee in the UK he would have failed the 'wholly, exclusively and necessarily' test resulting in the cost of the tennis clothes and shoes being disallowed for tax purposes. A self-employed tennis player in the UK

[61] *The taxpayer claimed that, by custom, usage, and traditions of the tennis profession, such items were not worn outside the work environment. Regarding his tennis shoes, he stated that he was required by his employer to wear such shoes while on the clubs' tennis courts and that they were necessary to protect him from injury. Finally, he testified that he did not wear his tennis clothes or tennis shoes outside the work environment, except while travelling between clubs. Judge Simpson rejected these claims on the basis that* "the petitioner presented no corroboration for his statements that tennis professionals in general, and he in particular, do not wear such items outside the work place. Finally, the petitioner's uncorroborated and vague statements concerning the safety function of his shoes were not persuasive."

in like circumstances would probably suffer the same fate as the dual purpose of the clothes and shoes would fail a strict application of the 'wholly and exclusively' test.[62]

It must not be assumed that the *Mella* case is indicative of all clothing costs being disallowed for tax purposes. As in the UK, the cost of uniforms have been held to be an allowable expense (*Mortrud v. Commissioner*[63] and *Benson v. Commissioner*[64]). In *Harsaghy v. Commissioner*[65] a deduction was allowed because custom and usage forbade off duty wearing of the clothing and, of particular relevance to performers, in *Denny v Commissioner*[66] a deduction was allowed because the clothes were a theatrical costume. Though it should be noted that most of the stage clothing worn by the taxpayer in the aforementioned rock band case of *Teschner v Comm*[67] only qualified for a nominal deduction. Judge Nameroff reasoned:

> *"To support a stage clothes deduction, petitioner submitted receipts ... representing purchases of various stage clothes items for which [IRS] has not allowed any amount. The receipts reflect the purchases of silk boxers, leather pants, men's underwear, hats, and a vest. Clearly the underwear does not qualify as a business expense. As to the remaining clothes items, we find that the majority of them are adaptable for general and personal wear and, therefore, are not a deductible employee business expense. Some of the more "flashy" and "loud" items, however, might not be acceptable ordinary wear. Although the receipts do not indicate*

[62] This is discussed at length in Chapter 2, section 2.1.3.1.
[63] 44 T.C. 208 (1965)
[64] 2 T.C. 12 (1943), affd. 146 F.2d 191 (9th Cir. 1944)
[65] 2 T.C. 484 (1943)
[66] 33 B.T.A. 738 (1935)
[67] Tax Analysts Citation: 1997 TNT 215-13, Parallel Citations: T.C. Memo. 1997-498

which items fall into that category, we allow petitioner a $200 deduction for stage clothes."[68]

2.6 SERVICE COMPANIES

The advantages of performers in the UK trading through service companies were discussed in section 1.7 of Chapter 1. The advantages of offshore service companies and offshore licensing companies are discussed in chapter 3 under subsections 3.2.5.1 and 3.2.5.2, respectively. This section examines the tax effectiveness of service companies in the US, both US service companies and offshore service companies.

2.6.1 US Service Companies

The service company has a long history in the US (where it is more commonly referred to as a 'loan-out corporation') and has been particularly popular with sportsmen and entertainers. The 1930's decisions in *Fox v Comm*[69] and *Laughton v Comm*[70] upheld the recognition of service companies as separate legal personalities enjoying the same tax treatment as any other companies.[71] The

[68] Ibid., para. 30
[69] 37 B.T.A. 271 (1938)
[70] 40 B.T.A. 101 (1939)
[71] In *Fox v. Commissioner* the taxpayer was a cartoonist who formed a corporation. He transferred to the corporation cash and property and assigned to the corporation copyrights and his exclusive services for a number of years. The corporation executed a contract with a syndicate giving the syndicate the right to use the taxpayer's cartoons in return for a percentage of gross sales. The amount the corporation thus received greatly exceeded the amount the corporation paid the taxpayer for his services. The Court held the excess amounts were not the taxpayer's income. In *Laughton v. Commissioner*, 40 B.T.A. the taxpayer, an actor, formed a corporation. He contracted

recent appellant decision in *Sargent v Comm*[72] has served to confirmed their legitimacy.

In this case the appellants were professional hockey players with the Minnesota Northstars Hockey Club. Their personal service corporations (PSCs), contracted with the club to provide each player's services to the club as a hockey player. The club paid each PSC for its player's services. Each PSC paid its player a salary and contributed the remainder to the PSC's qualified pension plan. The players were not considered employees for purposes of the National Hockey League Players' Pension Plan. In each case, the club paid the PSCs the amounts that it would have otherwise contributed to the pension plan on the player's behalf.

The IRS treated the players as employees of the club and taxed the appellants on amounts received by the PSCs under s. 482 of the Code,[73] an anti-avoidance provision enabling the IRS to allocate income and deductions between businesses under joint ownership, whether or not incorporated. The IRS also disallowed the deductions for pension contributions claimed by the PSCs. At first instance the

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with the corporation to receive a weekly payment and certain expense payments in return for his exclusive services. The corporation executed contracts with two film studios whereby the taxpayer's services were loaned to the film studios. The Court held the taxpayer was not taxable on the amounts paid to the corporation by the studios because those amounts were paid "under contracts between it [the corporation] and the studios" and there simply was no assignment of income by the taxpayer.

72 929 F.2d 1252 (8th Cir, 1991), reversing 93 TC 572 (1989)

73 Section 482 of the Tax Code provides: In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

Tax Court upheld the IRS's contention finding that the players were employees of the club, not their PSCs, given the extensive control exercised by the club over the players' services. The players appealed.

The Eighth Circuit reversed the decision of the Tax Court, holding that the players were not employees of the club. Senior District Judge Bogue rejected the Tax Court's position that because the players were members of a 'team', the club, not the PSCs, controlled the performance of their services. The appellate court reasoned that two requirements must be met before the PSC, rather than the club, is considered the employer of the player. Both requirements were met in this case, the Eighth Circuit concluded (Circuit Judge Arnold dissenting)[74] because (1) the players were bona fide contractual employees of PSCs who contractually had the right to control them, and (2) a contract existed between the PSCs and the club recognizing the PSCs' right to control the players.

Senior District Judge Bogue quoted with approval the fifty year old doctrine enunciated by the US Supreme Court:

> *The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or*

[74] *Sargent v Comm*, op. cit., Circuit Judge Arnold, dissenting, said: "I would affirm, essentially for the reasons given in Judge Tannenwald's thorough opinion for the Tax Court, 93 T.C. 572 (1989). In my view, the finding that the taxpayers were employed by the Minnesota North Stars Hockey Club, rather than by their respective personal-service corporations, is not clearly erroneous. The coach of the North Stars had the right to control, and actually did control, the conduct of Sargent and Christoff on the ice. The idea that the coach issued orders to Sargent and Christoff in their capacity as corporate officers, which orders they then relayed to themselves as corporate employees, is fanciful."

> *undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity.*[75]

Judge Bogue, however, was not called on to address a more recent doctrine, an anti-avoidance provision, s. 269A of the Code, aimed directly at service companies in the US, because it took effect for tax years commencing after the years covered by the *Sargent* case.[76] Though, it is likely that the court would have held that the section did not apply.[77] The section is discussed at length in section 2.6.3 below.

The US service company should be as legitimate a trading vehicle for the non-resident alien as for a US citizen. However, there may be valid tax minimisation reasons for the non-resident alien performer to use a foreign or offshore service company to provide his services in the US. Such service companies have not faired as well in the US courts.

2.6.2 Offshore Service Companies

The case of *Johansson v United States (1964)*,[78] concerned the professional boxer Ingemar Johansson, a citizen and resident of Sweden, who had formed a Swiss

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[75] *Moline Prop. Inc. v. Commissioner*, 319 U.S. 436, 438-39 (1943)

[76] The Notices of Deficiency with respect to the federal income taxes of Gary A. Sargent were for the years 1978 through 1981; and for Steven M. Christoff for the years 1980 through 1982.

[77] See *Sargent v Comm*, op. cit., footnote 17 "[T]he Appellants' PSCs were established for a legitimate purpose, and Appellants had bona fide employment contracts with their respective PSCs."

[78] 336 F.2d 809, 813 (5th Cir. 1964)

corporation at the time he signed the contracts for the World Heavyweight Boxing Championship match with Floyd Patterson in the United States. He claimed exemption from tax under the business visitor article of the treaty between the United States and Switzerland, based on a preliminary residence permit granted by Switzerland and an employment contract entered into by him with the corporation. The courts found that the corporation had no legitimate business purpose, but was merely a 'controlled depository and conduit' through which the taxpayer had attempted to divert the income earned by him in the United States in order to escape taxation thereon by that country.

Offshore service companies for US citizens have also come before the US courts. In *Johnson v Comm*[79] the taxpayer, a professional basketball player, executed a contract with a Panamanian corporation whereby he granted the corporation the right to his services in professional sports, and the corporation agreed to pay the taxpayer a monthly sum.[80] The taxpayer played for a professional basketball club with which he signed player contracts. The club remitted the compensation for the taxpayer's services to the Panamanian corporation pursuant to assignments of contract rights executed by the taxpayer. However, there existed no contract between the club and the corporation. It was held by the Tax Court that in the absence of a contract between the basketball club and the Panamanian corporation it was the taxpayer, rather than the corporation, who actually controlled the

[79] 78 TC 882 (1982)

[80] The Panamanian corporation in turn licensed its rights and obligations under its contract with the taxpayer to a British Virgin Islands limited liability company. This fact, however, is not relevant to understanding the court's decision.

earning of the amounts paid by the basketball club, and consequently were taxable on him as an employee of the club. It was on these grounds that the cases of *Laughton*[81] and *Fox*,[82] mentioned above, were distinguished.

The ratio decidendi is interesting for international tax planning purposes in so far as it did not turn on the fact that the service company was offshore. Indeed, had a contract existed between the basketball club and the Panamanian corporation, a contract which the basketball club, the San Francisco Warriors, had refused to sign, it would appear as though the offshore structure would have been recognised by the courts. This view finds support in the judgment in *Sargent v Comm*[83] discussed above in section 2.5.1. In distinguishing *Johnson* Senior District Judge Bogue said:

> *"Ultimately, Johnson was required to pay individual income tax on the entire amount paid to his PSC, but only because his PSC had no contractual arrangement with the Warriors basketball team. Said the Tax Court regarding the second prong of the "control" test: "[c]rucial is the fact that there was no contract or agreement between the Warriors and [the PSC]."[[84]]. We are not faced with such a dilemma in this case. Not only did Appellants have a contractual arrangement with their respective PSCs, thereby passing the first prong of the analysis, each PSC also had a contractual relationship with the North Stars Hockey Club."*[85]

However, the recognition of the offshore company as being an legitimate PSC does not mean that the income of the offshore PSC escapes US taxation. The US

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[81] 40 B.T.A. 101 (1939)
[82] 37 B.T.A. 271 (1938)
[83] 929 F.2d 1252 (8^{th} Cir, 1991), reversing 93 TC 572 (1989)
[84] 78 TC 882 (1982) at 884
[85] Ibid., Senior District Judge Bogue judgment, Part I

controlled foreign corporations (CFC) anti-avoidance legislation was enacted by Congress in 1962 as Subpart F of the Internal Revenue Code. A controlled foreign corporation is a company incorporated offshore with more than 50% of its voting power (or total value) in the hands of United States shareholders.[86] A 'United States shareholders' is defined as a US person (individual or company) owning at least 10% of the voting power of the corporate stock.[87] In determining whether a foreign corporation is a CFC, the IRS takes account of direct ownership, indirect ownership and constructive ownership. Where a foreign corporation is a CFC, its US shareholders must include in their income tax return their pro rata share of the company's subpart F income. This is then taxed on the shareholder as if the company did not exist (whether or not the income disclosed had actually been distributed).

2.6.3 Assignment of Income Doctrine: Section 269A

Section 269A of the Code was enacted by Congress in 1982 and is applicable to years beginning after December 31, 1982. The provision was enacted in response to court decisions involving the relationship between the assignment of income doctrine and the use of closely held PSC's. Congress intended that s. 269A overturn the decisions reached in cases like *Keller v. Commissioner*,[88] where an individual service provider owner of a PSC was held, with a notable dissenting

[86] I.R.C. § 957(a)
[87] I.R.C. § 951(b)
[88] 77 T.C. 1014 (1981), affd. 723 F.2d 58 (10th Cir. 1983)

judgment,[89] to have successfully attributed income to the PSC that was in substance earned by the individual service provider.[90] Generally, section 269A allows the IRS to reallocate income from a PSC to the service-provider owner if substantially all of the services are performed for one other entity, and if the principal purpose for forming the PSC or the principal use of the PSC is to avoid or evade Federal income tax.

This provision was discussed in, though notably not applied in, *Leavell v Commissioner*.[91] This case is now analysed as it is important for two reasons: one, it is post s. 269A; and two, it is the most recent major US case which examine the legitimacy for tax purposes of personal service companies in the sport and entertainment market place.

The case concerned a taxpayer, who was a professional basketball player, and who had formed a personal service corporation (PSC). The taxpayer agreed to furnish his services to his PSC, and the PSC, in turn, executed a National Basketball Association (NBA) Uniform Player Contract with the Houston Rockets to furnish the taxpayer's services. The contract required that the "player" fulfill a range of specific conditions that could only be fulfilled by an individual, for example that the player attend each training camp, report at the time and place

[89] In a footnote, Judge Wilbur's dissent in *Keller v. Commissioner*, 77 T.C. at 1045, stated "[a]nd plainly, we will sooner or later be confronted with arrangements between professionals and corporations for which sec. 482 will be inadequate, and the decision today to so lightly discard the assignment of income doctrine will come home to roost."
[90] H. Conf. Rept. 97-760, at 633-634 (1982), 1982-2 C.B. 600, 679-680
[91] Tax Analysts Citation: 1995 TNT 20-15; Parallel Citations: 104 T.C. 140

fixed by the Rockets in good physical condition and play the scheduled games.[92] As a condition to executing the player contract, the Rockets required the taxpayer to execute a written agreement with the Rockets wherein the taxpayer personally agreed to perform the individual services called for by the terms and conditions of the player contract. Without the taxpayer's personal agreement, executed on the same day as the player contract, the Rockets would not have signed the Uniform Player Contract.

The Tax Court held that Leavell was an employee of the Rockets, and that he must include in gross income the compensation the Rockets paid to his PSC. The judgment was based not on s.269 but rather on the employee/self-employed distinction. In delivering the judgment of the court Judge Ruwe wrote:

> *"Where an individual taxpayer attempts to provide his services through a personal services corporation, the determination of whether income derived from such services should be attributed to the individual taxpayer or his personal services corporation depends on who is the actual employer of the individual taxpayer."*

That determination, Judge Ruwe held, must be based on all the facts and circumstances. The language of the Uniform Player Contract clearly indicated that

[92] Other conditions included that the player give his best services and loyalty to the Rockets; observe and comply with all requirements of the Rockets respecting conduct of its team and its players; play only for the Rockets or its assignees; keep in good physical condition throughout each season; agree to give immediate notice of any injury suffered; submit to a medical examination and treatment by a physician designated by the Rockets; and report to any other club to whom the player's contract has been assigned. The contract also required that the "player": be neatly and fully attired in public and conduct himself according to the highest standards on and off the court; refrain from any conduct that is detrimental to the best interests of the Rockets or of the NBA; not engage in sports endangering his health or safety; allow the Rockets or the NBA to take his picture at such times as the Rockets or the NBA may designate; make himself available for interviews by representatives of the media conducted at a reasonable time; agree to participate in

it contemplated binding a specific individual person to perform the services for, and under the specific supervision of, the Rockets. Reviewing the terms of the contract, Judge Ruwe found that it exhibited the intent to give the team a degree of control over an individual player "that transcends the control most employers have over their employees." Furthermore, the court concluded, the Rockets would not have executed the contract with the taxpayer's PSC in the absence of his separate agreement personally to perform the required services.[93]

The IRS based their case on the 'substance over form' employee status of the taxpayer with the Rockets. Yet this was exactly the type of case to which the s. 269A anti-avoidance provision would appear to have been directed. In a concurring judgment Judge Swift highlighted the diffident approach of the IRS to s.269A and urged its robust use in cases such as *Leavell*:

> *"The applicability and scope of section 269A has not yet been addressed in any published opinion. In this case, [the IRS], without adequate explanation, has conceded that the facts before us are not within the scope of section 269A. I suggest that in future*

all other reasonable promotional activities of the Rockets and the NBA; and conform his personal conduct to standards of good citizenship, good moral character, and good sportsmanship.

93 Clearly on similar facts *Sargent v. Commissioner*, 93 T.C. 572 (1989), rev'd 929 F.2d 1252 (8th Cir. 1991), discussed in 2.5.1 above, reached a different conclusion. Judge Ruwe cited *Sargent* in which the court applied the assignment of income doctrine. In *Sargent*, Judge Ruwe explained, the court used the test for determining whether an individual player was an "employee" of his team, as opposed to being an employee of his PSC, to determine whether compensation paid by the team was income of the player or the PSC. The criteria, Judge Ruwe confirmed, are the same as those used to determine whether an individual is an employee or an independent contractor, and the primary consideration is whether the team has the right to control the activities of the individual player. Accepting that *Sargent* was reversed by the Eighth Circuit, Judge Ruwe nontheless disagreed with the appeals court that the Tax Court employed "a doctrinaire approach requiring that any individual who provides services as a member of a 'team' should be automatically considered an employee of the team organization." Rather, per Judge Ruwe, the appeals court relied on language in the written agreements between the individual taxpayers and their PSCs, and between the PSCs and the teams, which purported to recognize the PSCs' controlling position as employers. Though Judge Ruwe warned: "We do not believe that the mere existence of such terms in a contract is sufficient when the reality of the relationship is otherwise."

similar situations [the IRS] not shy away from utilizing the statutory provisions Congress has provided to address adjustments involving the assignment of income between PSC's and individual owners of the PSC's."

This raises the question as to why a provision aimed at assisting the IRS in denting the tax planning effects of the personal service companies has not been vigorously employed in the 17 years since its enactment. The answer would appear to be its narrow drafting,[94] specifically the requirement that 'principal purpose' for forming the PSC must be to avoid tax. This certainly is the reason it was not employed in the *Leavell* case. The IRS accepted in its submissions that the principal purpose of the taxpayer's company was not tax avoidance. The IRS stipulated:

"22. The corporation, Allen Leavell, Inc.[the PSC], was formed for the primary purpose of creating flexibility for Allen Leavell [the taxpayer] to act as a free agent or claim the benefits of free agency in the event the Houston Rockets failed to release him from obligations imposed by the Uniform Player Contract.
23. Although certain tax benefits may have resulted from the incorporation of Allen Leavell, Inc. by Allen Leavell, by securing the benefits of deductions, credits, or other allowances which would not otherwise be available.
24. Accordingly, based upon the facts of this case, the parties agree and Respondent [the IRS] concedes that no allocation of income, deductions, or credits is to be made under the specific authority of I.R.C. section 269A."[95]

Judge Laro in his dissent in the *Leavell* case, a dissent supported by Judges Hamblen, Jacobs and Wells, felt that as the IRS had, in effect, stipulated that the

[94] Judge Swift in his supporting judgment in *Leavell* seems to bemoan this fact by pointing out the significance "that in enacting section 269A Congress did not inject into that remedial statute the employee-independent contractor analysis and factors that the majority utilizes in its analysis (i.e., the employee-versus- independent-contractor status of the individual service provider to the service recipient is simply not a factor)."

tool Congress had given to the Government to deal with perceived abuses by PSC's was not applicable and that the income in question was not to be reallocated under that section, the majority opinion's use of the 'manner and means' test was nothing more than "a solution in search of a problem."[96]

The reality is that the greater degree of judicial certainty that should be found in a codified system of law is clearly absent in the revenue law area regarding service companies. There are powerful arguments and advocates on both sides of the issue. For the performer who wishes to use a service company in the US, be it a domestic company, a foreign company or an offshore company,[97] there is a wealth of judicial authority supporting the recognition of the company as a separate personality in law for tax purposes. On the other hand, any lapse in contractual documentation between the service provider and his company, or a relationship between the individual service provider and the US principal which grants the principal too great a degree of control, may result in the service company being ignored for tax purposes. Paradoxically the anti-avoidance provision enacted specifically to restrict the use of service companies may be safely avoided by (1) making sure the company supplies the services of the performer to more than one principal and (2) ensuring (and preferably supporting by documentation) that the

[95] *Leavell v Commissioner*, op. cit., footnotes to dissent, no. 4
[96] Ibid.
[97] Technically, under US law an offshore company is simply a foreign company. The use of the term 'offshore company' here, as further explained in Chapter 4, section 4.2, refers to a company incorporated in and resident in a low tax territory jurisdiction. For the purposes of this thesis the term 'offshore company' refers to those companies incorporated or resident in an offshore financial centre.

'principal purpose' for the service company is not the avoidance or evasion of Federal income tax.

2.7 ROYALTIES

As discussed in 2.2.2 above, the US imposes a 30% withholding tax on "items of fixed and determinable annual or periodical gains, profits, or income from sources within the United States".[98] This applies to royalties from the US. The US Treasury Regulations note that "royalties for the use of ... copyrights . . . and other like property" may be considered fixed or determinable annual or periodical income;[99] and royalties from intangible property located in the US, including copyright, trademarks and personality merchandising, are deemed by the Code to be US source income.[100]

The U.S. model income tax treaty exempts royalties from tax at source. The actual bi-lateral treaties between the US and specific other countries provide for withholding tax on royalties at a rate of anything from 0% to 30%. This will be explored in Chapter 4, on double taxation treaties. For this section it is sufficient to stress that a royalty recipient, whether a performer, his service company, his licensing company or other vehicle, resident in an offshore financial centre, for tax or other purposes, will suffer the 30% tax as the US has no tax treaties

[98] IRC s. 881(a)(1)
[99] Treas. Reg. 1.881-2(b)
[100] IRC s. 861(a)(4) "Rentals or royalties from property located in the United States or from any interest in such property, including rentals or royalties for the use of or for the privilege of using in

exempting royalties from withholding tax with any OFC. This is of central relevance, given the size and importance of the US sport and entertainment industry, in the examination of the use of offshore financial centre in international tax planning for sportsmen, sportswomen and entertainers.

2.8 CONCLUSIONS

That the US taxes its citizens on the basis of nationality rather than residence, restricts the opportunity for US performers to enjoy the benefits of using offshore financial centres in their international tax planning. Further restriction may be found in the US anti-avoidance legislation, notably the controlled foreign companies provisions. For those sportspeople and entertainers who are not US citizens who look to establish an intermediate offshore vehicle for their performances in the US, the withholding tax provisions serve to negate most tax advantages.

The US, however, has a long history of recognising properly established service companies and opportunities do exist for non-US citizens to use US service corporations for their engagements in the US. Moreover, treaty shopping may be effective in tax planning for royalty income from a US source. These issues are further explored in Chapter 4, Double Taxation Treaties, and Chapter 5, Case Studies.

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the United States patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like property."

CHAPTER 3

THE OFFSHORE FINANCIAL CENTRE

3.1 INTRODUCTION

The offshore financial centre is a relatively recent phenomenon which combines a modern financial infrastructure with the traditional characteristics of the tax haven. There is a subjective element to the recognition of a tax haven. A tax haven, it could be argued, is any country which levies rates of tax on profits and gains lower than one's own. As Masters[1] has observed, the UK in the days of stock relief[2] and extensive capital allowances[3] was looked on by many to be a corporate tax haven. It is true, however, that there are generally agreed objective definitions of a tax haven, though the definitions differ in their precise wording. Masters set out the following three categories into which he held most tax havens normally fall:

1. Countries with nil or very low taxes in the areas of operation in which the particular taxpayer is involved.

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[1] C.D. Masters The Avoidance of Tax on Income, Profits and Gains Unpublished PhD thesis, University of Southampton (1990) p.1254

[2] This was relief given during the 1980s for the increase in the value of stock that was attributable to inflation.

[3] From 22 March 1972 to 13 March 1984 the first year allowances in the UK on plant and machinery was 100%

2. Countries which have substantial taxes but only in relation to operations taking place inside their borders, with nil or low tax rates on overseas sources.

3. Countries which give tax privileges in particular fields of operations.[4]

This definition or categorisation of tax havens is unsatisfactory on several levels. First, it suggests that tax havens must be countries. This is usually but need not necessarily be the case. The tax haven jurisdiction of Labuan, for example, is not a separate country but is rather part of the federal territory of Malaysia. Secondly, to refer to countries with nil or low taxes in the taxpayer's own area of operation is too subjective for a workable definition.[5] Thirdly, the term 'substantial' in category 2 is wholly redundant and potentially very misleading.

A far better definition of a tax haven is a jurisdiction (a) where there are no relevant taxes; (b) where taxes are levied only on internal taxable events but not at all, or at low rates, on profits from foreign sources; or (c) where special tax privileges are granted to certain types of taxable persons or events.[6] This definition also describes accurately the characteristics of an offshore financial centre, save that it is incomplete. All offshore financial centres have the key attributes of a tax haven, but not all jurisdictions with these attributes are offshore

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[4] C.D. Masters, op. cit.

[5] This is potentially to confuse countries which offer special tax incentives, such as Canada and Ireland who offer tax incentives to film makers, with tax havens.

[6] See A.S. Ginsberg Tax Havens New York, Simon Schuster (1991) p.3 and B. Spitz Tax Havens Encyclopaedia London Butterworths p.1

financial centres.[7] In addition to the advantageous tax regime, all modern offshore financial centres are host to branches or subsidiaries of major international banks. They have first class telecommunication systems, excellent transport facilities and a professional infrastructure of accountants, lawyers and administrators equal in quality and experience to their peers in mainland financial centres.[8]

A map of the distribution of the world's offshore financial centres is reproduced the Appendix.

3.2 HISTORICAL DEVELOPMENT OF OFCs

To obtain a better understanding of modern offshore financial centres it is valuable to review their historical development. To render this manageable the development of two representative offshore financial centres are examined: Jersey, representing 'offshore Europe' and the Cayman Island representing 'offshore America'.

That Jersey is 'offshore Europe' is largely non-contentious. It is geographically in Europe and benefits from the free movement of industrial and agricultural

[7] M.P. Hampton, Offshore Financial Centres and Small Island Economies. Can and Should Jersey be Copied?, Unpublished PhD thesis, East Anglia University (1993) p.95 prefers to state, "although OFCs are usually tax havens, not all tax havens are also OFCs." This suggests a jurisdiction can be an OFC and a tax haven at the same time. The author prefers to see OFCs as distinct from tax havens, though possessing their characteristics as a necessary but not sufficient condition.

[8] P. Gartland *'No Crime Please, We're IOFCs'* Accountancy, December 1992 p.83

goods within the European Economic Community (though exempt from the provisions of the Treaty of Rome). Some may argue that the Cayman Islands are an inappropriate choice to represent 'offshore America' because they are a British Crown colony. However such an argument is easily resisted, for in this context geographic and economic factors outweigh the political. Not only are the Islands less than 500 miles from the coast of the United States, the rate of their currency, the Cayman Island dollar, is fixed to the US dollar[9] and the US currency is readily accepted throughout the Islands. Moreover, under the 1972 Constitution the Cayman Islands enjoy a large amount of political autonomy from the UK.

3.2.1 Jersey

It has been asserted that Jersey did not consciously set out to be a tax haven.

> *"The standard rate of tax of 20% was all that was necessary to meet [Jersey's] budgetary needs as it does not have the external and military commitments of large jurisdictions. However over the years by a mixture of tax concessions for nonresidents and the introduction of different types of companies to meet their needs Jersey has increased its attractiveness to nonresidents."*[10]

This is a generous, almost quaint, view of the development of Jersey into an offshore financial centre. The historical evidence suggests a more deliberate path. The 20% income tax rate was introduced in 1940 to finance Jersey's wartime expenditure. The Island was occupied from 1940 to 1945 by the German armed forces. The cost of reconstruction (and debt repayment) after the war was

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[9] CI$1.00=US$1.20

estimated to be over £7.5 million. The UK government provided a grant to the island of £4.2 million and the balance was borrowed by the Jersey government.[11] Taxes on income, notwithstanding a clear need to raise revenue, were not increased.

Hampton has identified five phases of the development of Jersey into an offshore financial centre: [12]

Phase I	Notional Tax Haven	1955-61
Phase II	Functional Tax Haven and Sterling OFC	1962-71
Phase III	Moratorium and Consolidation	1972-74
Phase IV	International Level OFC	1975-78
Phase V	Global Level OFC	1979 onwards

In fact the use of Jersey as a tax haven pre-dates even 1955. The island was used in the 1920s as a haven against death duties by wealthy individuals by effecting a change of domicile. The absence of death duties in Jersey led a number of high net worth individuals to establish a Jersey domicile and thereby avoid UK death duties.[13]

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[10] Coopers & Lybrand, Channel Island *'Jersey'* in Tolley's Tax Havens Croydon, Tolley Publishing (1993) p.315
[11] M.P. Hampton, op. cit., p.236
[12] Ibid. p.239
[13] The most celebrated case involved UK shipping millionaire Sir Robert Houston who moved to Jersey with his new wife Lady Byron in 1924. When Sir Robert died in 1926 the UK Treasury estimated a death duty liability of £3 million, which they assessed on Lady Byron intending for this to become a test case. Instead Lady Houston negotiated directly with Winston Churchill, the Chancellor of the Exchequer, and agreed a settlement of £1.5 million.

Using Hampton's "periodisation", Phase I was characterised by the continued immigration of high net worth individuals. Some of these individuals were simply leaving the UK after making substantial profits in the post-War boom. Others were wealthy UK nationals displaced from Africa and elsewhere as a consequence of the policy of decolonisation and the rapid break-up of the British Empire. The attraction of Jersey over the UK was principally a direct tax rate of only 20%. The attraction of Jersey over other low tax territories was its political stability, its proximity to London, its relatively warm climate and its stable currency.

One of the consequences of the settling in Jersey of the high net worth immigrants was the substantial increase in bank deposits in the island. Bank deposits in Jersey rose from £32 million in 1958 to £44 million by 1961.[14] This led to the increased availability of local loans and advances which increased by 85% between 1958 and 1960[15] which, in turn, served to accelerate the island's development. Indeed, it is the huge increase in banking activity that characterises the second phase of Jersey's development.

From 1962 to 1971 the deposits on the island rose to £470 million and the number of operating banks rose from 7 to 30.[16] The secondary banks and their subsidiaries enjoyed substantially more lending freedom than the clearing banks under the Bank of England regulations at the time. Loans were available locally at

[14] M.P. Hampton, op. cit., p.242
[15] Ibid., p.243

low rates of interest, the Jersey banks, largely due to the advantageous tax regime, enjoying a surplus of funds. This coincided with the UK credit restrictions from 1965 to 1969. The result was the setting up of Jersey subsidiaries of UK secondary banks to collect deposits and loan funds back to the UK parent company.[17]

In addition to the low tax rates, banking secrecy was also a factor in generating the substantial increase in bank deposits. The secrecy was more than the standard onshore client confidentiality. It was augmented by Jersey's separate legal jurisdiction, the relatively easy incorporation of Jersey registered companies with nominee directors and nominee shareholders, and secrecy clauses in banking employment contacts.

The principal Jersey-based tax planning activity during this period was primarily administered and controlled by the banks. This involved the setting up of offshore trusts and offshore companies, largely to avoid UK tax. The activity fell under the head of 'private banking' and was actively promoted by the merchant banks and the trust departments of the clearing banks.

This process led to the development of one of the key distinction between a traditional tax haven and an offshore financial centre; namely, the professional infrastructure. As Hampton observed:

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[16] Ibid., p.247

"The rapid growth of banking in Jersey in Phase II was accompanied by an expansion of associated services such as lawyers, accountants, stockbrokers, fund and trust managers and so forth. The 'pin-stripe infrastructure' that had developed from the increasing demand of wealthy immigrants for sophisticated financial services was then well placed to offer these services to an international clientele."[18]

At the same time the physical infrastructure was being improved, including the modernisation of the airport to accept jet aircraft, and the telecommunication system was being changed to accept the latest technology.

Hampton's Phases III to V may be neatly categorised as the internationalisation of Jersey as an offshore financial centre. In 1973 States of Jersey's Policy Advisory Committee specifically recognised Jersey as a low tax offshore financial centre and it identified the need to attract profits from banking, company administration, trust management and financial services generally to maintain the islands prosperity.[19] To compete with other offshore financial centres Jersey has over recent years enacted trust and company law legislation favourable to the international tax planner. As regards offshore trusts, these include the Trusts (Jersey) Law 1984 and the Trusts (Amendment) (Jersey) Law 1989. These provisions enable a Jersey trust to be created, without Jersey resident settlor,

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[17] Including United Dominions and Whyte, Gase and Co, both of which crashed in the secondary banking crisis of 1973/74.
[18] M.P. Hampton, op. cit., p.257
[19] The Policy Advisory Committee which reported in 1974 stated that "the island's low tax status is ... fundamental to [its] continuing existence as a prosperous, independent economy" and "future emphasis must be on the development of activities which generate the greatest stream if income with the least demand on resources, either ... office space or ... housing." This clearly means an increased volume of banking, company administration, trust management and financial services generally.

trustee or beneficiary, simply by stating in the trust deed that the trust is to be governed by the laws of the States of Jersey.[20] As regards offshore companies, these include the introduction of the Jersey Exempt Company in 1989 and the Jersey International Business Company in 1993. The former company may be managed and controlled in Jersey without becoming resident there for tax purposes.[21] The latter company is deemed resident in Jersey but enjoys a favourable rate of tax on its international business activities.[22]

Today, with nearly £100 billion in bank deposits,[23] Jersey stands as one of the world's leading offshore financial centres. Commenting on the £96.5 billion bank deposits at 30 September 1997, Jeremy Norfolk, President of the Jersey Bankers Association, stated:

> *"This quarter's figures are very encouraging and confirm the industry view that Jersey's banking sector is doing extremely well. The statistics clearly demonstrate the international nature of the Island's finance industry as it continues to draw in business not only from Europe, but from around the globe."*[24]

Jersey shares this premier league OFC distinction with the Cayman Islands, a small Caribbean archipelago, whose historic development was very different.

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[20] This does not make the trust Jersey resident for tax purposes, but it does allow the trust the benefit of the 100 year perpetuity period and the unlimited accumulation of income throughout the trust's existence.

[21] Prior to this legislation all companies wherever incorporated became resident in Jersey, and subject to its 20% tax rate, if their central management and control was exercised there, in accordance with English common law.

[22] A tax rate of 2% on all profits up to £3 million from international activities. The rate is reduced on profits in excess of that figure. IBCs are taxed at 20% on all Jersey source income.

[23] States of Jersey Financial Services Department Press Release *'Jersey Bank Deposits Show Strong Growth in 3rd Quarter'* 24 November 1997: "Jersey bank deposits grew by over 8% in the third quarter to stand at £96.5 billion (at 30 September 1997), up from £89.2 billion in June 1997."

3.2.2 The Cayman Islands

There is a much told romantic story about the early tax haven status of the Cayman Islands: 'The Wreck of the Ten Sails'.

> *"Legend says that one night in November, 1788, the 'Cordelia', the lead ship of a convoy of merchant ships bound from Jamaica to Britain ran aground on the reef at East End [Cayman, along with nine other ships in the convoy] ... The people of East End are reported to have shown great heroism in ensuring that no lives were lost ... [O]ne of the lives saved was one of royalty. For this, King George III ... granted the islands freedom from conscription ... and freedom from taxation."*[25]

Though this tale is probably apocryphal, it is true that there has never been any income tax, capital gains tax, inheritance tax or corporation tax on the islands. In this sense the Caymans Islands have always been a tax haven, though they were never used as such until the 1960s.

The early history of the Cayman Islands followed the fairly typical colonial path of the smaller Caribbean territories:

> *"In 1734 the islands were proclaimed a British possession ... Catching green turtles was the chief occupation of the settlors although there was a lumber industry (mahogany) and some agriculture. The turtle meat was exported to London where it enjoyed the status of a delicacy during the 1800s. In 1863 the Cayman Islands were annexed to Jamaica: an arrangement which lasted until 1959. The islands were politically and economically dependent upon Jamaica and apparently suffered many of the*

[24] As quoted in the States of Jersey Financial Services Department Press Release, Ibid.

[25] Cayman Web World, 'A History of the Cayman Islands' Internet 1996/97

burdens of a dependent country under a policy of 'benign neglect'."[26]

In fact the formal links to Jamaica lasted until 1962,[27] the year Jamaica achieved its independence, which in turn followed the failure of the West Indian Federation. Cayman choose to remain part of Britain as a crown colony rather than to become a territory of a newly independent Jamaica.

This break with the largest and most developed island in the West Indies left the Cayman government with a need to generate income independently. It began systematically to nurture two industries: tourism and offshore financial services.[28] From this point the development of the Cayman Islands into a leading modern offshore financial centre echoes many of the patterns already explored in the foregoing analysis of the development of the island of Jersey.

For their model in creating the legal framework necessary for the encouragement of offshore financial services business, the Cayman Islands legislature used the Bahamas. It drew heavily on the Bahamas for its company law and trust

[26] S.M. Roberts The Local and the Global: The Cayman Islands and the International Financial System Unpublished PhD thesis, Syracuse University (1992) p.92-93

[27] Dr Robert's error was to confuse the adoption of a new Caymanian constitution in 1959 as evidence of its break with Jamaica. The constitution did not affect this relationship. Indeed the constitution vested executive powers over the Cayman Islands in the Governor in Jamaica. These powers were transferred after 1962 to a local Administrator, whose title was changed to Governor in 1971.

[28] See The Library of Congress Country Studies: 'The Cayman and Turk and Caicos Islands' accessible via the internet on http://lcweb2.loc.gov

legislation introduced in 1960 and 1967.[29] Under the Companies Law 1961 (as amended) a variety of companies could be incorporated, including resident, nonresident and exempted companies. Under the new company law legislation there were minimal filing requirements. No Cayman company had to file accounts or have those accounts subject to audit. Bearer shares could be issued to maximise anonymity. The companies were subject to no taxes. The Trust Law (Revised) 1967, though based on English Common Law, enacted certain provisions to make Cayman trusts more efficient for tax minimisation purposes. In addition to there being no taxes on trusts in the Cayman Islands, the 1967 Act created an 'exempt trust' with a perpetuity period of up to 100 years and other benefits which will be examined in more detail later in this chapter. As with Jersey, favourable banking and insurance law changes were also made during this period. In contrast with Jersey, all these changes were subsequently supported by statutory secrecy provisions. Under the Confidential Relationships (Preservation) Law 1976, the disclosure of information by a government official or any other person acting under the provisions was guilty of a serious criminal offence punishable by a fine or imprisonment or both.

As this legislative framework was attracting offshore financial business, the Cayman government embarked on a substantial improvement in the country's physical infrastructure. There were essential investments in roads, airports and desalination plants for water supplies. These projects were initially partly funded

[29] See Gallagher Report '*Report of Mr Rodney Gallagher of Coopers and Lybrand on the Survey of Offshore Finance Sectors in the Caribbean Dependent Territories*' London, House of

by soft loan from the British Government. More recent finance has come from the Caribbean Development Bank and the European Union.[30] Encouraged by the government, the active local private sector and foreign private companies largely built the tourism infrastructure of four and five star hotels and beach front condominiums. The British multinational Cable & Wireless created an entire automatic system of over 9,000 telephones, and a small ground satellite station and submarine cables provided direct communication to the United States.[31]

Today the Cayman Islands are one of the largest offshore financial centres in the world, with 570 registered banks and 30,000 registered companies.[32] The 1990 Gallagher Report on the offshore financial sectors in the British dependent Caribbean territories found that:

> *"The Cayman Islands are now in the First Division of countries providing offshore financial services, comparable in many ways with the Channel Islands, Bermuda and the Isle of Man."*[33]

3.2.3 Parallels and Contrasts

In his review of the key factors in the development of Jersey as an offshore financial centre Dr Hampton identified "regulation, taxation, secrecy, political

Commons 1990 p.90

[30] Ibid.

[31] The Library of Congress Country Studies, op. cit.

[32] Financial Times, *'Caymans: New Stock Exchange Looks to Attract More Mutual Funds'* Wednesday 8 October 1997

[33] Gallagher Report, op. cit., p.94

stability, location, tourism, historical specificity, the island's infrastructure and its educated English-speaking labour force."[34] These factors also applied to a greater or lesser extent in the development of the Cayman Islands. Regulation, taxation and secrecy were discussed in some detail above in respect of both territories. The other factors are now examined and the similarities and differences highlighted.

Both territories have enjoyed exceptional political stability for small countries. This has been maintained largely by a close political relationship with the UK. The Cayman Islands are a British Crown colony. The British Crown appoints the Islands' Governor[35] on the advice of the Foreign Office. Laws are enacted by the Legislative Assembly, consisting of 15 elected members, and three senior civil servants appointed by the Governor. The Executive Council, responsible for the Islands' day-to-day affairs, is made up of the three appointed members and five of the elected members with the Governor as the non-voting Chairman. The Governor is responsible for internal security, the prison system and the administration of justice, including the appointment of judges and senior law officers. Defence and foreign affairs are the responsibility of the British Government. Jersey, too, is a possession of the British Crown. In contrast to Cayman, however, the Island is entirely self-governing in regard to domestic affairs.[36] Jersey has its own executive, legislature and judiciary. The parliament,

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[34] M.P. Hampton, op. cit., p.270

[35] The present Governor is John W Owen MBE, a former member of the UK Diplomatic Service. He was appointed in 1995.

[36] Like Cayman, its foreign affairs are the responsibility of the British Government.

known as the 'States', has 53 elected members, each sitting as an independent. Like Cayman, Jersey has no history of strong political parties, ensuring a continuity of established programs and an absence of radicalism.

One factor not mentioned by Hampton as a key factor in the development of a modern offshore financial centre is a stable local currency. This omission may be accounted for because most international transactions are denominated in one of the world's hard currencies (say, £ sterling, US dollars or deutschmarks), easily handled by the international banks. However, there will often be some interface with the local currency and, given the wide choice of offshore financial centres, a jurisdiction with a local stable currency will virtually always be preferred. The Cayman dollar is tied to the US dollar at the rate of CI$1.20:US$1.00, and Jersey's official currency is the pound sterling.

Having examined the historical background and modern characteristics of the offshore financial centre, one of the principal vehicles for tax minimisation, the offshore company, is now discussed.

3.3 THE OFFSHORE COMPANY

The word 'company' in its most common commercial usage is usually taken to mean any group of persons gathered together for the purposes of carrying on a business. For UK tax purposes a company is defined as any body corporate or unincorporated association, but excluding a partnership or local authorities.[37] The majority of such companies are limited liability companies incorporated under the Companies Acts. For clarity, the term 'company' throughout this work refers to limited companies properly incorporated under the relevant legislation of jurisdiction in which it is registered.

The 'offshore company' is a term of art, not law. A strictly legal approach would define companies according to their country of incorporation and residence, under which all non-UK resident companies would be offshore, insofar as they are not onshore (i.e. UK resident). This approach, however, hinders analysis. Within an international tax planning context the offshore company is usually taken to mean a company incorporated in and resident in a low tax territory jurisdiction. For the purposes of this work the term 'offshore company' refers to those companies incorporated or resident in an offshore financial centre.

Most international tax planning schemes make use of offshore companies or offshore trusts (similarly defined, see section 3.4.2). Frequently both vehicles are used together. It is considered more appropriate for analytical purposes to examine them separately. This section addresses the offshore company. The offshore trust has been explored in section 3.4.

[37] Income and Corporation Taxes Act 1988, s.832

3.3.1 The Company in General

To appreciate fully the efficacy of using offshore companies in international tax planning, it is necessary to understand the nature of the company in general. The essence of the company, wherever incorporated, is that it has a separate personality in law. That is, a company has a legal personality separate from its directors and shareholders. This contrasts, say with a partnership which has no personality in law separate from its partners.[38] In the seminal case of *Salomon v Salomon & Co Ltd,* [39] Lord Halsbury LC stated in his judgement that it is impossible to dispute that once the company is legally incorporated it must be treated like any other independent person with its rights and liabilities appropriate to itself.

A company is an artificial legal personality and, as such, its existence can only come into being following the completion of recognised legal formalities. These formalities are known in English law as the process of incorporation.[40]

As a company is a separate legal personality, it has sole liability for its debts. The liability of the owners of the company, the shareholders, is limited to the unpaid

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[38] *Baird's Case* (1870) L.R. 5 Ch. App. 725

[39] *Salomon v Salomon & Co Ltd* [1897] A.C. 22

[40] As Professor Hahlo has somewhat prosaically observed, a company "becomes animated with the breath of life when the Registrar of Companies authenticates the certificate of incorporation with his seal." H.R. Hahlo and M.J. Trebilcock Hahlo's Casebook on Company Laws (2nd ed) London, Sweet & Maxwell (1977) p.43

element of their shares (if any) or the amount of their guarantee.[41] A range of other company characteristics stems from it separate legal personality. For example, a company's property, including its business interests, is clearly separate from that of its directors or shareholders.[42] A company enjoys perpetual succession because its existence is independent of its directors and shareholders. Companies may engage in contracts in virtually the same manner as natural persons.[43] Finally, a company may sue and be sued in tort and is capable of having the necessary mens rea for a criminal act. [44] It is the separate legal personality and all that flows from it that renders companies valuable vehicles in international tax planning, particularly those companies, offshore companies, resident in offshore financial centres.

3.3.2 Company Residence

In international tax planning the issue of company residence is of central importance for, in broad terms, companies are taxed in the jurisdiction in which they are resident. From a UK perspective, companies resident in the UK are

[41] The principle was established as long ago as 1867 in the House of Lords case of *Oakes v Turqand and Harding* (1869) L.R. 2 H.L. 325 where is was held that a creditor of a company had no right of action against the shareholders of that company for recovery of his debt. Lord Cranworth observed, "[t]here is no doubt that the direct remedy of a creditor is solely against the incorporated company... [H]e must sue the company and not any member of whom it is composed."

[42] The courts have consistently upheld these corporate property rights, sometimes to the disadvantage of the shareholder. In *Macaura v Northern Assurance Co Ltd* [1925] A.C. 619 (H.L.) timber owned by a company was destroyed by fire. The courts refused to order payment on an insurance policy held on the timber in the name of the principal shareholder because he had no insurable interest, the timber being the property of the company.

[43] This for many years was subject to the law of ultra vires under which only contracts authorised by a company's Memorandum of Association were binding on the company. However s. 108 Companies Act 1989 effectively struck out the ultra vires doctrine.

subject to UK corporation tax on their worldwide profits and gains.[45] Nonresident companies are not subject to UK corporation tax unless they carry on a trade through a UK branch or agency. This section will examine the rules by which company residence is determined.

Historically, the UK relied on common law for determining a company's residence. A company was deemed to be resident where its 'central management and control' resided. This rule was modified for all UK incorporated companies by the Finance Act 1988, which provided:

> *"...a company which is incorporated in the United Kingdom shall be regarded for the purposes of the Taxes Acts as resident there; and accordingly, if a different place of residence is given by any rule of law, that place shall no longer be taken into account for those purposes."*[46]

Put simply, with effect from 15 March 1988 all companies incorporated in the UK are deemed UK resident, subject to the transitional provisions.[47] The rule is also subject, as discussed in Chapter 4, to Double Taxation Treaty obligations. This was formally recognised by the Inland Revenue in their 1990 Statement of Practice on company residence.[48]

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[44] *Tesco Supermarkets Ltd v Nattrass* [1972] A.C. 153 (H.L.)
[45] Income and Corporation Taxes Act 1988, s.6
[46] Section 66(1) Finance Act 1988.
[47] Schedule 7 to the Finance Act 1988.
[48] Inland Revenue Statement of Practice SP1/90 (9 January 1990): *"The incorporation rule in FA 1988 s.66 (1) determines a residence which supersedes a difference place 'given by any rule of law'. This incorporation rule determines residence under UK domestic law and is subject to the provisions of a double taxation agreement. It does not override the provisions of a double taxation agreement which may make a UK incorporated company a resident of an overseas territory for the purposes of the agreement."*

The central management and control test is still relevant for determining the residence of those companies incorporated outside the UK. That is, if a foreign incorporated company, including an offshore company, has its central management and control exercised in the UK, the company will be deemed UK resident and taxed accordingly. It is for this reason that a review of the case law on residence remains important for international tax planners.

Cases dating back to 1876 have confirmed the 'central management and control' principle.[49] However, the acknowledged landmark case was the 1906 House of Lords decision in *De Beers*.[50] De Beers, a company incorporated in South Africa with its head office and mining activities there, was held to be UK resident because its Board meetings were held in London. The Lord Chancellor made clear in his opinion that the question was one of substance:

> *"..it is clearly established ... that the Directors' Meetings in London are the meetings where the real control is exercised in practically all the important business of the Company.... "*[51]

A similar decision occurred in *Bullock* [52] regarding East African incorporated subsidiaries of a UK parent company. That residence is a question of substance is very important. An international tax planning arrangement involving an offshore company will fail if the real central management and control of the company is exercised in the UK. It is not sufficient merely to incorporate a company

[49] See S. Picciotto, International Business Taxation, London, Weidenfeld and Nicholson (1992) p.6
[50] *De Beers Consolidated Company Limited v Howe* (1906) 5 TC 198
[51] Ibid., p.213
[52] *Bullock v Unit Construction Co Ltd* (1959) 38 TC 712

offshore, appoint nonresident nominee directors and hold Board meetings offshore to meet the criteria of a non-UK resident company. The central management and control must *de facto* be exercised outside the UK.[53]

The Inland Revenue's approach to questions of company residence, as laid down in their Statement of Practice,[54] emphasises this point:

> *"...first try to ascertain whether the directors of the company in fact exercise central management and control ... If so, ... determine where the directors exercise this central management and control (which is not necessarily where they meet)... In cases where the directors apparently do not exercise central management and control of the company the Revenue then look to establish where and by whom it is exercised"*[55]

3.3.3 Company Recognition

The issue of company recognition is fundamental to an analysis of international tax planning techniques. The key question is this: are there circumstances in which the revenue authorities will fail to recognise a company as a separate legal personality? More specifically, when a company is incorporated in a foreign country is the UK bound to recognise the company as a corporate entity having the same rights and characteristics as a company incorporated in the UK? The answer to this question is of great significance, for if the UK is not bound to recognise a company incorporated overseas as a separate personality in the law,

[53] See, for example, reference to the 'Sark lark' in Case Study I of Chapter 6, section 6.1.4.
[54] Op. cit.
[55] Ibid., para.16

the company would lose most of its associated rights (e.g. to own property and enter into contracts in its own name), and any tax minimisation arrangement involving the company would lose its effectiveness. Certainly, the company's shareholders would lose their limited liability status and the company's profits would fall to be taxed on them as partners in the business enterprise.

In fact, the UK recognises all companies incorporated abroad provided they have been properly incorporated in accordance with the laws of their country of incorporation. This is known as 'the doctrine of incorporation'. It may be contrasted with the doctrine of the Real Seat followed by civil law countries such as Germany.[56]

All companies incorporated in Germany must have a German 'seat' and 'place of management'. The term 'seat' is defined by the German Fiscal Code as the place designated as such in the company's constitution.[57] In this sense it is similar to the British 'registered office'. The 'place of management' is defined in the Code as the centre from which its activities are directed, the 'real seat'.[58] German academics have argued that by virtue of the doctrine of the 'Real Seat' a company incorporated abroad but with its 'place of management' in Germany would not be

[56] Another example of a civil law country which follows the doctrine of the Real Seat is France.
[57] German Fiscal Code, s.11
[58] German Fiscal Code, s.10

recognised as a legal person in Germany and thus not resident for tax purposes; rather, it is argued, the company would be treated and taxed as a partnership.[59]

This goes to the centre of distinction of the doctrine of the Real Seat and that of Incorporation. A country which operates the Real Seat doctrine, only recognises a company if its structure is consistent with the corporate laws of the country in which it has its management and administration, i.e. its real seat. Should this place be Germany, then, subject to treaty obligations, unless the company was incorporated in Germany, it will not be recognised because it has failed to accord to German company law which requires its 'seat' to be in Germany. Under the doctrine of Incorporation, however, a company will be recognised as such if it has satisfied the company law of the country in which it was incorporated, irrespective of where its management and administration reside.

This distinction is particularly relevant for companies incorporated in offshore financial centres, often jurisdictions without double taxation treaties. For example, a tax planning scheme that failed in the UK because, say, an offshore company retained its central management and control, and thus its residence, in the UK would result in the offshore company falling in charge to UK corporation tax, but the company would still be accorded its status as a separate personality in law.

[59] Professor Frommel disputes this statement of German law on the basis that Germany has signed international treaties on corporate recognition which adhere to the Incorporation principle, and under the German constitution international treaties are incorporated into the national law. The most important of these, in this context, is the EEC Treaty. A company incorporated in one of the Member States, with its registered office (or 'seat') located there, must be accorded full corporate recognition in the other Member States. S.N. Frommel, "The Real Seat Doctrine And Dual-

However, should the same situation arise in Germany it is likely that a properly incorporated offshore company with its 'real seat' in, say, Düsseldorf would fail to be recognised as a separate legal personality in Germany, thereby enabling the German tax authorities to collect tax at a higher rate from the company's shareholders by taxing them as individually as partners.[60]

There are circumstances in the UK company law when the formal structure of a company is suspended to ensure that justice is done. This process is known as 'lifting the corporate veil'. Circumstances in which the corporate veil has been lifted include (i) prevention of unfair expropriation of shares of minority shareholders by majority shareholders;[61] (ii) winding up a company under the 'just and equitable' rule where the relationship between members resemble that of a partnership;[62] (iii) where the subsidiary is considered to be acting as the agent for its holding company;[63] (iv) where a company is formed for a fraudulent purpose;[64] and (v) where a company trades with intent to defraud creditors.[65] It can be seen that the 'lifting of a corporate veil' is a company law concept, not a revenue law concept. The process of lifting the corporate veil has never been applied by the UK courts as an anti-avoidance tool.[66]

Resident Companies Under German Law: Another View", European Taxation, October 1990 267-274.

[60] At current rates (1997) at potentially 53% as opposed to 45%..

[61] *Re Bugle Press* [1961] Ch 270 (C.A.)

[62] *Ebrahimi v Westbourne Galleries* [1973] A.C. 360 (H.L.)

[63] *Smith, Stone and Knight Ltd v Birmingham Corporation* [1939] 4 All ER116

[64] *Re FG Films Ltd* [1953] 1 All E R 615 (Ch D)

[65] Insolvency Act 1986 ss. 213 & 214

[66] It could be argued that *Furniss v Dawson* [1984] STC 153 (H.L.) represented the lifting of the corporate veil, but this would be inaccurate. As discussed in section 4.5.2, Dawson owned two companies F and K which he wished to sell to an unrelated company WB. To defer capital gains tax on the transaction Dawson incorporated a company in the Isle of Man, named Greenjacket, and

3.3.4 Offshore Company Formations

As discussed in section 3.3.1, for the purposes of this thesis the term 'offshore company' refers to those companies incorporated or resident in an offshore financial centre. This section deals with the formation and characteristics of these companies. In keeping with the foregoing analysis of the Cayman Islands and Jersey, offshore companies in these jurisdictions will be examined. First, however, the legislative provisions of the Bahamian international business company will be explored as these are arguably the most modern provisions for the offshore company, and are likely to form the basis for future of offshore company legislation in offshore financial centres around the world.

3.3.4.1 The Bahamian International Business Company

The Bahamas is a sovereign state made up of approximately 700 islands located in the Atlantic, south east of Florida. Its capital is Nassau on the island of New

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transferred his shares in F and K at their market value to Greenjacket in return for Greenjacket shares. Greenjacket then sold the shares in F and K to WB at market value for cash. The House of Lords ruled against the scheme because the sale of the shares to Greenjacket had no commercial purpose and, under the *Ramsay* doctrine, could be disregarded for tax purposes. At no time did Lord Brightman or his fellow Law Lords suggest that Greenjacket could be disregarded as a separate legal personality.

Providence. The Bahamas has a population of 254,000. The Bahamian IBC is a modern and flexible corporate entity designed to put "the name of the Bahamas as an offshore financial centre back in the forefront of offshore jurisdictions".[67] The Registrar General's Department of the Commonwealth of the Bahamas was proud of the birth of the international business company (IBC):

> *"The International Business Companies Act 1990 [sic],[68] signalled the beginning of a new commitment to the enhancement of the Bahamian financial services sector. This creative legislation is the first born child of a brand new relationship between the public and private sectors of The Bahamas. This Act was created and [moulded] [69] with the intention of producing a modern facility which would be highly functional and yet exude simplicity of operation."*[70]

The Bahamian international business company is designed to appeal to those who require a simple, flexible and inexpensive offshore corporate vehicle. The Registrar General guarantees that the reservation of a company name will be dealt with within a 24 hour period.[71] To incorporate formally only the Memorandum of Association need be submitted to the Registrar for inspection and approval (provided that the Articles of Association are submitted within 30 days of incorporation).[72] This process permits, perhaps encourages, the stocking of

[67] Bethel O S-M, "The Evolution of the Bahamas as an International Offshore Financial Centre", The International Offshore & Financial Centres Handbook 1993, Vol. 11 p.56
[68] To refer to 'The International Business Companies Act 1990' is a mistake, repeated elsewhere, including in Tolley's Tax Havens. The Act received its Assent on 11 January 1990, but s. 1 of the Act provides that its short title "be cited as the International Business Companies Act, 1989".
[69] Spelt 'molded' in the text.
[70] The Registrar General's Department of the Commonwealth of the Bahamas, International Business Companies Of The Bahamas Nassau, The Government of The Bahamas (1991) p. 1
[71] Ibid., p.7
[72] International Business Companies Act (As Amended) 1989, s.13(1)

Bahamian off-the shelf IBCs by international company secretarial agencies.[73] The Bahamian IBC became an immediate success. [74] The 1989 Act has been amended twice, in 1992 [75] and 1994.[76] It stands today as model legislation for the incorporation, registration and operation of offshore companies.

As its name indicates an IBC is a company established for the conduct of international, that is non-Bahamian, business. Thus under the legislation a Bahamian IBC may not carry on business with persons residing in the Bahamas.[77] An IBC may also not own real property in situated in the Bahamas,[78] nor lease property other than for use as its own office premises.[79] It may not carry on banking or trust business,[80] insurance or reinsurance business,[81] nor provide a registered office for companies.[82] These restrictions are not onerous for the international tax planner in the field of sport and entertainment. The prohibition on the carrying on of business with persons residing in the Bahamas, for example, does not include professional contact with Bahamian counsel and attorneys, bookkeepers, trust companies, management companies, investment advisors and similar persons carrying on business in the Bahamas;[83] it does not include holding

[73] It is the author's experience that the Bahamian IBCs are among the quickest and least expensive offshore companies to obtain from international company secretarial agencies.
[74] From 1990 to 1993 over 14,000 companies were registered in the Bahamas alone under the International Business Companies Act 1990. Source: Owen S-M Bethel, Executive Director, Financial Services Secretariat, Office of the Prime Minister.
[75] International Business Companies (Amendment) Act, 1992
[76] International Business Companies (Amendment) Act, 1994 .
[77] International Business Companies Act (As Amended) 1989, s.5(1)(a)
[78] Ibid., s.5(1)(b)
[79] Ibid., s.5(2)(e)
[80] Ibid., s.5(1)(c)
[81] Ibid., s.5(1)(d)
[82] Ibid., s.5(1)(e)
[83] Ibid., s.5(2)(b)

directors' and shareholders' meetings in the Bahamas;[84] nor does it include holding shares and debentures[85] in Bahamian companies.[86]

The principal benefit of a Bahamian IBC is that it is exempt from all taxes. There are no taxes on income, profits or gains for individuals or companies in the Bahamas in any event. The IBC and its shareholders are nevertheless statutorily exempt from:

> *"... any business licence fee, income tax, corporation tax, capital gains tax or any other tax on income or distributions accruing to or derived from such company or in connection with any transaction to which that company or shareholder, as the case may be, is a party."*[87]

The Act exempts IBCs from estate, inheritance, succession or gift tax, rate, duty or levy in respect of any shares, debt obligation or other securities.[88] The Act also suspends the provisions of the Stamp Act,[89] regulating the imposition of stamp duties, and the Exchange Control Regulations Act,[90] restricting Bahamian companies to transact domestic business in the Bahamian dollar, in relation to IBCs. Finally the Act provides that all these exemptions shall remain in force for all IBCs a period of 20 years from the date of their incorporation.[91]

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84 Ibid., s.5(2)(d)
85 The term 'shares and debentures' is the author's summary. The legislation refers to 'shares, debt obligations or other securities'
86 Ibid., s.5(2)(f)
87 Ibid., s.109(1)
88 Ibid., s.109(2)
89 Ibid., s.109(3)
90 Ibid., s.109(4)
91 Ibid., s.109(5)

The permitted capital structure of an IBC is very liberal and may include bearer shares, multiple voting shares, unnumbered shares and shares at no par value.[92] An IBC may choose its corporate designation from 'Limited or Ltd.', 'Corporation or Corp.', 'Incorporated or Inc.', 'Gesellschaft mit beschranker Haftung or GmbH', 'Societe Anonyme or SA' or 'Sociedad Anonima or SA'.[93]

The other features of a Bahamian IBC are designed for simplicity and flexibility. The company's objects clause may be phrased as "any object or purpose not prohibited by … [the] law … of The Bahamas",[94] thereby effectively abolishing for IBCs the doctrine of ultra vires. The company can be incorporated with as few as two subscribers, and managed by as few as one director, individual or corporate and of any nationality.[95] Once trading, the IBC is obligated to keep only those accounts and records considered necessary or desirable by the directors to reflect the financial position of the company.[96] There is no obligation for the accounts to be audited or filed, only for them to be kept, together with copies of minutes and resolutions, at the company's registered office,[97] where they may be inspected only by a member of the company, and even then only "in furtherance of a proper purpose."[98]

[92] Ibid., s.9(1)(b)
[93] Ibid., s.11(1)
[94] Ibid., s.8
[95] Ibid., s.41
[96] Ibid., s.65(1)
[97] Ibid., s.65(3)
[98] Ibid., s.66(1)

As regards the holding of Board meetings, these may take place "at such times and in such manner and places within or outside The Bahamas as the directors may determine to be necessary or desirable."[99] Moreover, a director shall be deemed to be present at such meetings if he participates by telephone or other electronic means.[100] [101] These provision are very important for tax planning purposes, as, properly structured, an IBC can be resident in the Bahamas: both incorporated in the islands and with its central management and control there. Unless it trades *in*, as opposed to *with*, another country through a branch or agency or other permanent establishment, it profits would fall in charge to tax in the Bahamas, a jurisdiction with no taxation on income, profits or gains.

The Bahamian legislature, in drafting the IBC legislation, sought to make the IBC available to as many companies and individuals as possible. To this end, the Act permits companies incorporated in the Bahamas or elsewhere to re-register as Bahamian IBCs.[102] The Act also permits provisional re-registration, which involves the submission of all re-registration documentation, save the formal notice of continuation. International tax practitioners have hailed this new development.

> *"Companies incorporated in other jurisdictions are able to provisionally register under the IBC Act in order to hedge against the uncertainty of the company's present jurisdiction. If and when the need arises to 'export' such a company to the Bahamas, all that*

[99] Ibid., s.47(1)
[100] Ibid., s.47(2)
[101] The same flexibility is extended to members in general meetings. Ibid., s.58(3)
[102] Ibid., s.82(1)

need be done is to serve the requisite notice, and the registration becomes complete."[103]

The legislation also permits IBCs to merge or consolidate with other companies of whatever status, Bahamian or foreign, providing that the surviving company is an IBC.[104]

3.3.4.2 The Jersey Offshore Company

Jersey, too, has an international business company,[105] but it differs in many important respects from that of the Bahamas. One of the most important differences is that the Jersey IBC is subject to Jersey income tax, albeit at a reduced rate. The standard Jersey income tax rate for individuals and companies is 20%,[106] but this rate is not applied to the IBC. Profits from international activities ("international business profits") are taxed at a downward sliding scale starting at 2%,[107] subject to a minimum annual tax liability of £1,200. IBC income other than international business profits ("other income") is charged to tax at 30%. The principal requirement for companies incorporating under or applying for IBC status is that no Jersey resident has a beneficial interest in the

[103] A.S. Ginsberg Tax Havens New York, Simon Schuster (1991) p.192
[104] IBC Act 1989, op. cit., ss. 73-81
[105] Regulated by the Companies (Jersey) law 1991
[106] The 205 tax rate has been fixed since first introduced in 1940. See 4.1.1
[107] The rates are 2% on the first £3 million profits, 1.5% on the next £1.5 million, 1.0% on the next £5.5 million and 0.5% on the remainder.

company,[108] though Jersey international business companies are Jersey resident.[109] IBC status must be applied for annually.

Paradoxically, it is the fact that Jersey IBCs pay tax that make them attractive in certain international tax planning circumstances. Where the Jersey company is a subsidiary of a major multinational trading concern, various anti-avoidance provisions[110] aimed at offshore financial centres will become factors in developing an effective tax minimisation strategy. It may become necessary, to satisfy these provisions, to prove that the Jersey subsidiary is subject to an acceptable rate of tax.[111] The Jersey IBC legislation assists in this by allowing any proportion of an IBC's international business profits to be reclassified as other income, thereby effectively allowing the directors to choose their own tax rate between 2% and 30%.

It is unlikely that a sportsperson or entertainer would look to take advantage of a Jersey IBC, geared as it is to the offshore subsidiaries of multinational companies. They would look instead to the Jersey exempt company.

[108] By concession, an owner which is a listed or public company with Jersey resident shareholders or debenture holders may not be treated as Jersey resident for the purposes of granting IBC status.
[109] The Jersey IBC may be a Jersey registered company, a foreign registered company controlled and therefore resident in Jersey, or the Jersey branch of a nonresident company.
[110] Most notably controlled foreign companies legislation.
[111] Under the UK's controlled foreign companies legislation, a foreign company's is 'lower level of taxation' is defined as 75% of the tax it would have paid had the company been resident in the UK: s.750 ICTA 1988. From 1984 to 1993 the relevant percentage was 50%.

The Jersey exempt company is not subject to Jersey income tax on its non-Jersey source income.[112] It pays instead a flat rate tax of £600 per annum.[113] This is because an exempt company is treated as being not resident in Jersey for tax purposes, a status which required a 1989 amendment to the island's principal taxing provision, the Income Tax (Jersey) Law 1961. Article 123 of the Act provides that all companies incorporated in Jersey are Jersey resident for tax purposes. The same article provides that any company incorporated overseas becomes Jersey resident "if its business is managed and controlled" in the island. The amending provision, Article 123A permitted companies incorporated in Jersey to be treated as not resident there provided they met the conditions for exempt company status.

Like the IBC, exempt company status is dependent on no Jersey resident individual having any beneficial interest in the ownership of the company, and a declaration to this effect must be made annually. The company may, however, appoint Jersey resident nominee shareholders. It may also appoint Jersey resident directors and exercise the company's central management and control from Jersey without affecting the company's exempt status. All Jersey registered companies must have a registered office in Jersey.

There are clear similarities between the Jersey exempt company and the Bahamian international business company, in that they are aimed at a similar

[112] By concession interest earned by an exempt company from a bank account held in Jersey does not fall in charge to Jersey taxation.

international market. In addition to the absence of taxation and other factors discussed above, both companies may issue shares in any currency and both enjoy no restrictions on the nationality or residence of the shareholders. The Jersey exempt company is not subject to the ultra vires doctrine.[114] The minimum number of directors is one and the minimum number of shareholders is two,[115] and their formal meetings can take place on the island or elsewhere. As with the Bahamian IBC, it is under no obligation to have its annual accounts audited or filed.[116]

There are also very important differences marking out the Jersey exempt company as considerably less flexible. There are no off-the-shelf Jersey companies and the submission of a company name for approval is subject to more scrutiny than in the Bahamas.[117] Stamp duty of 0.5% is levied on the authorised share capital. Bearer shares and shares with no par value are not permitted in Jersey. The beneficial owners of the company must be disclosed to the Registrar, together with a declaration that none of them have ever been declared bankrupt or involved with a company that became insolvent.

The question arises as to why the States of Jersey apply such restriction to their exempt companies given the highly competitive nature of offshore financial

[113] From 1 January 1998. Previously it was £500 per annum.
[114] Abolished in Jersey by the Companies (Jersey) Law 1991.
[115] The director cannot be a body corporate.
[116] Unless, of course, it is a public company. Public companies are allowed to apply for exempt company status.
[117] Three suggested names must be submitted together with an indication of the significance of each name.

centres. The answer lies in their relationship with Europe and their wish to be seen as a 'legitimate'[118] economy. This was highlighted in the 1994 Financial Times Survey on Jersey:

> *"Jersey seeks to promote itself as a clean and well-regulated financial centre. 'We are not regarded as a thorn in the side of either the UK or Europe,' insists Senator Horsfall. 'It can be argued that we are of significant benefit to our neighbours'"*[119]

This theme also runs through the promotional literature of the Jersey based professional practices and companies. In discussing the formalities of incorporation in the island the Jersey based Atticus Trust states:

> *"Prior to incorporation of a Jersey company it is necessary to disclose details of the proposed beneficial ownership to the Companies Registry. This is consistent with the status of Jersey as a first class financial centre. The rationale of the rule is that unscrupulous people will be deterred from such disclosure and will seek to incorporate in less demanding jurisdictions.*[120]

3.3.4.3 The Cayman Islands Offshore Company

The Cayman Islands would probably be considered by Atticus Trust to be one of those "less demanding jurisdictions," insofar as the names of the shareholders of their exempted companies do not form part of the public record and are unknown

[118] In his doctoral thesis on Jersey Dr Hampton, op. cit., drew a distinction between functional OFCs, where actual financial activity takes place, notional OFCs where shell and brass-plate offices of banks book entries of financial transactions, and compound OFCs which host a mixture of functional and notional activities. Dr Hampton classified Jersey and the Isle of Man as functional OFCs, Labuan and Antigua were classified as notional OFCs and the Bahamas and the Cayman Islands were classified as compound OFCs. See pp.81-87
[119] Financial Times Survey on Jersey, Financial Times, Tuesday March 22 1994 p.3
[120] 'Jersey Companies' Unpublished Promotional Literature, Atticus Trust Company Limited p.2

to the Registrar of Companies.[121] The Cayman exempted company is the islands' principal 'offshore' company.[122] Like the Bahamian IBC, it receive a 20 year guarantee of tax free status on incorporation.[123] In fact the similarities between the Bahamian IBC and the Cayman exempted company are considerable.

The exempted company may have an objects clause permitting it to carry out any activity not prohibited by law, ruling out the ultra vires doctrine, and it may have a name in a foreign language,[124] making it acceptable to an international clientele. The company may not carry on business in the Cayman Islands, except in the furtherance of its international business. It may not own land on the islands except with special permission, though the company's registered office must be in the Cayman Islands.[125] The minimum number of directors and shareholders is one. As regards directors' meetings, only one must be held annually in the islands and this may be attended by alternate directors or proxies.[126] Shareholders' meetings may be held anywhere in the world. The exempted company may issue bearer shares

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[121] The names of first subscribers to the memorandum and articles of association do form part of the public records, but such names are usually those of the principals of company secretarial agency which incorporates the company. It would be rare indeed for the subscribers to be beneficial owners.

[122] It is also possible to operate through ordinary nonresident Cayman company. The exempted company, however, is more flexible and its provisions were enacted specifically to attract an international clientele.

[123] This guarantee may, on application, be granted for a period of up to thirty years.

[124] This is one of the distinctions between an exempted company and an ordinary nonresident company. The latter must include the work 'Limited' or 'Ltd' in its name.

[125] As with most offshore financial centres the registered office is usually the office of the company's professional advisors or agents.

[126] It may be advisable for all such meetings to take place in the Cayman Islands so that other jurisdictions may not argue that the company is in fact resident elsewhere insofar as its central management and control is not exercised on in Cayman.

and shares of no par value. The annual reporting requirements are minimal.[127] Finally, there is no obligation for auditing or filing of accounts. As discussed above in 4.1.2, there is a complete absence of direct taxes in the Cayman Islands, enabling the profits of an exempted company to accrue in a tax free environment.[128]

To return to the issue of 'legitimacy', the question arises as to whether, say, a Jersey IBC or exempt company is in any way more legitimate than a Cayman exempted company or a Bahamian international business company. The answer to a large extent depends on who is asking the question. Certainly, if the question is posed by the UK tax authorities as part of a controlled foreign companies enquiry, the Jersey IBC is the company that may be able to prevent its profits being apportioned for UK tax purposes. This, of course, is only because the Jersey IBC is taxpaying. For the purposes of providing a shelter from taxation by sportspeople and entertainers none of the above companies is more legitimate than the others. It is to the use of such companies in such tax planning that this thesis now turns.

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[127] Such requirements consist of a statement signed by a Director or the Company Secretary confirming that the operations of the company have been carried on mainly outside the Cayman Islands and that no changes to the Memorandum and Articles of Association have been made unless already notified to the Registrar.

[128] Exempted companies are subject to a small annual registration fee: US$500 for companies with registered capital not exceeding US$51,200; US$700 for companies with registered capital exceeding US$51,200 but not exceeding US$2,073,200; and US$1,750 for companies with registered capital exceeding US$2,073,200.

3.3.5 USES OF OFFSHORE COMPANIES IN TAX PLANNING FOR SPORTSPEOPLE AND ENTERTAINERS

Having examined the characteristics of offshore companies in three jurisdictions, it is now valuable to outline in general terms how offshore companies may be used in international tax planning for sportspeople and entertainers. This subject is returned to and explored in greater detail in the Chapter where four cases studies form the background for an analysis the use of OFC shelters in tax planning, together with an appraisal of their effectiveness.

3.3.5.1 Offshore Service Company

The tax effectiveness of general UK-based service companies[129] is discussed in Chapter 1, section 1.7.1. In short, performers 'incorporate themselves' by setting up a service company and contracting with it only to perform those entertaining or sporting activities directed by the company. In this way, the company contracts on behalf of the individual and all earnings accrue to the company. The profits left in the company after the allowable deductions, including the performer's salary are subject to a lower rate of tax than if the profits were left in charge to the performer as an individual.

An offshore service company works on the same basic principles as a UK service company. There are, however, significant differences in both benefits and risks.

From the standpoint of benefits, the potential tax savings achievable by an offshore service company are substantially higher than a UK service company could achieve. From the standpoint of risks, there are several anti-avoidance provisions aimed at neutralising the tax effect of offshore tax planning. These must be successfully addressed in any tax minimisation strategy involving the use of offshore companies.

Moreover, offshore service companies are not always an effective option. For example, it is not possible to pay a UK footballer's income from his club into a service company of any kind. Under the Football League rules, a player is personally contracted to the club. Similar rules exist in other team sports and should be consulted prior to a tax planning exercise. However, even in these cases, an offshore service company may be a useful tool for sheltering the performer's intellectual property income, be it from sponsorship, advertising or personality merchandising. Such companies are called for the purpose of this work 'licensing companies'.

3.3.5.2 Offshore Licensing Company

As previously discussed, sportspeople and entertainers have income arising from many different sources often in different tax jurisdictions. One form of income is royalties derived from their intellectual property rights, be they trademarks, copyrights or personality merchandising. A sportsman or entertainer may set up

[129] These are often referred to in the US as 'loan-out corporations.'

an offshore licensing company for the purposes transferring to it all of his intellectual property rights thereby ensuring that the royalty income arising therefrom accrues in a low or nil tax jurisdiction.

This structure may involve the use of more than one offshore company in more than one jurisdiction. This is because royalty income is usually subject to withholding tax. Withholding tax will only be reduced or eliminated if the paying country has a double taxation treaty with the receiving country. For example, should royalty income be generated in the United States it will be subject to a 30% withholding tax unless the recipient is in a country with whom the United States has a tax treaty. The artiste would thus not be advised solely to establish a royalty offshore company in the Netherlands Antilles with whom the United States no longer has a treaty. However the offshore company may wish to establish a subsidiary in the Netherlands, with whom the US does have a treaty stipulating no withholding tax on dividends, and sub-licence to the Netherlands subsidiary its intellectual property rights. This way the royalties would be paid from the US free of withholding tax to Dutch company, who in turn can pay royalties to its offshore parent in the Netherlands Antilles free of withholding tax under their bilateral treaty provisions.

At this stage in this work it is not suggested that this arrangement is problem free. It is set out merely to illustrate the potential uses of offshore financial centres for sportsmen, sportswomen and entertainers. A general review of the anti-avoidance provisions is set out in section 3.6. A more specific appraisal the tax effectiveness of this and other arrangements will be examined in detail in the case studies set out in Chapter 6. Before these can be properly assessed it is necessary to explore the characteristics of the second pillar in offshore tax planning: the offshore trust.

3.4 THE OFFSHORE TRUST

In contrast to the offshore company, the 'offshore trust' may be defined differently depending on whether it is being used as a tax shelter for income, capital gains or capital transfers. This is explored in section 3.4.2. In broad and general terms, a trust is 'offshore' when its trustees are non-UK resident and the general administration of the trust is conducted, and the trust assets are located, outside the UK.

To meet the demand for offshore trusts a large number of professional trust administrators, individual and corporate, operate within offshore financial centres. Indeed, as stated above, [130] one of the factors that distinguishes an offshore financial centre from a tax haven is the presence of a professional infrastructure of accountants, lawyers and trust administrators.

[130] See section 4.0.

The OFCs themselves have enacted legislative regulation of the operation of trusts to provide a degree of security for the nonresident investor.[131] In addition, in keeping with the penchant for security developed in these territories, anonymity may be provided to the settlor by keeping him out of the trust deed altogether.[132]

To appreciate the efficacy of the offshore trust, however, it is necessary to place it in the context of the trust in general.

3.4.1 The Trust in General

One of the most approved definitions of a trust is to be found in Underhill's Law of Trusts:[133]

> *"A trust is an equitable obligation, binding a person (who is called a trustee) to deal with property over which he has control (which is called the trust property), for the benefit of persons (who are called the beneficiaries...) of whom he may himself be one, and any one of whom may enforce the obligation. Any act or neglect on the part of a trustee which is not authorised or excused by the terms of the trust instrument, or by law, is called a breach of trust."*[134]

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[131] An example is Panama whose modern trust legislation was introduced in 1984. Despite recent political difficulties the number of trusts established in Panama continues to increase markedly taking advantage of the flexible trust laws. The actual trust legislation is known as 'Law 1 of 1984'.

[132] A good example of secrecy is to be found under the trust laws of the British Virgin Islands (BVI) whose Trustee Ordinance CAP 260 is based on the English Trustee At 1925. In the BVI it is sufficient for the trustee to declare of the trust deed that he is holding property of trust for specified beneficiaries without mentioning the settlor at all.

[133] This description was approved by Cohen J. In *Re Marshall's Will Trusts* [1945] Ch. 217 at 219 and by Romer L.J. in *Green v Russell* [1959] 2 QB 266 at 241

[134] R.T Oerton, Underhill, Law of Trust and Trustees, 12th ed., London, Butterworth Law Publishers Limited, P.3

The essence of the trust is the separation of the legal ownership of property from the power to enjoy that property. The advantage of this is further enhanced by the fact that a trust is a non-registrable document. That is, there is no legislative or other regulatory obligation on settlors, trustees or beneficiaries to register the trust document with any public body. This enables the beneficial holdings of property under a trust to be kept confidential.

It is now axiomatic that trust creation is about the preservation of family wealth: "about protecting the family wealth from the depredations of creditors and of particular members of the family with extravagant, reckless dispositions."[135] This is certainly true of a protective trust,[136] but it may be asserted with some confidence that one of the principal objective of most trusts, particularly offshore trusts, is tax minimisation.

3.4.2 A Trust's Residence

The residence of trusts may be viewed from two different perspectives: income tax and capital gains tax. The rules pertaining to residence are the same as those discussed in Chapter 1, section 1.6. However, the degree to which these rules are applied to trustees and beneficiaries in order to determine whether a trust is non-

[135] D.J. Hayton, Nathan & Marshall Cases and Commentary on The Law Of Trusts 6the ed., London, Stevens & Sons (1975) p.1

[136] Under the terms of a protective trust an individual may enjoy the life tenancy of the trust assets subject to a termination of his interest should he become bankrupt or enter into a voluntary arrangement with his creditors. Should either event occur and the life interest become terminated, the trust becomes a discretionary settlement and the individual becomes one of several beneficiaries who may benefit under the trust at the sole discretion of the trustees.

UK resident differ depending on whether one is determining trust residence for the purposes of income tax or capital gains tax.

3.4.2.1 Non-UK Resident Trusts: Income Tax

For income tax purposes the residence of a trust is only of importance with regard to those trusts without a fixed interest. Beneficiaries with a fixed interest in trust income are taxed on that income as if the trust did not exist. This was firmly established over seventy years ago in *Williams v Singer*[137] and *Baker v Archer-Shee*.[138] It follows that a 'non-UK resident' trust has little meaning for UK tax purposes if the beneficiaries have a fixed interest in the income of the trust.

For accumulation and discretionary trusts, those trusts without fixed interest beneficiaries, the UK tax situation is different. Where income arises in such a trust from a non-UK source, one must look to the residency of the trustees to determine whether the income falls in charge to UK taxation. Foreign source income from securities or possessions is assessable under the UK's schedular income tax system (set out in tabular form in Chapter 1, section 1.1) under Schedules IV and V.[139] Such income only falls in charge to UK tax if the persons to whom it accrues are resident in the UK.[140] Reference to 'persons' under UK

[137] [1921] 1 AC 65
[138] [1927] AC 844
[139] Income Tax Schedule IV taxes income arising from securities out of the UK and Schedule V taxes income arising from possessions out of the UK.
[140] ICTA 1988, s. 18

law includes 'a body of persons'.[141] As such, it covers the trustees of a settlement. Thus, for income tax purposes, a nonresident trust is an accumulation or discretionary trust all of whose trustees are non-UK resident. A trust with mixed trustees (some UK resident, others non-UK resident) will only be treated as non-UK resident if the settlor was both nonresident and non-domiciled at all times when he put funds into the settlement.[142]

3.4.2.2 Non-UK Resident Trusts: Capital Gains Tax

Under the capital gains tax legislation all trusts are UK resident unless: (i) a majority of the trustees are neither resident nor ordinarily resident in the UK; and (ii) the general administration of the trust is ordinarily carried on outside the UK.[143] With regard to point (i) as mentioned above, in determining the residence of individual trustees the UK's normal residency rules, set out in Chapter 1, section 1.6, are applied. Where the trustee, or one of the trustees, is a company the UK's normal residency rules pertaining to companies, as set out in this chapter, section 3.3.2, are applied. It is therefore important that the central management and control of an offshore company acting as a trustee is not exercised in the UK; though, perhaps surprisingly, the residence status of offshore corporate trustees has rarely, if ever, been attacked in practice.[144] As regards point (ii), there is no legislative guidance as to what constitutes 'general

[141] Interpretation Act 1978
[142] Section 110 Finance Act 1989
[143] Section 69(1) Taxation of Chargeable Gains Act 1992
[144] G. Clarke Offshore Tax Planning (Fifth Edition) London, Butterworths (1998) p.16

administration'. This will be a question of fact to be determined in each specific case. With a view to maintaining nonresident trust status, it would be prudent for all day-to-day trust decisions and general bookkeeping to take place offshore, and for the trust deeds to be held offshore.[145]

There is an exception to this general rule relating to professional trustees. A person carrying on business which consists of the management of trusts, and who acts as a trustee in the course of that business, may be treated as nonresident in relation to a particular trust if all of the trust property was provided by a person not at the time resident, ordinarily resident or domiciled in the UK. If this rule results in a majority of the trustees being treated as nonresident, then the general administration of the trust will be deemed to be carried on abroad.[146] The purpose of this exception is commercial: it is to allow UK trust companies to attract foreign business.

3.4.3 Offshore Trust Formations

Notwithstanding the potential for doubt as regards what constitutes an offshore trust for UK tax purposes, as discussed in 3.4.2, in most instances it is very clear whether or not a trust is offshore. The trust law provisions in offshore financial centres are geared, not only to minimise the incidence of taxation, but also to eliminate any doubt as regards the trust's residence. This section deals with the

[145] R.D.A. Fraser and J.R. Wood Taxation of Offshore Trusts and Funds Croydon, Tolley Publishing (1998) p. 55

formation and characteristics of offshore trusts. Again, in keeping with the foregoing analysis of Jersey and the Cayman Islands, trusts in these jurisdictions will be examined in detail.

3.4.3.1 The Jersey Offshore Trust

The first statute in Jersey relating to trust law was enacted in 1984. The Trust (Jersey) Law 1984 codified[147] the then existing common law and increased the protection given to beneficiaries. It has been subject to only three amendments since its introduction[148] and has served as a model statute for other offshore financial centres.[149]

Article 1 defines a "Jersey trust" as a "trust whose proper law is the law of Jersey". Such trusts will have expressed by their terms that Jersey shall be the proper jurisdiction;[150] or, failing that, the law of Jersey will have been intended by the settlor as the proper law.[151] By article 5 the Act the Royal Court of Jersey has jurisdiction where

(a) the trust is a Jersey trust; or

(b) a trustee of a foreign trust is resident in Jersey; or

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[146] Section 69(2) Taxation of chargeable Gains Act 1992

[147] This is broadly true, though to avoid the problems of omissions Art.1(5) of the Act states: "This Law shall not be construed as a codification of laws regarding trusts, trustees and persons interested under trusts.

[148] Trust (Amendment) (Jersey) Law 1989, Trust (Amendment No.2) (Jersey) Law 1991 and Trust (Amendment No.3) (Jersey) Law 1996.

[149] 'Jersey: Financial Times Survey' Financial Times 22 March 1994 p.6

[150] Trust (Jersey) Law 1984, Art.4(a)

[151] Ibid., Art.4(b)

(c) any trust property of a foreign trust is situated in Jersey; or

(d) the administration of any trust property of a foreign trust is carried on in Jersey.

If the beneficiaries of a Jersey trust are not Jersey resident, the trust is usually referred to as a "nonresident Jersey trust". Nonresident Jersey trusts receive favourable tax treatment. All income arising from non-Jersey sources is not subject to Jersey income tax, nor are the distributions to the beneficiaries (though this does not mean that the distributions escape taxation in the jurisdiction in which the beneficiaries are resident). By concession, and to encourage the use of the island's banking industry, interest from a Jersey bank account accruing to a nonresident Jersey trust also escapes income tax. No other taxes apply to the trust as there are no taxes on capital gains, inheritance or capital transfer on the island. Resident Jersey trust are subject to the island's standard income tax rate of 20%.[152]

The Jersey trust law allows for the full range and complexity of trust deeds. For example, the spendthrift or protective trust is specifically written into the legislation,[153] being a trust in which a beneficiary's interest is subject to:

> *"... diminution or termination in the event of the beneficiary becoming bankrupt or any of his property becoming liable to sequestration for the benefit of his creditors."*[154]

[152] There is no double taxation as the distributions are treated as received net of Jersey income tax.
[153] Op. cit., Art.31
[154] Ibid., Art.31(2)(b)

Similarly, the legislation specifically provides for an accumulation and maintenance trust.[155] Indeed, subject to the terms of the deed, the legislation permits the accumulation of income within the trust for its entire duration,[156] and a Jersey trust may last until one hundred years from the date of its creation.[157] A foreign trust[158] may become a Jersey trust by amending its deed to indicate that the governing law is to be the law of Jersey and a Jersey trust may become a foreign trust by amending its deed to indicate that the governing law is to be that of a foreign jurisdiction.[159] As regards secrecy, there is no public register of trusts in Jersey and there is no obligation for the contents of a deed to be publicly disclosed. There is also no obligation to file trust accounts.[160]

There is a generous treatment as to the range and identity of beneficiaries. The legislation provides that a beneficiary shall be identifiable by name,[161] ascertainable by reference to class[162] or ascertainable by reference to:

> *"... a relationship to some person whether or not living at the time of the creation of the trust or at the time which under the terms of the trust is the time by reference to which members of a class are to be determined.."*[163]

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[155] Ibid., Art.34
[156] Ibid., Art.34(1)
[157] Ibid., Art.11(1); there is no limit on trusts for charitable purposes (art 11(2))
[158] This is not to be confused with a Jersey nonresident trust. A nonresident trust is still a Jersey trust; its beneficiaries, however, are non-Jersey resident. A foreign trust, in this context, is a trust governed by the laws of a jurisdiction other than Jersey.
[159] Op. cit., Art.37
[160] There is an obligation to keep accounts, though these accounts need not be audited unless specifically provided for in the trust deed.
[161] Op. cit., Art.9(1)(a)
[162] Ibid., Art.9(1)(b)(i)
[163] Ibid., Art.9(1)(b)(ii)

A settlor or a trustee of a Jersey trust may also be a beneficiary under the same trust.[164] A Jersey trust may provide for the addition of a person as a beneficiary or the exclusion of a beneficiary from benefit.[165] A beneficiary may sell, charge or transfer his interest in a Jersey trust.[166] Moreover, a beneficiary may disclaim all or part of his interest.[167]

Jersey is a respected jurisdiction for the enforcement of the fiduciary duties of trustees. This is of central importance as trusts are only valid if the settlor unconditionally vests the ownership of the trust property in the trustees. This is not to suggest that Jersey has not had its trust frauds. In the early 1990s a certified accountant who controlled Deltrust and Sentinel Management was sentenced to six years' imprisonment after pleading guilty to defrauding clients of more than £1.1 million; and in 1993 a barrister and company and trust advisor was sentenced to six years after pleading guilty to defrauding 17 clients of £4.75 million in the island's biggest ever fraud.[168] The key point, however, is that the Jersey authorities take the issue of fraud or breaches of trust very seriously. The aforementioned frauds led to the inclusion in the Jersey trust law, by the Trusts (Amendment No.3) (Jersey) Law 1996, of a new concept: the enforcer.[169] The enforcer serves in addition to the trustees and his role is to enforce the terms and conditions of the trust.[170]

[164] Ibid., Art.9(12)
[165] Ibid., Art.9(2)
[166] Ibid., Art.9(11)
[167] Ibid., Art.9(4) - (9)
[168] 'Jersey: Financial Times Survey' op. cit., p.6
[169] Op. cit., Art.10B (as amended)
[170] Only in relation to the trust's non-charitable purposes.

The Jersey trust legislation sets out the trustees duties: to act with due diligence, as would a prudent person, to the best of his ability and skill, and to observe the utmost good faith.[171] He must preserve the value of the trust property, ensure that the trust property is vested in him or under his control, and so far as is reasonable enhance the value of the trust property.[172] Neither the trustee nor the enforcer is permitted to profit, directly or indirectly from their appointment or permit others to do so.[173] Corporations may act as trustees of Jersey trusts[174] and the minimum number of trustees, corporate or otherwise, is two, unless only one trustee was originally appointed.[175]

3.4.3.2 The Cayman Offshore Trust

As with offshore companies, the Cayman Islands has a liberal legal structure for offshore trusts. The principal statutory provisions are to be found in the Trust Law (1996 Revision), a consolidating Act incorporating all the amendments over thirty years to the original Trust Law 1967.[176] The Cayman trust is not subject to taxation on income, capital gains or capital transfers as there are no such taxes on the islands, as discussed in 3.2.2. However, as with companies, it still draws a distinction between ordinary trusts and exempted trusts.

[171] Op. cit., Art.17(1)(a)
[172] Ibid., Art.17(3)
[173] Ibid., Art.17(4) (as amended)
[174] Ibid., Art.1(1)
[175] Ibid., Art.12(1)
[176] There were twelve separate amending Acts to the original Trust Law 1967 between its enactment and the 1997 consolidating legislation.

An exempted trust is a trust whose beneficiaries do not include persons resident or domiciled in the islands.[177] In order to qualify as an exempted trust its trustees must register the trust with the Registrar of Trusts. This, at first, seems a more onerous requirement than is to be found in the jurisdiction of Jersey. However the creation of the office of the Registrar enabled the Cayman legislature to enact an innovative trust provision. The registration of a discretionary trust results in all rights and remedies in respect of the trust being vested in the Registrar of Trusts, as opposed to the beneficiaries.[178] This structure has served to challenge many anti-avoidance provisions around the world which rested on the beneficiaries' right to enjoy the trust property ultimately enforceable through their right of action against the trustees.[179] The office of the Registrar of Trusts does not compromise secrecy. He cannot by law disclose the details or existence of any trusts registered.

In most other respects the Trusts Law (1996 Revision) is comparable to the Trust (Jersey) Law 1984. Like the Jersey trust law, the Cayman legislation makes specific provision for protective trusts[180] and accumulation and maintenance trusts.[181] Trustees may be individuals or companies[182] and are subject to common law rules applicable to fiduciary duties, though unlike in Jersey these are not spelt

177 Trust Law (1996 Revision), s.70
178 Ibid., s.79
179 In the UK what is now s.742(3) ICTA 1988, part of the transfer of assets abroad anti-avoidance provisions (discussed below), was enacted specifically to counter these Cayman Island trust provisions.
180 Op. cit, s.31
181 Ibid., s.29

out in the Act. Similarly, the range of potential beneficiaries is wide, but by omission: they are not addressed in the Act. Two further differences with Jersey is (i) the Cayman exempted trust has enjoys on application 50 year tax exemption guarantee;[183] and (ii) all trust established under Trusts Law (1996 Revision) have a perpetuity period of up to 150 years.

The latest trust innovation from the Cayman Islands is to be found in the Special Trust (Alternative Regime) Law 1997.[184] Under this legislation trusts, known as STAR trusts, may be formed without specific beneficiaries.[185] Such trusts require the appointment of an enforcer, though this enforcer performs a role different to that laid down in Jersey's Trusts (Amendment No.3) (Jersey) Law 1996. Under the latter legislation the role of the enforcer, namely to enforce the terms and conditions of the trust, complements the rights of the beneficiaries. Under the Cayman legislation, the enforcer rights against the trustees and third parties exist instead of, rather than in addition to, the rights of the beneficiaries. By s. 7(1) of the Act:

> *"A beneficiary of a special trust does not, as such, have standing to enforce the trust or an enforceable right against a trustee or an enforcer, or an enforceable right to the trust property."*

STAR trusts must have a corporate trustee licensed under the laws of the islands as a trust company. They are not subject to a perpetuity period. Such trusts

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[182] Ibid., s.2
[183] Ibid., s.77
[184] For an excellent analysis of this new legislation see A. Duckworth STAR Trusts Grand Cayman, Gostick Hall Publications (1998)
[185] Such trust must be for non-charitable purposes.

would fail under UK law.[186] However under the Cayman's Trust Foreign Element Law 1987, where there is a conflict between the laws of other jurisdictions and the laws of the islands, the laws of the Cayman Islands prevail over the laws of those of other jurisdictions.

3.4.4 Uses of Offshore Trusts in Tax Planning for Sportspeople and Entertainers

The offshore trust is a virtually indispensable tool in international tax planning for sportspeople and entertainers. It may be used for sheltering income or gains for UK resident individuals. For ease of analysis the tax planning opportunities is explored separately for sheltering income (3.4.4.2) and gains (3.4.4.3). First the use of the offshore trust in conjunction with the offshore company will be examined.

3.4.4.1 Offshore Trusts with Offshore Companies

As discussed in section 3.3.2, from the UK perspective a foreign incorporated company is resident where its central management and control exercised. If it is exercised in the UK then, notwithstanding its foreign incorporation, the company will be deemed UK resident and accordingly subject to UK corporation tax on its worldwide income. Where an offshore service company or a licensing company

[186] They would fail as they offend the rule of perpetuities. They would probably also fail for offending public policy and for lack of certainty.

is directly owned by a UK resident performer, it is open to the revenue authorities to argue that the company is effectively managed and controlled from the UK. This is not to confuse the different roles of shareholders and directors. The directors have the responsibility for the management of the company, not the shareholders. However, given the widespread use of nominee directors[187] for offshore companies, if the directors are seen effectively to take their instructions from the shareholders, central management and control could be held to rest in the jurisdiction from which the shareholders issue their instructions.[188]

It is for this reason that such offshore companies are best owned by offshore trusts. The essence of a trust, as explored in 3.4.2, is that the ownership and control of the trust assets rest with the trustees. If the trustees are nonresident it provides a strong prima facie case that central management and control does not reside in the jurisdiction in which the settlor or beneficiaries of the trust, the performer and, say, his family, reside.

3.4.4.2 Sheltering Income

As a general rule, as discussed in Chapter 1,[189] a UK resident is subject to UK taxation in respect of his worldwide income; and a nonresident is subject to UK

[187] The term 'nominee director' is not a term of law. It is not recognised in the Companies Act. All directors must exercise the duties and obligations laid down by law. A director is a 'nominee' insofar as he is directed by another, usually the beneficial owner of the share capital.
[188] For an example of this in practice see the 'Sark lark' discussed in Case Study I in Chapter 6, section 6.1.4.
[189] See Chapter 2, section 2.6.

taxation in respect of his UK source income. Thus an offshore trust with UK source income would not be an effective shelter against UK income tax.

A trust may be an effective means of sheltering, say, royalty income arising in foreign jurisdictions, provided the trust is one without an interest in possession or, if there is an interest in possession, provided the beneficiary is non-UK domiciled. For sportspeople and entertainers resident, ordinarily resident and domiciled in the UK, only accumulation and discretionary trusts can be referred to as offshore trusts for income tax purposes with any meaning (see section 3.4.2). It follows that for such individuals the only effective income tax shelter through offshore trusts involve accumulation and discretionary trusts consisting exclusively of non-UK source income producing assets. These trusts themselves are limited in their effectiveness by specific anti-avoidance legislation. These provisions are discussed in sub-section 3.6.1 below.

A recent and important decided case of a sportsman attempting to use an offshore trust to shelter income was *O'Leary v McKinlay*.[190] David O'Leary was a professional footballer and an employee of Arsenal Football Club. He was resident and ordinarily resident in the UK, but domiciled in the Republic of Ireland. He also played for the Irish national team. In August 1979, in the course of negotiating a new contract with Arsenal, O'Leary stated that in addition to his basic salary he wished to receive the annual sum of £28,985 in a tax efficient

[190] [1991] STC 42

manner. The club agreed and entered into the following arrangement.[191] A third party settled £10 in a Jersey trust in which O'Leary was granted a life interest. The club lent the trustees the sum of £266,000 free of interest and repayable on demand, though the employment contract with O'Leary was terminable in the event that repayment was demanded. The trustees placed the money in an interest earning Jersey bank deposit account. The income so earned, which amounted to the 'tax efficient' annual sum stipulated in the negotiations, accrued to O'Leary as the life tenant. This income, O'Leary contended, was income from a foreign possession,[192] his life interest in an offshore trust, and as such fell to be taxed under Schedule D(V). Given that he was non-UK domiciled, it followed that the income only fell in charge to UK tax if it was remitted to the UK. As the income had not been remitted no tax charge arose.

This argument found no favour with Vinelott J in the Chancery Division of the High Court who held that the income from the trust was in fact an emolument arising from the taxpayer's employment by the club and was assessable to tax under Schedule E to the exclusion of any charge under Schedule D(V).

> *"The purpose and effect of the arrangement was to provide the taxpayer with the income derived from the investment of £266,000 (calculated to be approximately equal to the stipulated sum if put on deposit after deducting the trustees fee) for so long as he continued to be employed by the club; the £266,000 could not*

[191] This arrangement was entirely orchestrated by O'Leary's advisors. See Case Stated, ibid., p.44

[192] The question arises, though it was not specifically addressed in this case, as to what exactly was the foreign possession. Was it O'Leary's life interest in the Jersey trust or was it the Jersey bank deposit account holding the £266,000. On reflection it would appear to be the latter. In *Baker v Archer-Shee* [1927] AC 844, 2 LTC 630 the House of Lords held that a fixed interest beneficiary must be taxed as though he owned each of the trust assets, unless the proper law in the trust's jurisdiction provides otherwise (see also *Garland v Archer-Shee* (1931) 15 TC 693.

otherwise be invested without his consent and if it had been the income (and I think any capital advanced to him) would equally have been emoluments from his employment."[193]

In justifying this 'substance over form' approach whilst remaining within the *Westminster* doctrine, Vinelott J quoted Lord Wiberforce:

"While obliging the court to accept documents or transactions, found to be genuine, as such ... [the Westminster *doctrine] ... does not compel the court to look at a document or a transaction in blinkers, isolated from any context to which it properly belongs."*[194]

There is a limited application of the use of trusts to shelter income without the simultaneous use of other offshore vehicles, be they companies or limited partnerships. This will be explored in much more detail in the Case Studies in Chapter 4.

3.4.4.3 Sheltering Gains

First, it will be recalled from section 3.4.2.2 that where a majority of the trustees are neither resident nor ordinarily resident in the UK and the general administration of the trust is ordinarily carried on outside the UK, the trust is non-UK resident for capital gains tax purposes. Secondly, as noted in Chapter 1, section 1.6.5.5, a person must be UK resident or ordinarily resident to fall in charge to capital gains tax.[195] Add these two principles together and the potential advantages of offshore trusts for the sheltering of chargeable gains becomes clear.

[193] Ibid., p.51
[194] Ibid., quoting *W T Ramsay vIRC* [1981] STC 174 at 180

An individual may through an offshore trust realise gains on capital assets, whether situated in the UK or overseas, free of capital gains tax. This remains so, in contrast to income tax (see 3.4.4.2), whether or not the beneficiaries have an interest in possession. Great care, however, must be taken over the anti-avoidance provisions explored in section 3.6 and the subsidiary sections. That said, opportunities still exist, principally for those sportspeople and entertainers who are non-UK domiciaries, to shelter the often substantial gains arising from the sale of those intellectual property rights which arise in their industry.

3.5 OFFSHORE LIMITED PARTNERSHIPS

The offshore limited partnership has a less common usage in international tax planning. It remains, however, an important and flexible tax minimisation tools, particularly for sportspeople and entertainers. As with offshore companies and trusts, the offshore limited partnership is usually used in conjunction with other offshore vehicles. It is addressed here separately for ease of analysis alone.

3.5.1 Limited Partnerships in General

The concept of the limited partnership is well established in English Law. It combines the flexibility of a partnership with, for the limited partner, the limited liability enjoyed by companies. Under the Limited Partnership Act 1907 the investor in a partnership can limited his liability to the amount he has invested or

[195] Section 2(1) Taxation of Chargeable Gains Act 1992

pledged. The limited partner role under the legislation is restricted to that of an investor. He may take no part in the management or running of the partnership business; if he is does he loses his limited liability status. This restriction, however, is largely fictitious. For the general partner in the partnership may itself be a limited liability company with the limited partner or partners serving as directors. Notwithstanding this flexibility, the limited partnership has not been a favoured corporate structure in Britain.[196] It has proved much more popular as an offshore structure in international tax planning schemes.

3.5.2 The Residence of a Limited Partnership

The rules for determining the residence of a limited partnership are similar to the common law rules applying to the residence of companies. Where a partnership is managed or controlled abroad the partnership is deemed to be resident outside the UK. The partnership's foreign residence is unaffected by fact that one or more of the partners are resident in the UK[197] or that some of the partnership's trading activities are conducted in the UK.[198]

[196] Per the Companies in 1994/95, HMSO, there were only some 4,000 limited partnerships registered under the Act.
[197] ICTA 1988 s.112(1)(a)
[198] Ibid., s.112(1)(b)

3.5.3 Offshore Limited Partnership Formations

The most celebrated case of the use of an offshore limited partnership, *Newstead v Frost*,[199] involved David Frost, the well known television interviewer. In the early 1970s, with a view to minimising his exposure to tax on his overseas income (principally from the US), Frost entered into a limited partnership with an off-the-shelf Bahamian company, LP Ltd, activated solely for this purpose. Frost and LP Ltd agreed to be partners in the business of television and film consultants and advisors throughout the world outside the UK. The partnership also agreed to exploit international copyrights and interests in copyrights. The partnership agreement provided that LP Ltd was to manage the day to day operations of the business, the general partner, enabling Frost was to be the limited partner. Partnership income was agreed to be shared 95%:5% and capital assets 99%:1%, both in Frost's favour. In any dispute LP Ltd were entitled to exercise two votes to Frost's one.

Large income accrued to the limited partnership, all resulting from Frost's activities, while LP contributed, in accordance with the agreement, "administrative and secretarial experience and financial and fiscal advice." Prior to 1974, a UK resident partner of a nonresident partnership was liable to tax on his share of the partnership profits only to the extent that he remitted those profits to the UK. None of Frost's share of the income was remitted to the UK. The Inland Revenue raised assessments on Frost for the full amount of his profit share, attacking the tax planning arrangement as a sham. The Revenue lost at the General Commissioners, the High Court, the Court of Appeal and the House of Lords. First, it was held that LP was a bona fide company and its business activities were *intra vires*;[200] secondly, that the income in question arose under the valid partnership agreement between Frost and LP Ltd and thus accrued to that partnership. The third element of the judgement confirmed that, on the authority of *Colquhoun v Brooks*,[201] Frost's share of the partnership income was from a foreign possession and hence taxed under Schedule D Case V (on a remittance basis) rather than from a trade or profession taxed under Schedule D Case II (on an arising basis). This reasoning remains relevant today particularly for non-domiciled individuals, as discussed below. Finally, the House of Lords addressed the issue of tax avoidance and opined that although the agreement between Frost and LP Ltd was clearly formed with the object of avoiding tax, it must also have been formed with a view to profit. Their Lordships were not prepared to strike any element of the plan out and Frost escaped tax on the non-remitted element of his partnership share. The courts may have viewed this last point differently after *Furniss v Dawson*.[202]

Most offshore financial centres have the limited partnership as an available tax minimisation tool. Prior to a further examination of their role in international tax

[199] *Newstead v Frost* [1980] 1 W.L.R. 135 (H.L.)
[200] The ultra vires issue would no longer be a problem. The modern Bahamian form for LP Ltd would be an International Business Company for which the ultra vires doctrine has been abolished. See 4.2.4.1.
[201] 2 TC 490
[202] *Furniss v Dawson* [1984] S.T.C. 153 (H.L.), 1 LTC 407

planning for sportspeople and entertainers, and in keeping with the comparative theme, the limited partnerships of Jersey and the Cayman Islands is now outlined.

3.5.3.1 The Jersey Offshore Limited Partnership

Limited partnerships are regulated in Jersey by the Limited Partnerships (Jersey) Law 1994. Under this Act a limited partnership must consist of one or more persons who are general partners and one or more persons who are limited partners.[203] The same Article specifies that a body corporate may be a general or a limited partner.[204] A Jersey limited partnership only becomes effective in law on registration,[205] following which a certificate is issued by the registrar.[206] The names of each such partnership must end with the words "Limited Partnership" or "LP".[207] A Jersey LP must have a registered office in the island.[208] As regards accounts, it is under an obligation to keep accounting records,[209] but not to file accounts nor to have them audited.[210]

The taxation of a Jersey limited partnership is potentially very favourable. The limited partnership itself is not subject to Jersey income tax. This is because the limited partnership is not treated as a separate legal entity for tax purposes. It is

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[203] Limited Partnerships (Jersey) Law 1994, Art.3(2)(a)&(b)
[204] Ibid., Art.3(2)(c)
[205] Ibid., Art.4(1)
[206] Ibid., Art.4(5)
[207] Ibid., Art.7(1)
[208] Ibid., Art.8(1)
[209] Ibid., Art.9(1)
[210] Ibid., Art.9(2)

the individual partners that are assessed to tax on their partnership share.[211] Under Jersey tax law, nonresident partners are only liable to Jersey income tax on that part of their profit share that arises from a Jersey source (with the exception, by concession, of Jersey bank interest).[212] Given that the income of a limited partnership of an entertainer or athlete would consist of profits and royalties from international trading events, the potential for tax saving is considerable, as discussed in 3.5.4.

3.5.3.2 The Cayman Islands Offshore Limited Partnership

The Cayman Islands, maintaining a consistency of legal terminology, have legislated for an exempted limited partnership, an offshore vehicle that sits alongside its exempted company (3.3.4.3) and exempted trust (3.4.3.2). A Cayman exempted LP, like its namesakes, may only carry on business outside the Cayman Islands. Under the Exempted Limited Partnership Act 1991, the basic structure of the Cayman limited partnership is very similar to the Jersey limited partnership. One difference relates to taxation. A Cayman LP is treated as a separate fiscal entity. However, it is not subject to taxation as there is no tax on income, profit and gains in the Cayman Islands. This absence of taxation can be

[211] This is, in fact, consistent with the UK treatment. Under s.111(1) ICTA 1988, "Where a trade or profession is carried on by persons in partnership, the partnership shall not, unless the contrary intention appears, be treated for the purposes of the Tax Acts as an entity which is separate and distinct from those persons."
[212] Clearly, Jersey resident partners liable to Jersey income tax on the whole of their profit share from whatever source.

backed by a guarantee of up to 50 years.[213] A further difference between the two vehicles relates to the right of a Cayman limited partner to assign his interest. Under the Jersey statute a limited partner may only assign his interest if all the limited partners and all the general partners consent or the partnership agreement permits it.[214]

3.5.4 Uses of Limited Partnerships for Sportspeople and Entertainers

The offshore limited partnership has been promoted in the UK as a valuable tool in tax planning for "entertainers of all descriptions, including professional sportsmen [and] sportswomen."[215] City solicitors Reid Minty proposed the following:

> *"The partnership is entered into between the entertainer and an offshore company, incorporated in Jersey or possibly another jurisdiction. The partnership carries on business under a name registered with the Financial Services department of the States of Jersey. The offshore company is the managing partner of the partnership. The services of such an offshore company, along with the necessary directors resident in Jersey will be arranged in order to carry out the necessary functions of management. It should be noted that the entertainer, being the limited partner, is not concerned in the ownership of the offshore company."*[216]

The objective of this arrangement is to transform the entertainer's income into a form that falls to be taxed under Schedule D(V). As discussed in 3.5.3, income

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[213] This does not mean, of course, that the limited (or general) partner's share of the partnership's profits escape charge to tax in the partner's jurisdiction of residence.
[214] Op. cit., Art.21(1)
[215] 'Sport and Entertainment and the Limited Partnership (Jersey) Law 1994' Unpublished Promotional Literature, Reid Minty, Solicitors and Privy Council Agents, p.1
[216] Ibid.

from a foreign partnership clearly falls into Case V. The tax advantages of such a classification do not accrue to all individuals. Certainly, the Frost tax scheme would fail today because, as a UK resident and domiciled individual, he would fall to be taxed under Schedule D(V) on an arising basis, as opposed to a remittance basis.[217] The remittance basis, however, continues to apply to certain classes of individuals in respect of Schedule D(IV) and D(V) income. Under section 65(4) ICTA 1988 the remittance basis applies to these cases where the taxpayer:

(a) is UK resident but not domiciled in the UK; or

(b) is a Commonwealth citizen (including British) and is not ordinarily resident in the UK.[218]

3.5.4.1 Offshore Limited Partnership v Offshore Company

For these sportsmen, sportswomen and entertainers who satisfy conditions (a) or (b) above there is a significant advantage of an offshore limited partnership over an offshore service or licensing limited company. This is best understood by reference to the UK anti-avoidance legislation discussed in section 3.6 below. It will also be more graphically illustrated in the Case Studies in Chapter 4. For now it is sufficient to emphasise the comparative lack of artificiality.

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[217] This change was effected to 1974 as an anti-avoidance measure; now s.65 ICTA 1988

[218] In both instances the taxpayer must make a claim to the Board of the Inland Revenue stating (a) that he is not domiciled in the UK or (b) that he is not ordinarily resident.

The offshore limited partnership can serve as a service or royalty vehicle in virtually the same way as an offshore company. The tax effectiveness of the offshore company rests on the fact that it is a separate personality in law. The objective is for the company to earn income, that would otherwise accrue to the individual, in a relatively tax free environment. If the company can be successfully challenged by anti-avoidance provisions the whole income could fall to be taxed on the individual in the UK. The likelihood of success of any challenge would rest on the tie of ownership, direct or indirect, say through a trust, between the individual and the company. The individual will wish to retain some control over the company for this is the entity in which 'his' income is being accumulated. The offshore limited partnership does not require such a tie. There is no need for the individual to own the offshore general corporate partner at all. The fees earned by the general partner could simply equal the professional fees of the arrangement. The individual's income accrues to him in his capacity as an individual taxpayer. The key is that such income only falls in charge to UK tax when remitted to him. Until then the income can accumulate in an offshore financial centre without falling in charge to tax at all.

There remains one potential problem common to both the offshore company and the offshore limited partnership, which is the issue of withholding taxes on royalties. Thus even for a non-UK domiciled individual utilising a limited partnership in his international tax minimisation strategy, it may remain necessary to have more than one vehicle in more than one jurisdiction. This, too, will be returned to in the Case Studies.

3.6 ANTI-AVOIDANCE PROVISIONS

The anti-avoidance provisions in the UK may be conveniently broken down into case law and statute law. Both have a history almost as long as the imposition of taxation itself,[219] and both have grown in detail and complexity to combat the increasingly sophisticated tax planning techniques on the part of the taxpayer and his advisors. Case law has arguably moved further than the statutory law,[220] its changes reflecting a fundamental shift in attitude on the part of the judiciary itself.

3.6.1 Statutory Law

Most statutory anti-avoidance provisions are to be found in Part XVII of the Income and Corporation Taxes Act 1988. These provisions cover a wide range of commercial situations susceptible to tax avoidance, including trading in securities. This section will examine those statutory anti-avoidance provisions pertinent to the use of offshore financial centres in international tax planning for athletes and entertainers.

[219] Though, it must be said that initially tax avoidance was not considered a major problem. Indeed, the first Select Committee set up to consider tax avoidance was appointed in 1906.

3.6.1.1 Section 739 ICTA 1988: Transfer of Assets Abroad

The current s.739 ICTA 1988 was enacted in its first guise in 1936.[221] It is anti-avoidance legislation of some pedigree aimed at schemes involving the transfer of assets offshore to eliminate or minimise UK income tax by individuals. Tax falls to be charged under the section where:

a. the taxpayer is ordinarily resident in the UK;

b. he makes a transfer of assets;

c. income becomes payable to a person resident or domiciled outside the UK;

d. the income becomes so payable by virtue or in consequence of the transfer, either alone or in conjunction with associated operations;

e. the taxpayer or his spouse have power to enjoy the income or receive a capital sum; and

f. the motive defences in s.741 do not apply.

This provision is best understood by examining each constituent part of separately.

[220] There is at present no general anti-avoidance provisions on the statute book, but the court have sought to develop a general judicial anti-avoidance doctrine commencing with *Ramsay*, infra, in 1981.

[221] Section 18 Finance Act 1936

The taxpayer is ordinarily resident in the UK.

The application of s.739 is limited to individuals ordinarily resident in the UK. This requirement was recently affirmed by the House of Lords in *IRC v Willoughby*,[222] in which it was held that s.739 did not apply in a situation where the relevant transfer was made when the taxpayer was not ordinarily resident in the UK, notwithstanding that he subsequently became ordinarily resident.

He makes a transfer of assets.

A 'transfer of assets' would include the obvious case of transferring the ownership of UK rented property to an offshore company directly or indirectly owned by the taxpayer. The legislative definition of the terms, however, is considerably broader. The word 'assets' is defined to include property or rights of any kind and 'transfer', in relation to rights, is deemed to include the creation of those rights.[223] This is of particular relevance to tax planning for sportspeople and entertainers a substantial proportion of whose income derives from the creation and exploitation of intellectual property rights.

Income becomes payable to a person resident or domiciled outside the UK.

In the tax plan adjudicated on in *McGuckian*,[224] a case explored in detail in 4.5.2 below, the objective was to turn dividends into capital receipt by selling the right to receive the dividends so that what accrued to the 'person resident or domiciled

[222] [1997] 4 All ER 65
[223] ICTA 1988, s.742(9)(b)
[224] 3 All E.R. 817

outside the UK', in this case an offshore trust, was capital not income and thus outside the scope of s.739.

The income becomes so payable by virtue or in consequence of the transfer, either alone or in conjunction with associated operations.

Section 742(1) defines 'an associated operation' as being "an operation of any kind effected by any person in relation to any of the assets transferred, or any assets representing, whether directly or indirectly, any of the assets transferred, or to the income arising from any such assets, or to any assets representing, whether directly or indirectly, the accumulations of income arising from any such assets." A recent example of an associated operation occurred in *Lord Chetwode v IRC*,[225] in which it was agreed that a UK ordinarily resident settlor and life tenant of a Bahamian trust was liable under s.739 on the income generated from investments held by a separate Bahamian company wholly owned by trust. The trustee's purchase of the company, the transfer to it of the trust assets, the use of those assets by the company to make investments in land and US stocks were all associated operations under the Act.

The taxpayer or his spouse have power to enjoy the income or receive a capital sum.

There was a view, supported by case law, that s.739 could apply in instances in which the power to enjoy the income rested with individuals other than the

[225] (1974) 51 TC 647

taxpayer and his spouse.[226] This view was held to be incorrect by the 1980 House of Lords' decision in *Vestey v IRC (Nos 1 and 2),*[227] which reasserted the narrower view of s.739 under which its charging provisions can only be applied to the individual (or individual's spouse) who made the relevant transfer. This re-opens tax planning opportunities, though it should be noted that a person who, though not technically a transferor, nevertheless procures a transfer may still be liable under s.739.[228]

The motive defences in s.741 do not apply.

There are two motive defences to a charge under s.739 set out in s.741. The taxpayer must satisfy the Board either (a) the purpose of avoiding liability to taxation was not the purpose or one of the purposes for which the transfer was effected; or (b) the transfer and any associated operations were a bona fide commercial transactions and not designed for the purpose of avoiding liability to taxation. These are difficult concepts insofar as virtually all individuals contemplating a commercial transaction will consider the 'cost' of taxation and seek, if possible, to minimise it. The 1997 decision in *IRC v Willoughby*,[229] in which the taxpayer was successful under s.741(a),[230] offers some guidance. Distinguishing between 'tax avoidance' to which the section applies and 'tax mitigation' to which it does not, Lord Nolan opined that:

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[226] See *IRC v Congreve* (1946) 30 TC 163 and *Bambridge v IRC* (1954) 36 TC 313

[227] [1980] AC 1148

[228] In *IRC v Pratt* [1982] BTC 319 Walton J applied the Vestey decision but also (at 324) regarded it as "established that a person who is not a transferor may nevertheless be liable as if he were a transferor, if he 'procured' the transfer"

[229] *IRC v Willoughby* [1997] 4 All ER 65

"The hallmark of tax avoidance is that the taxpayer reduces his liability to tax without incurring the economic consequences that Parliament intended to be suffered by any taxpayer qualifying for such reduction in his tax liability. The hallmark of tax mitigation, on the other hand, is that the taxpayer takes advantage of a fiscally attractive option afforded to him by the tax legislation, and genuinely suffers the economic consequences that Parliament intended to be suffered by those taking advantage of the option."[231]

3.6.1.2 Attribution of Offshore Company Gains to Participator

Persons who are participators[232] in an offshore company that would be a close company if it were resident in the UK,[233] which includes virtually all offshore service or licensing companies for performers, may be treated as if the chargeable gains of the company had accrued directly to them.[234] The purpose of this legislation is to prevent the avoidance of capital gains by UK resident companies and individuals by the interposing of offshore (or nonresident) companies. The legislation effectively looks through the offshore company and apportions the

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230 Section 741(b) was not considered, Lord Nolan stated, "I think it better to defer consideration of s.741(b) until a case arises in which it is crucial to that decision."

231 *IRC v Willoughby,* op. cit., at 73

232 By ICTA 1988, s. 417(1), a 'participator' is a shareholder or any other person who has an interest in the capital or income of the company, including:
(i) any person who possesses, or is entitled to acquire, shares or voting rights in the company;
(ii) any loan creditor of the company;
(iii) any person who possesses or is entitled to acquire a right to receive or to participate in distributions of the company (subject to specified exclusions); and
(iv) any person who is entitled to secure that income or assets (whether present or future) of the company will be applied directly or indirectly for his benefit.

233 By ICTA 1988, s. 414 a 'close company' is a company resident in the UK which:
(i) is under the control of five or fewer participators; or
(ii) is under the control of any number of participators who are also directors; or
(iii) is such that five or fewer participators (or any number of participators who are directors) would receive more than 50 per cent of the company's assets available for distribution to the participators as a whole on a winding-up.

234 TCGA 1992, s. 13(2); FA 1996, s. 174(2)

gains to the UK-resident (or ordinarily resident) persons who are behind in the company. Until 1995, the apportionment was made to those who held shares in the offshore company. Following the 1996 Finance Act,[235] apportionment is now made to the 'participators'.

These rules do not apply to individuals who are not domiciled in the UK. In addition, there is no apportionment if:[236]

(i) the gain was on movable or immovable tangible property, or on a lease of such property, and the property was used only for the purposes of a trade carried on by the company wholly outside the UK;[237]

(ii) the gain is on the disposal of foreign currency, or a foreign currency bank account which represented money used by the company for a trade carried on wholly outside the UK;[238] or

(iii)the gain is one on which the nonresident company is chargeable to corporation tax on chargeable gains, being a disposal of assets used for the purposes of a trade carried on in the UK via a branch or agency[239] (which is in any event taxable under TCGA 1992, s. 10)

Where the person to whom a gain is apportioned is itself an offshore (or nonresident) company which would be a close company if it were UK resident, that apportioned gain may also be apportioned, through any number of similar

[235] FA 1996, s. 174
[236] TCGA 1992, s. 13(5)
[237] TCGA 1992, s. 13(5)(b)
[238] TCGA 1992, s. 13(5)(c)

companies, until the amount is apportioned to the ultimate UK-resident participators.[240] Where the person to whom a gain is apportioned is an offshore trust, a structure recommended in section 3.4.4.1 above, the gain is apportioned to the offshore trustees, who being nonresident are exempt. However, if the trust is within TCGA 1992, s. 86 any apportioned gains are assessed on the settlor.

3.6.1.3 Attribution of Trust Income and Gains to the Settlor

The income of an offshore trust may be attributed to the settlor under ICTA, s. 739, discussed above in section 3.6.1.1. Income may also be similarly attributed under ICTA, Part XV, though strictly speaking this applies to all trusts whether resident or not. Income may be attributed to the settlor under Part XV if he or his spouse retains an interest in the settlement. In this sense 'retaining an interest' means 'being able to benefit from'. This is to be distinguished from the far wider definition of the term given under FA 1991 s. 86, discussed below in relation to the attribution of gains to the settlor. The other circumstance in which income may be attributed to the settlor under Part XV is where the trustees make payments to the settlor's unmarried minor child.

The legislation under which the capital gains of a settlement may be attributed to the settlor was enacted relatively recently. It has been considered reactive in

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[239] TCGA 1992, s. 13(5)(d)
[240] TCGA 1992, s. 13(9)

nature,[241] following, as it did, adverse press comment. In the year before the provisions were enacted, the Sunday Times reported:

> *"The Treasury is losing up to £1 billion a year in unpaid capital gains tax because of a loophole in the tax laws. The loss which amounts to almost 1p in the pound income tax for Britain's 25m taxpayers has been discovered by an Insight investigation into tax avoidance... Those using the loophole include Richard Branson, head of the Virgin empire, Sophie Mirman, founder of Sock Shop, and Lady Porter, leader of Tory-controlled Westminster council. By transferring money, property, shares or other assets into offshore trusts, those with enough income to pay the administrative costs can avoid the 40% capital gains tax that they would normally face... Senior Tory and Labour MPs angered by the disclosure will this week urge John Major, the chancellor, to stop this form of tax avoidance."*[242]

The result was FA 1991 s. 86, which introduced a charge on certain UK-domiciled and resident settlors of nonresident (or offshore) trusts. The capital gain of the settlement may be attributed to the settlor where in the year in which the gain arises:[243]

(i) he is UK-domiciled and resident or ordinarily resident;[244]

(ii) he has an interest in the settlement;[245]

(iii) the settlement is a 'qualifying settlement' in the tax year concerned;[246] and

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[241] *"In 1990 and early 1991 there was widespread press comment on the tax avoidance possibilities of offshore settlements. Although in many respects this comment was misinformed, it led to legislation in the 1991 Finance Act attributing the gains of certain offshore settlements to the settlor. In 1998 further misinformed comment, and embarrassment on the part of a government minister, led to an enlargement of the categories of settlement caught by the 1991 legislation."* G. Clarke Offshore Tax Planning (Fifth Edition) London, Butterworths (1998) p. 77

[242] 'Super-rich in massive 'tax-dodge'' The Sunday Times, October 21, 1990

[243] That is, property originating from the settlor is disposed of by the trustees in respect of which a charge to capital gains tax would arise if the trustees were resident or ordinarily resident in the UK throughout the tax year and if no double taxation arrangements applied.

[244] TCGA 1992, s. 86(1)(c)

[245] TCGA 1992, s. 86(1)(d)

[246] TCGA 1992, s. 86(1)(a)

(iv) the trustees are not UK-resident or ordinarily resident or dual-resident at any time in the tax year.[247]

A settlor is deemed to have an interest in the settlement if the beneficiaries or potential beneficiaries include the settlor, the settlor's spouse, any child or stepchild of the settlor or of the settlor's spouse or the spouse of any such child, or a company controlled by any one of the above or a company associated with such a company.[248] The 1998 Finance Act extended this list to include any grandchild of the settlor or of the settlor's spouse or the spouse of any such grandchild.[249]

A 'qualifying settlement', for the purposes of the provisions attributing gains of nonresident trusts to settlors, was a settlement created after 18 March 1991.[250] However the 1998 Finance Act effectively abolished the distinction between pre-1991 and post-1991 settlements, thereby rendering all settlements qualifying settlements.[251]

3.6.1.4 Transfer Pricing

'Transfer prices' are the prices at which associated enterprises transfer goods, services and other assets between one another. The anti-avoidance legislation is aimed at preventing transfer prices being set at levels that reduce the taxable

[247] TCGA 1992, s. 86(1)(b), (2)
[248] TCGA 1992, Sch. 5, para. 2(3), (7)
[249] FA 1998, s. 131, Sch. 22
[250] TCGA 1992, Sch. 5, para. 9

profits or gains arising in the UK below those that would have arisen had arm's length prices been used. The transfer pricing anti-avoidance provisions are primarily applied to multinational companies. The legislation, however, would cover the situation where a UK resident individual controlled an offshore company or partnership. The legislation refers to person and persons include individuals.[252]

Until 1999 arm's length prices did not have to be used in the tax computations submitted to the Inland Revenue unless the Revenue gave a direction under s. 770 ICTA 1988. Changes were made to this system in the 1998 Finance Act.[253] The reasoning behind the changes were set out in a press release.

> *"The UK's transfer pricing legislation is, by current international standards, very unusual in that it only applies when the Board of Inland Revenue direct that it shall. The effect of this is that taxpayers are not obliged to apply the arm's length standard when submitting their tax returns. The system depends upon the Inland Revenue detecting inappropriate transfer pricing and intervening to set it right. In the increasingly global economy, this leaves the UK tax base vulnerable to unacceptable risks. It also creates potential unfairness as between taxpayers who take care to set their prices on the arm's length basis and those who do not."*[254]

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[251] FA 1998, s. 132

[252] The pre-Finance Act 1998 legislation (s. 770 ICTA 1988) applied where:

- a buyer, being a body of persons, is controlled by a seller who need not be a body of persons;
- a seller, being a body of persons, is controlled by a buyer who need not be a body of persons; or
- both the buyer and the seller are bodies of persons controlled by the same person or persons who need not be bodies of persons.

Section 770 did therefore apply to an individual who either sold at undervalue to an offshore company or partnership he controlled or bought at an overvalue from such a entity. The concept of 'buying' and 'selling' would covered the licensing of intellectual property rights.

[253] FA 1998, s. 108(1) inserted ICTA 1988, s. 770A, which in turn made effective ICTA 1988, Sch. 28AA, inserted by FA 1998, s. 108(2).

[254] Inland Revenue Press Release, 2 July 1997, para. 1

Under the new legislation, applicable to companies for accounting periods ending on or after 1 July 1999,[255] and to individuals for fiscal years commencing 6 April 1999,[256] there is an obligation on the part of UK taxpayers to apply the arm's length principle in calculating taxable profits and gains. Application of the arm's length principle in this way is consistent with transfer pricing guidelines published by the Organisation for Economic Co-operation and Development (OECD), viewed by the UK Inland Revenue as constituting the modern, internationally accepted standard in the area of transfer pricing.

Under the new transfer pricing regime the following conditions are laid down in the new schedule as triggering the new transfer pricing rules:[257]

(i) a provision ('the actual provision') has been made or imposed between any two persons ('the affected persons') by means of a transaction or series of transactions;

(ii) at the time this actual provision is made or imposed, one of the affected persons was directly or indirectly participating in the management, control or capital of the other; or the same person or persons were so participating;

(iii) the actual provision differs from the provision which would have been made between independent enterprises ('the arm's length provision'); and

(iv) the actual provision confers a potential advantage in relation to UK taxation on one or the other or both of the affected persons;

[255] FA 1998 s. 109(5)(a)
[256] FA 1998 s. 109(5)(b)
[257] ICTA 1988, Sch. 28AA, para. 1

Where these conditions are satisfied, the arm's length provision must be substituted for the actual provision in computing the taxable profits of the advantaged person.

The new transfer pricing provisions are widely drawn. The term 'transaction' in (i) above includes arrangements,[258] understandings and mutual practices, whether or not legally enforceable.[259] As regards 'participation in the management, control or capital of a person' in (ii) above, direct participation in another person means having control of a body corporate of partnership,[260] 'control' being defined in accordance with ICTA 1988, s. 840.[261] Indirect participation covers members of a joint ventures and persons who would fulfil the conditions for direct participation once certain extended rights and powers were attributed to them. Finally, 'a potential advantage in relation to UK taxation' in (iv) above occurs when the effect of the actual provision, when compared with the arm's length provision, is to reduce profits, increase losses, or turn a profit into a loss.[262]

A notable omission from the statutory definitions is a definition for 'arm's length'. For this and all other unspecified matters, the new transfer pricing regime is to be construed in accordance with OECD guidelines.[263] It is specifically provided that the where the new transfer pricing rules apply they

[258] 'Arrangement' is defined to mean any scheme or arrangement of any kind: ICTA 1988, Sch. 28AA, para. 3(5);
[259] ICTA 1988, Sch. 28AA, para. 3(1), (5)
[260] ICTA 1988, Sch. 28AA, para. 4(1)
[261] ICTA 1988, Sch. 28AA, para. 14(2)
[262] ICTA 1988, Sch. 28AA, para. 5(1)
[263] ICTA 1988, Sch. 28AA, para. 2

should be interpreted to give the effect that most closely matches the effect of the rules in Article 9 of the OECD Model Convention,[264] as applied in accordance with the OECD's 'Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations'.[265]

3.6.1.5 Controlled Foreign Companies

The controlled foreign companies (CFC) legislation applies to companies resident in the UK who have an interest in companies resident in an offshore financial centre or another low taxation territory. It is therefore unlikely to apply to sportspeople and entertainers unless, say, their UK service company owned an interest in their offshore service or licensing company, a structure not favoured by tax advisors. Consequently, this anti-avoidance measure will only be briefly outlined.

In summary, the CFC legislation seeks to prevent the avoidance of corporation tax by companies resident in the UK through the use of nonresident companies which they control. A CFC is any such company that pays tax on its income at less than three-quarters of the UK effective rate. The legislation attributes the profits of the CFC to the UK corporate shareholders and levies a deemed corporation tax charge on them.

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[264] See Chapter 5, section 5.2

[265] ICTA 1988, Sch. 28AA, para. 2(1), (2)

Like transfer pricing, the Finance Act 1998 introduced changes to the CFC regime, partly to bring it into line with the new corporate self-assessment system.[266]

3.6.2 Case Law

In *IRC v Duke of Westminster (1935)*,[267] in what is almost invariably referred to as his 'celebrated dictum', Lord Tomlin laid down the following principle of tax law:

> *"Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be."*[268]

Though on the facts of this case it would clearly be decided differently today,[269] the decision has never been directly overruled, though subsequent cases have restricted its general applicability.

The change in the attitude of the judiciary was a reaction to the tax avoidance industry which came into existence in the UK in the 1950s,[270] developed in a

[266] ICTA 1988, 747-756 and Schs. 24-26
[267] [1936] A.C. 1(H.L.), 1 LTC 358
[268] Ibid., 1 LTC 358 p.368
[269] In this case the Duke of Westminster was successful in obtaining tax relief for payments to his servants under a deed of covenant; whereas normal wages would have attracted no such relief. There was no doubt that the deeds were executed purely as a tax avoidance device.
[270] One of the first major players in the industry was the accountancy partnership of Stanley Gorrie Whitson. In the early 1950s the tax partner Bernard Kimble developed several 'off-the-peg' tax avoidance schemes which he successfully sold to high earning individuals in the entertainment field, including Albert Finney, Tommy Steele and Christopher Plummer.

large scale through the 1960s[271] and matured with increasing sophistication in the 1970s.[272] The term 'tax avoidance industry', in this context, describes the creating, marketing and selling of specialised and, more importantly, 'off-the-peg' tax avoidance schemes on a widescale basis.[273]

The period of judicial anti-avoidance law-making commenced in 1981 with *Ramsay*.[274] W T Ramsay Ltd had made a substantial gain on the sale of farming land. On advice, the company bought an 'off-the-peg' tax avoidance scheme known as the 'exempt debt capital loss scheme.' This had no purpose other than the avoidance of tax.[275] Under the scheme, Ramsay bought shares in a newly formed company and, through the advancing, amending and cancelling of loans,[276] generated a non-taxable capital gain and an allowable capital loss which

[271] By the 1960s the specialised firms were setting up schemes to avoid income tax by turning pre-earned income into tax-free capital. In short, the scheme sought to avoid the high levels of income tax (surtax), by converting an entertainer's right to income into capital. The investment income from the capital would be controlled to avoid or minimise the surtax.

[272] The most adventurous tax avoidance schemes in this period were developed by the accountant Roy Tucker, a former tax manager at Arthur Andersen, and backed by Ron Plummer's Rossminster banking group. Its first scheme was a capital income plan which involved setting up a charity: Home and Overseas Voluntary Aid Services (HOVAS). The plan converted higher-rate taxpayers' income into lower taxed capital receipts, with a capital loss being created to offset against the capital gain, enabling an individual to exempt his income from taxation. A characteristic of virtually all the Tucker-Plummer schemes was a high level of artificiality.

[273] For a full account of the tax avoidance industry over this period, the 1950s to 1980s see N. Tutt, The Tax Raiders, The Rossminster Affair, London, Financial Training Publications (1985)

[274] *Ramsay v IRC* [1981] STC 174 (H.L.), 1 LTC 378

[275] The scheme was purchased from Dovercliff Consultants whose promotional literature made clear: "the scheme is pure tax avoidance scheme and has no commercial justification insofar as there is no prospect of the T [the prospective taxpayer] making a profit; indeed he is certain to make a loss representing the cost of undertaking the scheme." As quoted in Lord Wilberforce's judgement 1 LTC 378 at 385.

[276] Under the scheme Ramsay bought shares in a newly formed company, Caithmead Ltd, for £185,034. Ramsay then made two loans to the company of £218,750 each at 11% interest. The interest rate on loan 1 was then reduced by Ramsay to zero and the interest on loan 2 was increased to 22%. The second loan, now considerably more valuable, was sold by Ramsay generating a non-taxable gain (as Ramsay contended) of £172,731. Caithmead then transferred loan 2 to a subsidiary company which was liquidated. Caithmead was left with the non-interest

it sought to offset against the gain generated by the land sale.[277] The entire series of transactions was funded by the providers of the exempt debt capital loss scheme.[278] The Revenue challenged the scheme and, when the case reached the House of Lords in 1981, argued, without the backing of any statutory authority, that the court should treat the entire scheme as a fiscal nullity, as producing neither a gain nor a loss.[279] Their Lordships accepted the argument,[280] and thereby created the foundation for future judicial law-making in this area. In his judgement Lord Wilberforce stated:

> *"On these facts it would be quite wrong, and a faulty analysis, to pick out, and stop at, the one step in the combination which produced the loss, that being entirely dependent upon, and merely a reflection of the gain. The true view, regarding the scheme as a whole, is to find that there was neither a gain nor a loss, and I so conclude."*[281]

In reaching his decision Lord Wilberforce quoted with approval several anti-tax avoidance judgments in the United States.[282] This too was the start of a new trend. Later that year in *CIR v Burmah Oil*,[283] the House of Lords applied the newly enunciated Ramsay principle. Lord Scarman emphasised:

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bearing loan 1 which would not mature for 30 years. Ramsay sold its shares in Caithmead at the negligible market value of £9,387, giving rise to a capital loss of £175,647.

[277] This was the deduction that the Revenue disallowed that led to the appeals through the Special Commissioners up to the House of Lords.

[278] This was considered important by Lord Wilberforce in holding that neither a gain nor loss arose of the series of transactions. "The taxpayer" he states in his judgment "provided no finance". *Ramsay v IRC* 1 LTC 378 at 384

[279] An argument that D C Potter QC, representing Ramsay, described as 'revolutionary.' Ibid., at 380

[280] The Law Lords found that the scheme failed for technical reasons in any event, the capital gain falling in charge to tax as a debt on security rather than a simple debt.

[281] *Ramsay v IRC* 1 LTC 378 p. 385

[282] *Knetch v United States* (1960) 364 US 361 and *Gilbert v Commissioner of Inland Revenue* (1957) 248 Feb 2nd 399

[283] *CIR v Burmah Oil* [1982] STC 30 (HL), 1 LTC 396

> *"[I]t is of the utmost importance that the business community (and others, including their advisors) should appreciate... that* Ramsay's *case marks a significant change in the approach adopted by this House in its judicial role towards tax avoidance schemes."*[284]

In the landmark 1984 case of *Furniss v Dawson*[285] the *Ramsay* doctrine was significantly expanded. Dawson owed two manufacturing companies F and K which he wished to sell to unrelated company Wood Bastow. To defer capital gains tax on the transaction Dawson incorporated an investment company in the Isle of Man, named Greenjacket, and transferred his shares in F and K at market value to Greenjacket in return for Greenjacket's shares. Greenjacket then sold the shares in F and K to Wood Bastow at market value for cash.

Before turning to the judgement it is worth examining why Dawson's advisors thought the scheme would work. It was anticipated that no tax would be payable on the share transfers between Dawson and Greenjacket because of the reorganisation exemption provisions in the Income and Corporation Taxes Act 1970.[286] No tax would be payable on the transfer by Greenjacket of the shares in F and K to Wood Bastow, not because Greenjacket was an offshore company, but because the shares were purchased and disposed of by Greenjacket at the same market price giving rise to no taxable gain.[287] It should be mentioned that the scheme had none of the circular and artificial characteristics found in *Ramsay*.[288]

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284 Ibid., at 406

285 *Furniss v Dawson* [1984] STC 153 (HL), 1 LTC 407

286 Now consolidated in the Income and Corporation Taxes Act 1988

287 This is an oft misunderstood aspect of *Furniss v Dawson*.

288 It is interesting that Lord Brightman acknowledged in his judgement to be "not a tax avoidance scheme, but a tax deferment scheme ... a simple and honest scheme which seeks merely

The House of Lords, however, unanimously ruled against the scheme. In the leading judgement Lord Brightman stated that:

> *"The formulation by Lord Diplock in* Burmah [[289]] *expresses the limitation of the Ramsay principle. First, there must be a pre-ordained series of transactions; or, if one likes, one single composite transaction. This composite transaction may or may not include the achievement of a legitimate commercial (ie business) end ... Secondly, there must be steps inserted which have no commercial (business) purpose apart from the avoidance of a liability to tax - not "no business effect". If those two ingredients exist, the inserted steps are to be disregarded for fiscal purposes. The courts must then look to the end result [and tax accordingly]".*[290]

This anti-avoidance judicial formulation was recast by Lord Oliver some four years later in *Craven v White*.[291] In a case the facts of which were very similar to those in *Furniss v Dawson*,[292] Lord Oliver stated that for the Ramsay principle, as developed by Dawson, to be applied to an intermediate transaction designed to avoid tax, it was essential that:

> *"(1) that the series of transactions was, at the time when the intermediate transaction was entered into, pre-ordained in order to produce a given result; (2) that the transaction had no other purpose than tax mitigation; (3) that there was at that time no practical likelihood that the pre-planned events would not take place in the order ordained... and (4) that the pre-ordained events did in fact take place."*[293]

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to defer the payment of tax until the taxpayer has received into his hands the gains which he has made." 1 LTC 407 p.412

[289] CIR v Burmah Oil [1982] S.T.C. 30 (H.L.), 1 LTC 396

[290] Furniss v Dawson 1 LTC 407 p.423

[291] [1988] 3 WLR 423

[292] White, in anticipation of a sale or merger of the company he owned, Q, acquired an Isle of Man company, M, and transferred to it his shares in Q (in exchange for shares in M). M later sold the Q shares to a third party, O.

[293] *Craven v White*, op. cit. at 462-3

On the facts of this case their Lordships decided that the transactions were not sufficiently pre-ordained.[294] Lord Oliver delivered the leading judgement in a 3-2 majority decision. Lords Templeman and Goff dissented. The view, however, that *Craven v White* had definitively determined the limit of judicial intervention in 'artificial' tax avoidance schemes has been recently shattered by the House of Lords decision in *IRC v McGuckian*.[295] The nature of the judgment has caused a stir within the taxation profession.

> *"Arguably, their Lordships have never been so robust in their assault on tax avoidance as in their speeches in* McGuckian. *The decision is important not only for the application of ... the* Ramsay *principle ... to a series of steps in a composite transaction, but for the purposive construction of the taxing statutes under which the transaction fell to be assessed."*[296]

The facts of *McGuckian* were these. In 1976, on the advice of a tax consultant, Mr and Mrs McGuckian transferred their shares in B, a successful company wholly owned by them, to a Guernsey trust (Shurltrust) under the terms of which they were both beneficiaries, the wife being entitled to the income under the trust. In 1979 the trustee sold their right to receive a dividend to M for 99% of the value of the forthcoming dividend. A dividend of £400,055 was subsequently paid to M, out of which £396,054 was paid to the trustee. The Inland Revenue raised an assessment on Mr McGuckian for £400,055 under s.478 ICTA 1970 (now s.739

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[294] White had sought the same capital gains tax deferral as Dawson. Unlike Dawson, however, White was successful. His success rested on the following factual differences in the two cases. When White incorporated M and transferred to it his shares in Q he did not know whether the ultimate sale of Q would be to O or whether it would be merged with another independent company with whom negotiations were progressing. This was sufficient for Lord Oliver to distinguish *Craven v White* from *Furniss v Dawson*.

[295] *IRC v McGuckian* [1997] 3 All ER 817

[296] Ibid., at 827

ICTA 1988). There were several facets to this case, but in essence the Revenue's argument centred on whether the money received by the trust was capital (deriving as it did from the sale of a right) or income (by ignoring the step involving the sale of the right under the Ramsay and *Furniss v Dawson* principles). Section 478 could only apply if the money received by the trust was held to be income, as indeed their Lordships held. It was, however, the scope of the judgments, rather than the narrow technical issues, that is of primary interest in the context of the judiciary's approach to tax avoidance cases.

Lord Steyn laid out the general legal context in which the case fell to be decided thus:

> *"During the last 30 years there has been a shift away from literalist to purposive methods of construction... But under the influence of the narrow* Duke of Westminster *doctrine, tax law remained remarkably resistant to the new non-formalist methods of interpretation... Tax law was by and large left behind as some island of literal interpretation... [T]he courts regarded themselves as compelled to adopt a step by step analysis of such schemes, treating each step as a distinct transaction producing its own tax consequences... The result was that the court appeared to be relegated to the role of a spectator concentrating on individual moves in a highly skilled game ... and paid no regard to the strategy of the participants or the end result. [T]he intellectual breakthrough came in 1981 in the Ramsay case, and notably Lord Wilberforce's seminal speech."*[297]

Lord Steyn was equally forthright on turning to the facts of the case.

> *"On a formalistic view of the individual tax avoidance steps, and a literal interpretation of the statute in the spirit of* Duke of Westminster's *case, it is possible to say that the money which*

[297] Ibid., at 824

> *reached Shurltrust was capital. But the court is no longer compelled to look at transactions in blinkers, and literalism has given way to purposive interpretation... I would even without the benefit of the detailed legal analysis in the Ramsay line of authority have inclined to the view that the more realistic interpretation of the undisputed facts is that what Shurltrust received was income."*[298]

Each Law Lord deemed the money received by Shurltrust to be income. In Lord Browne-Wilkinson's opinion the case fell squarely within the *Furniss v Dawson* principle and he quoted with approval Lord Brightman's formulation of the same (as set out on page 84 above). This view is not without its detractors.[299] Lord Cooke, like Lord Steyn, opined that he could reach the conclusion that the money received by the trustees was income, rather than capital, even without the assistance of *Ramsay*.[300] Lord Clyde stated that the relevant taxing provision (s.478 ICTA 1970; now s.739 ICTA 1988) should be applied in this case to recognise the real substance of the whole transaction. Lord Lloyd agreed with the four other judgments without additional comment.

McGuckian establishes the current position of the UK judiciary on interpreting tax statutes and assessing tax avoidance schemes. This will not be the last word on

[298] Ibid., at 827

[299] In *'Where To Now?'* The Tax Journal, Issue 416, 11 August 1997, David Goldberg QC argues, "This must be a doubtful analysis. Lord Brightman insisted in *Furniss* that a taxpayer was to be taxed on the end result of his series of transactions. What happened in *McGuckian* was that Shurltrust, the person by reference to whose income the McGuckians were to be taxed under ICTA 1988 s.739, sold the right to a dividend for cash. The end result of the transaction was that Shurltrust received capital for selling the right to receive a dividend and, applying Lord Brightman's approach, the McGuckians should have been taxed on that end result. They have not been."

[300] "My Lords, it seems to me one has only to recount [the] facts to show that what was received by Shurltrust was essentially income. The dividend was intended to be for the benefit of Shurltrust and the circular route by which the payment was made was no more than machinery for giving effect to that intention." Op. cit. at 828

the subject. This whole field is ever evolving. It is clear, however, that rules have changed and the modern tax advisor must be cognisant of these changes. As a leading practitioner has observed:

> *"The noted dicta of Lord Tomlin in ...* IRC v Duke of Westminster *... looks significantly diminished by* McGuckian, *although this process started of course with earlier decisions in the* Ramsay *series of cases. It would be a foolish advisor who nowadays relied upon the words 'every man is entitled, if he can, to order his affairs so that a tax (under a tax statute) is less than it otherwise would be'"*[301]

For the international tax advisors in the field of sport and entertainment, the impact of this case should serve to focus their attention away from pre-planned 'off-the-peg' tax avoidance schemes with a high degree of artificiality and toward tax minimisation arrangements of business substance.

3.7 HARMFUL TAX COMPETITION

As underlined in the Chapter 1, this work has proceeded on the premise that the use of offshore financial centres in international tax planning for sportspeople and entertainers is a morally, jurisprudentially, politically and economically legitimate activity. This work would not be complete therefore without addressing the issue of 'harmful' international tax competition. This has been investigated by and reported on by two of the leading economic organisations in the industrialised world, the European Union[302] and the Organisation for Economic Co-operation

[301] Godman R. *'Loophole or GAP? McGuckian revisted',* Taxation Practitioner, January 1998, p.8-9

[302] Commission of the European Communities. 'A Package to Tackle Harmful Tax Competition

and Development,[303] with such work being endorsed by the Group of Seven countries.[304] The reports generated by these organisations hold that at a given level, competition between nations to attract economic activity based on lower rates of taxation is harmful and should be eliminated or, at least, minimised.

3.7.1 OECD Report

The OECD report presents the perceived problem most robustly. Though it acknowledges that globalisation has had a positive effect on the development of domestic tax systems, encouraging countries to reassess their tax and public expenditure policies with a view to making changes to improve the fiscal climate for attracting inward investment,[305] the report goes on to assert:

> *"Globalisation has, however, also had the negative effects of opening up new ways by which countries can exploit these new opportunities by developing tax policies aimed primarily at diverting financial and other geographically mobile capital. These actions induce potential distortions in the patterns of trade and investment and reduce global welfare.*[306]

The report considers that offshore financial centres,[307] by driving the effective tax rate levied on income from mobile activities significantly below rates in other countries, potentially cause harm by:

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in the European Union' COM(97) 564 Final, Brussels, 1997.

[303] Committee on Fiscal Affairs HARMFUL TAX COMPETITION: An Emerging Global Issue OECD Paris (1998)

[304] At their 1996 Summit in Lyon, the G7 Heads of State formally endorsed the OECD's project on harmful tax competition.

[305] Ibid., para.21

[306] Ibid., para.23

[307] The report labels all offshore financial centres as 'tax havens'.

- distorting financial and, indirectly, real investment flows;
- undermining the integrity and fairness of tax structures;
- discouraging compliance by all tax payers;
- re-shaping the desired level and mix of taxes and public spending;
- causing undesired shifts of part of the tax burden to less mobile tax bases, such as labour, property and consumption; and
- increasing the administrative costs and compliance burdens on tax authorities and taxpayers.[308]

The report continues:

> *"Clearly, where such practices have all of these negative effects they are harmful... [W]here only some of these effects are present, the degree of harm will range along a spectrum and thus the process of identifying harmful tax practices involves a balancing of factors. If the spillover effects of particular practices are so substantial that they are concluded to be poaching other countries' tax bases, such practices would be doubtlessly labelled 'harmful tax competition'."*[309]

In discussing the factors used to identify harmful preferential tax regimes, the Report does not attempt to identify any particular country. It does however draw a distinction between jurisdictions that tax income generally at a relatively low rate, but are not engaged in harmful tax competition, and those where the existence of a low rate is coupled with other factors and special features, which in combination constitute harmful tax competition. Jurisdictions of the first type are countries that collect significant revenues from the income tax, but whose generally applicable effective tax rate is lower than that levied in other countries. Jurisdictions of the second type are either 'tax havens' imposing no or only nominal taxation on income, or are countries with 'preferential regimes' that provide favourable tax treatment in the context of a general income tax system.

The Report refuses to draw a distinction between tax havens and offshore financial centres, preferring instead to label all jurisdiction fitting its criteria as 'tax havens'. The key factors set out in the Report in identifying tax havens are fourfold. Tax havens are described as jurisdictions that have no or only nominal taxation on income; the lack of an effective exchange of information procedure with other tax authorities; a lack of transparancy in legal, regulatory and administrative matters; and the absence of a requirement that activity within the jurisdiction be 'substantial' (suggesting the attempt to attract investments or transactions that are purely tax driven).[310]

The Report separately sets out the key factors in identifying harmful preferential tax regimes. Unsurprisingly, the factors largely mirror those which the Report uses to identify tax havens. The principal factors are: (i) a low or zero effective tax rate on the relevant income; (ii) the regime being 'ring fenced', ie insulated from the domestic market of the country providing the regime; (iii) the operation of the regime lacking transparency; and (iv) the jurisdiction operating the regime

[308] Committee on Fiscal Affairs, op. cit., para. 30
[309] Ibid., para.31
[310] Ibid., paras. 52-56

not effectively exchanging information with other countries.[311]

Nineteen recommendations are made by the Report aimed at curbing harmful tax competition worldwide. These are broken down into three areas: domestic legislation, tax treaties, and international cooperation. Under domestic legislation, the Report recommends actions that countries can take unilaterally by scaling back the tax benefits available to income arising in a tax-privileged setting. The first recommendation,[312] for example, is that countries consider adopting rules equivalent to the Controlled Foreign Corporation (CFC) rules already in existence in most OECD member countries. These rules, from a UK perspective, are discussed in section 3.6.1.5 above. Another recommendation is that countries applying the exemption method to eliminate double taxation on foreign source income, explained in Chapter 4,[313] restrict its application where the foreign source income has arisen from harmful tax competition practices.[314]

The recommendations concerning tax treaties focus on the bilateral and multilateral measures countries can undertake to curb harmful tax practices. These include recommendations on the more efficient use of exchanges of information. This can be achieved by bilateral treaties and the greater use of the Multilateral Convention on Mutual Administrative Assistance in Tax Matters, discussed in Chapter 4, section 4.8. Another important recommendation under tax treaties is the exclusion from treaty benefits of income arising from harmful tax practices.

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[311] Ibid., paras. 61-67
[312] Ibid., paras. 97-100
[313] See Chapter 5, section 5.4

So, for example, the normally reduced rates of withholding tax would not apply in situations where harmful tax practices were present.

It is widely considered that the most innovative recommendations aimed at curbing harmful tax competition fall in the area of intensifying international cooperation.[315] These recommendations focus on encouraging countries, both OECD member and non-member countries, to work together to curb the spread of harmful tax practices. The Report sets out Guidelines promoting the '3 R's':[316] countries will *refrain* from adopting new, or strengthening existing, harmful tax competition measures; they will *review* existing legislative and administrative measures to identify harmful tax competition measures; and they will *remove* the harmful features of their preferential tax regimes. The review period covers two years and the removal period covers five years.[317] The Report also recommends creation of a Forum on Harmful Tax Practices that will coordinate the implementation of the recommendations and guidelines. The Forum, which will be a subsidiary body to OECD's Committee on Fiscal Affairs, will be responsible for monitoring implementation of the guidelines, for drawing up a list of countries that fall into the tax haven category, and for improving international cooperation by implementing the Report's recommendations.

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[314] Committee on Fiscal Affairs, op. cit., paras. 104-105
[315] See Weiner J.M. and Ault, H.J. 'The OECD's report on harmful tax competition; Organization for Economic Cooperation and Development' National Tax Journal, No. 3, Vol. 51, September, 1998
[316] Committee on Fiscal Affairs, op. cit., paras. 140-148
[317] Both periods run from April 9, 1998, the date on which the OECD Council approved the Report. An additional two years is allowed for removing benefits to taxpayers currently subject to the preferential regime.

There is one final recommendation of particular relevance to the offshore financial centres focused on in this chapter, namely Jersey and the Cayman Islands. It is this:

> *"[T]hat countries that have particular political, economic or other links with tax havens ensure that these links do not contribute to harmful tax competition and, in particular, that countries that have dependencies that are tax havens are not used in a way that increase or promote harmful tax competition."*[318]

Within the context of Jersey and the Cayman Islands this is a call to action aimed directly at the UK.

3.7.2 The European Union Report

On 1 December 1997, the European Union ('EU') Finance Ministers, under the presidency of Luxembourg (paradoxically a country that effectively abstained from the OECD Report), agreed to a package of measures to tackle harmful tax competition. This package includes a political agreement on a Code of Conduct for business taxation, containing a proposed directive on savings and a proposed directive on withholding taxes on cross-border royalty and interest payments between related enterprises, and a commitment to remove harmful tax regimes as soon as possible following a review process.

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[318] Committee on Fiscal Affairs, op. cit., recommendation 17

Compared to the OECD Report, the EU Code is a much briefer document.[319] The documents, however, have many similarities, and the EU Members of the OECD worked carefully to ensure that the commitments made under the individual Reports remained consistent. Both Reports share the goal of attempting to limit the harmful effects of tax competition, and each Report attempts to do so in a manner consistent with its institutional framework.[320] A notable difference in emphasis is that the EU Code does not expressly target tax havens, though it does urges EU member countries to promote the adoption of its provisions in dependent or associated territories.

3.7.3 View of the US

It has been suggested in a leading international tax journal that the bulk of US tax practitioners and the US public have paid very little attention to the OECD Report. After all, it is argued, the OECD has no power to make binding law. Similarly, it is asserted, that for most Americans the EU Code seems distant because , except those with business entities in the EU, most Americans have not focused on the relevance of the Code of Conduct for the US or the rest of the world.[321]

The US government, however, a member of the OECD, supports in principle both

[319] The EU Code is five pages in length, compared to the OECD Report's 78 pages.
[320] See Weiner J.M. and Ault, H.J., op. cit.
[321] B. Zagaris 'The assault on low tax jurisdictions: A call for balance and debate' Tax Management International Journal, Vol. 28, No. 8, August 13, 1999, p. 474

the OECD Report and the EU Code. The attack of both Reports on harmful tax competition is consistent with the Limitation on Benefits provision included in all modern US double taxation treaties, as discussed in Chapter 5.[322] That said, the US itself competes on taxation, its income tax rates being lower than those in Eurpoe. This has given US businesses a competitive advantage in the global marketplace. Taken to their logical conclusions, the OECD Report and the EU Code may serve to undermine this advantage. This application of the rules on harmful tax competition, the US would be sure to resist. It should be noted that the EU and the US have been doing battle on tax policy in the 'court'[323] of the World Trade Organisation ('WTO') for over 25 years on the subject of what the EU calls US 'subsidies' to US resident companies engaged in qualified export sales.[324]

3.7.4 Harmful or Beneficial

The very term 'harmful' is pejorative in nature, implying damage, injury and hurt. A more neutral term would have 'unfavourable' or 'adverse'. Even this semantic issue begs a further question: harmful or unfavourable to whom? The OECD Report suggests "global welfare",[325] but it presents no arguments to support this view. Competition will invariably have a negative effect on some of the competitors. Indeed, the free market encourages the favoured producers to drive

[322] See Chapter 5, section 5.5.2
[323] More accurately, a dispute settlement procedure.
[324] For the full history of this case, including the arguments of each party, see B. Zagaris, op. cit.
[325] Committee on Fiscal Affairs, op. cit., paras. 4

out the less favoured. Nowhere in free market economics are the less favouured deemed to be 'harmed'. As quoted above in section 3.7.1, the Report refers to tax havens "poaching other countries' tax bases."[326] It could be argued that this is only so in the same way as the favoured 'poach' the clients of the less favoured.

Offshore financial centres owe their existence to the free market in capital. Businesses and investors, corporate and individual, choose to use offshore financial centres in structuring their financial affairs, taxation being a consideration along with other costs.[327] It is open to OECD and EU countries to restrict the free market in capital by implementing exchange controls, as they have done in the past. This is now considered economically dysfunctional. By the OECD Report and EU Code, these countries now choose instead to regulate the competitors, on the basis that any deviation from the perceived norm of economic regulation is unfair and harmful competition.

Neither the OECD nor the EU specifically describe this norm of economic regulation. From reading the OECD Report economist Mason Gaffney[328] has determined the following characteristics:

- a free market which is subject to bureaucratic regulation or direction

[326] Ibid., para.31
[327] A view endorsed in M. Gaffney International Tax Competition: Harmful or Beneficial Riverside, Mason Gaffney (1998) p. 7: *"The irony is that the effects of the tax haven countries on the OECD countries arise from the purely voluntary conduct of individuals and businesses internationally, responding to the attractive fiscal and legal environments of the tax haven countries in an international free market."*
[328] Professor of Economics, University of California

(particularly on the subject of "unfair competition");

- direct state intervention in the form of subsidies and tax expenditures;
- a high direct tax burden; and
- a welfare state, albeit leaving the precise mix of these elements to be determined by each individual state government.[329]

The problem with this determination is that most offshore financial centres, particularly those in the Caribbean, do not have the labour and infrastructure to structure such an economy. Support for this view comes from Bruce Zagaris, a prominent US law professor,[330] who argues that at a time when many countries in the Caribbean are experiencing 20% to 30% unemployment and considerable underemployment and the socio-political framework, especially among the youth, is in jeopardy, Caribbean governments are pressed to devise new economic and political initiatives. These small countries have limited resources and disadvantages in economies of scale. They have lost their monoculture staples, such as agricultural and other commodities, including sugar, bananas, and bauxite, leaving only tourism, which is very fickle.[331] As a result, Professor Zagaris concludes, many governments are turning to financial services as a legitimate economic force in the future in the Caribbean.[332]

[329] M. Gaffney 'Competition: More harm than good?' International Tax Review, Vol. 10, No. 1 pp. 46-49, December 1998/January 1999

[330] Partner, Berliner, Corcoran & Rowe, Washington, D.C.; adjunct professor, Washington College of Law, American University and School of Law, Fordham University; founder and editor-in-chief, International Enforcement Law Reporter.

[331] Zagaris argues that it only takes an airline strike, a war in the Gulf, an oil crisis, or adverse tourism incidents to cripple the Caribbean tourism industry.

3.7.5 Sovereignty

This gives rise to the issue of sovereignty. Taxation is a purely sovereign power. Under public international law, the sovereignty of a state is recognized as territorial in scope. It follows that the traditional rule and practice is that no state will assist another in levying taxes within its own territory. This applies doubly for offshore financial centres, which generally do not attempt to tax income or assets outside their territory. They therefore have no bilateral incentive to cooperate with countries, such as the OECD and EU members, which do tax on an extra-territorial basis. As a result, the sought-for cooperation between the OECD and EU member countries and offshore financial centres may be abandoned and replaced by various forms political pressure.[333]

3.7.6. The Islands Strike Back?

In response to the OECD Report and the EU Code both Jersey and Guernsey have issued statements aimed at ensuring that all countries have a clear understanding of their constitutional status with the UK; that is, that they are in charge of their own tax affairs. The Isle of Man has considered more forthright action. Concerned that, should the UK join the single currency, the Manx pound, which is

[332] B. Zagaris, op. cit.

[333] M. Gaffney International Tax Competition: Harmful or Beneficial' op. cit., p. 8: *"[Paragraph 26 of the OECD Report states:] 'Countries should remain free to design their own tax systems as long as they abide by internationally accepted standards in doing so.' There is no indication of what is meant by 'internationally accepted standards'. The implication is that the OECD intends that certain rules and practices relating to tax matters, as set out by the most powerful countries in the world, should be imposed internationally on other jurisdictions."*

pegged to sterling, could be left in limbo, the Chief Minister has called for the Isle of Man to prepare a contingency plan involving independence within the Commonwealth and linking the Manx pound to the US dollar. The thinking was to have a plan at hand in case the UK joins the euro and aggressive tax harmonisation follows.[334]

As regards the offshore financial centres in the Caribbean, on 19 November 1998 the Caribbean Financial Action Task Force (CFATF), at a meeting in the Cayman Islands, adopted a resolution appointing a working group to study the OECD Report and to report to the CFATF Plenary and Council on their implications and recommendations on the most appropriate response.

3.8 CONCLUSIONS

The concern expressed by the OECD, the EU and the G7 group of countries in no way heralds the decline of offshore financial centres. Indeed, it is their increasing growth and strength that has focused the attention of the developed world. In addition to expanding banking operations, offshore financial centres continue to develop legal vehicles for tax minimisation and asset protection, as evidenced by the Cayman Islands' STAR trusts[335] discussed in section 3.4.3.2 above..[336]

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[334] S.A. Bologna 'Havens fear taxing times' The Lawyer, March 29, 1999, pp. 25-26

[335] Special Trust (Alternative Regime) Law 1997

The offshore financial centre will thus remain an integral part of international tax planning for high net worth and high earning individuals, notably sportspeople and entertainers. It will be for the domestic legislation of OECD, EU and G7 member countries, and the limitation on benefits provisions of double taxation treaties,[337] to restrict the benefits to be derived by sportspeople and entertainers from the use of offshore financial centres in their international tax planning.

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[336] For an excellent analysis of this new legislation see A. Duckworth STAR Trusts Grand Cayman, Gostick Hall Publications (1998)

[337] See Chapter 4.

CHAPTER 4

DOUBLE TAXATION TREATIES

4.1 INTRODUCTION

Most offshore financial centres do not enter into double taxation agreements. It may therefore at first appear inappropriate to devote a chapter of this work to double taxation treaties, given that the central theme of the work is the use of offshore financial centres in international tax planning for sportspeople and entertainers. The relevance of this chapter rests on the fact that the offshore vehicles will be used for tax minimisation purposes by performers in countries which have a developed sports and entertainment industry. These countries will invariably also have an established network of double taxation treaties.

This chapter examines double taxation treaties as they relate to sportspeople and entertainers, from the comparative perspective of the UK and US, and with an emphasis on offshore tax planning through treaty shopping.

4.2 PURPOSE OF DOUBLE TAXATION TREATIES

Double taxation treaties are agreements entered into by governments for the allocation of fiscal jurisdiction. They serve to address juridical double taxation, where the same income or gains of the same person for the same period fall in charge to tax in two different jurisdictions.[1] In many instances, the provisions of a tax agreement are aimed specifically at eliminating double taxation.[2] An example is the tie-breaker clause where an individual is prima facie resident in both contracting states.[3] In other instances, notably in relation to sportspeople and entertainers,[4] who under these treaties are usually subject to tax both in the country of source and the country of residence, the treaties provide mechanism for double taxation relief.[5]

The focus on the elimination or relief of double taxation, though worthy, is not an end in itself. It is part of a wider economic objective. As the OECD stated in the Commentaries to the 1992 Model Convention, "[t]he purpose of double taxation conventions is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons..."[6] Seen from this perspective, a double taxation treaty is an agreement, usually

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[1] This is to be distinguished economic double taxation, where two different persons are taxable in respect of the same income or capital; for example, pre-distribution profits in the hands of a company and distributed dividends in the hands of its shareholders.

[2] The OECD has identified three cases in which international juridical double taxation may arise: *"a) where each Contracting State subjects the same person to tax on his worldwide income or capital;*
b) where a person is a resident of a Contracting State (R) and derives income from, or owns capital in, the other Contracting State (S or E) and both States impose tax on that income or capital;
c) where each Contracting State subjects the same person, not being a resident of either Contracting State to tax on income derived from, or capital owned in, a Contracting State; this may result, for instance, in the case where a non-resident person has a permanent establishment or fixed base in one Contracting State (E) through which he derives income from, or owns capital in, the other Contracting State (S)." OECD 1992 Model Convention – Commentary on Articles 23 A and 23 B Concerning the Methods For Elimination of Double Taxation, para. 3

[3] See Art.4, OECD 1992 Model Convention

[4] See Art.17, OECD 1992 Model Convention

[5] See Art.23, OECD 1992 Model Convention

bilateral, which limits the rights of each contracting state to levy taxes on residents of the other contracting state in the interest of, from fiscal considerations, the efficient exchange of goods and services and the unhindered movement of capital and persons, be they individuals or companies.

Interestingly, the US Congress has regarded the removal of the barriers to trade, capital flows and commercial travel as only a related objective of tax treaties.[7] Notwithstanding its free market outlook of the US, the traditional objectives of US tax treaties have been the avoidance of international double taxation and the prevention of tax avoidance and evasion. This concern with tax evasion and the perceived use of double taxation treaties as a preventative tool is reflected in the titles of US tax treaties. For example, the current US: UK income tax treaty[8] is a 'Convention Between The Government Of The United States Of America And The Government Of The United Kingdom Of Great Britain And Northern Ireland For The Avoidance Of Double Taxation And The Prevention Of Fiscal Evasion With Respect To Taxes On Income And Capital Gains'[9] Moreover, this perspective has led the US courts, for treaty interpretation purposes, to regard tax conventions as part of the vast array of anti-avoidance provisions. This in turn

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[6] OECD 1992 Model Convention – Commentary on Article 1 Concerning the Persons Covered by the Convention para. 7

[7] See the published work of the US Joint Committee on Taxation (JCT); for example JCT, Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Canada (JCS-19-97), October 6, 1997, para. 17

[8] Signed: December 31, 1975; Relevant Effective Dates: In the U.K.: income tax, from April 6, 1973; corporation tax, from April 1, 1975; capital gains tax, from April 6, 1975; petroleum tax, from January 1, 1975. In the U.S.: Article 23, from April 1, 1973; other provisions, from January 1, 1975.

[9] Citations: 85 TNI 27-21; Doc 93-30464; TIAS 9682; S. Exec. K, 94-2

has led to treaty interpretation decisions that contrast sharply with decisions on the same or similar provisions by the courts of other countries.[10]

4.3 HISTORY OF DOUBLE TAXATION TREATIES

The ideal resolution of the problems of juridical double taxation and international fiscal evasion would be a uniform, worldwide multilateral treaty. This was considered achievable in the 1920s when the International Chamber of Commerce, set up in Paris in 1920, identified the problem in essentially simple terms.

> *"If only the principle that the same income should only be taxed once it is recognised, the difficulty is solved, or very nearly so. It only remains then to decide what constitutes the right of one country to tax the income of a taxpayer in preference to any other country. It does not seem probable that there would be any serious difference on the matter."*[11]

The matter was referred to and taken up by the Financial Committee of the League of Nations, which explored the possibility of achieving a uniform multilateral treaty for the avoidance of double taxation. It became apparent, however, that a multilateral agreement would prove too difficult to achieve among countries with different legal, tax and economic systems,[12] not to mention differences in languages, currencies and accounting principles The multilateral project was rejected in favour of a network of bilateral tax treaties based on a

[10] See discussion of *Boulez v Commissioner* in section 5.2.6.
[11] Professor Suyling's Committee's Report to the 2nd ICC Congress in Rome in 1923, as quoted in S. Picciotto International Business Taxation London, Weidenfeld and Nicolson (1992) pp. 15-16.

single flexible model.

In 1928 the League of Nations issued draft model bilateral income tax treaties for the relief of double taxation. Today, the League of Nations models still serves as the basis for the model income tax treaties of the Organization for Economic Cooperation and Development (OECD), the UN and the US. However, over the ensuing seventy years treaty articles have become more complex, and the commentaries more detailed, in an attempt to thwart international tax planning techniques.

Almost all the major industrial nations - the members of the OECD - have bilateral tax treaties with one another. The OECD Model Treaty is the most commonly used as the basis for more than twelve hundred bilateral tax treaties now in force throughout the world.[13]

4.4 1992 OECD MODEL TREATY

The UK generally uses the OECD Model Treaty as the basis for negotiating double taxation agreements. The US, though a member of the OECD, uses its own model treaty as the basis for its negotiations, though this treaty itself is based

[12] Moreover, the very definition of what constituted double taxation became a subject on debate. See S. Picciotto, op.cit., pp. 16-18.
[13] M. J. Graetz & M. M. O'Hear 'The "Original Intent" Of U.S. International Taxation' Duke Law Journal, 46 Duke L.J. 1021, p. 1023

on the OECD model.[14] The US:UK double taxation treaty will be examined in detail as it pertains to sportspeople and entertainers below, in section 5.6. First, the OECD model treaty will be reviewed from the same perspective. The latest OECD Model Treaty was signed in 1992, the 1992 OECD Model Convention, and has been subject to updates in 1994, 1995 and 1997. Article 17 of the Model Convention deals specifically with the taxation of artistes and sportsmen. A full appreciation of the article is best obtained by a review of its history.

4.4.1 Artistes and Athletes: Article 17

In the 1963 OECD Draft Convention, Article 17, headed 'Artistes and Athletes' provided the following:

> *"Notwithstanding the provisions of Articles 14 and 15, income derived by public entertainers, such as theatre, motion picture, radio or television artistes, and musicians, and by athletes, from their personal activities as such may be taxed in the Contracting State in which these activities are exercised."*

Article 14, headed 'Independent Personal Services', [15] stated that the income derived by a resident of a Contracting State in respect of professional services or other independent (self-employed)[16] activities would fall to be taxed only in that State, unless he had a fixed base regularly available to him in the other

[14] The latest US model treaty is the 1996 Model Convention, Citations: 96 TNI 186-16; Doc 96-25867

[15] By article 14(2), "The term 'professional services' includes, especially independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants."

Contracting State for the purpose of performing his activities. If he had such a fixed base, the income was taxable in the other Contracting State but only to the degree that it was attributable to that fixed base. Article 15, headed 'Dependent Personal Services' stated that salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment would fall to be taxed only in that State provided:

a) the recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in the fiscal year concerned, and

b) the remuneration is paid by, or on behalf of, an employer who is not a resident of the other State, and

c) the remuneration is not borne by a permanent establishment or a fixed base which the employer has in the other State.

But for Article 17, Articles 14 and 15 would have applied to entertainers and athletes, with the consequence that most short term engagements, be they on a self-employed or employee basis, in a treaty country would not fall in charge to tax in that country. The Commentary to the 1963 Model Convention emphasised that "all public entertainers [come] under a special Article covering their activities whether independent or not (Article 17)."[17] This in turn raised the question as to why entertainers and athletes required a 'special article'. The answer provided by the Commentary on article 17 was that "[t]his provision makes it possible to avoid

[16] Paragraph 1 of the Commentaries to Article 14 specifically states that the phrase 'professional services and with other independent activities of a similar character' excludes industrial and commercial activities and also professional services performed in employment.
[17] OECD 1963 Draft Convention Commentaries; Citations: 95 TNI 237-35; Doc 95-30613

the practical difficulties which often arise in taxing public entertainers and athletes performing abroad."[18] Part of this difficulty related to the international mobility of sportspeople and entertainers and the fact that they could command large fees for appearances of very short duration, be it for a heavyweight boxing championship or a major rock concert. Another part of the difficulty, not articulated in the Commentary but fully explored in subsequent OECD publications,[19] was simple non-compliance, a failure to report income; in a word, tax evasion. This was addressed by article 17 insofar as a contracting state, having established the right to tax the non-resident performer, usually introduced a withholding tax system whereby the promoter of the event was charged with withholding tax at source from payments to the performer. The last part of the difficulty was legitimate tax avoidance schemes whereby the performer minimised his aggregate worldwide tax liability through the use of bona fide tax planning techniques. It was in this area that the 1963 Article 17 was found wanting. It was unable adequately to tax the performer's service or loan out company.

As drafted, Article 17 caused the income of the performer, whether from employment or self-employment, to fall in charge to tax in the contracting state in which the performance took place. By using a service or loan out company, which would contract with and be paid by the promoter, the performer could defeat the intentions of the article. The performer would not be self-employed,

[18] Ibid., Commentary on Article 17, para. 1
[19] See OECD Taxation of Entertainers, Artistes and Sportsmen Paris, OECD (1987)

rather he would be employed by the service company. Should the service company choose not to pay him remuneration specifically in respect of the overseas performance, the performer would have no income that falls to be taxed under article 17. The income paid to the service company itself would not fall in charge to tax in the source state provided the company did not have a permanent establishment there. Paragraph 1 of Article 7 of the 1963 Model Convention, headed 'Business Profits' stated: "The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein."

4.4.2 Artistes and Athletes: Article 17(2)

The OECD addressed these problems by introducing a second paragraph to Article 17 in their 1977 Model Convention. At the same time they tightened up the wording in paragraph one. The new Article 17, still headed, Artistes and Athletes, read as follows:

> *1. Notwithstanding the provisions of Articles 14 and 15, income derived by a resident of a Contracting State as an entertainer, such as a theatre, motion picture, radio or television artiste, or a musician, or as an athlete, from his personal activities as such exercised in the other Contracting State, may be taxed in that other State.*
> *2. Where income in respect of personal activities exercised by an entertainer or an athlete in his capacity as such accrues not to the entertainer or athlete himself but to another person, that income may, notwithstanding the provisions of Articles 7, 14 and 15, be taxed in the Contracting State in which the activities of the entertainer or athlete are exercised.*

This draft has stood the test of time. The only amendment to Article 17 in the 1992 OECD Model Convention is the replacement of the term 'athlete' by the term 'sportsman'. This change was made better to reflect the nature of the activities covered by the term. It was mooted in the discussions leading to the new convention that the term 'entertainer' should replace the term 'artiste' is the heading of the article, but this was rejected as given that the term 'entertainer' was in the text of the article it was clear that the terms could be used interchangeably. The issue of terminology will be returned to in section 4.4.3, for it is of central importance to determine which performers are covered by the article and which are not. At this point the work will focus on the full import of the second paragraph of Article 17.

The second paragraph of Article 17 seeks to permit the source country to tax the income of an entertainer or sports person where it is paid to a third person, whether or not that third person has a fixed base or permanent establishment in the source country. The Commentary to the 1992 Model Treaty identifies three situations in which this provision would be triggered.[20] The first is where the management company of, say, a group of sportsmen which is not itself a legal entity, receives income for the appearance of the group. The second is where, say, a team, troupe or orchestra, which is constituted as a legal entity, receives income for the performance. It was felt that if the members of the team, troupe or orchestra were paid a fixed periodic remuneration, making it difficult to allocate a portion of that income to particular performances, the remuneration would, without paragraph 2, possibly escape tax in the source country. The third situation, referred to above as the tax avoidance device necessitating the second paragraph, is where the remuneration for the performance of an artiste or sportsman is not paid to the artiste or sportsman himself but to his service company, referred to in the Commentary as the 'so-called artiste company', in such a way that the income, but for paragraph 2, would not be taxed in the source country either as personal service income to the artiste or sportsman or as profits of the enterprise, in the absence of a permanent establishment. It is of particular interest to note that the United States, together with Canada and Switzerland, appended a 'Reservation on the Article' in which they expressed their opinion that paragraph 2 of the Article should apply only to the third of the situations set out in the Commentary, i.e., tax avoidance by use of a service company, and they reserved to propose an amendment to that effect.[21] The reservation of the US is fully reflected in the Articles 17(2) its own modern treaties under which payment to a third person does not fall in charge to tax in the source country if neither the entertainer or athlete, nor persons related thereto, participate directly or indirectly in the profits of the third person. This is examined in more detail in section 4.4.3 below.

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[20] OECD 1992 Model Convention Commentary on Article 17 para. 11
[21] OECD 1992 Model Convention Commentary on Article 17 para. 16

4.4.3 Artiste or Entertainer; Athlete or Sportsman

As mentioned in the previous section, in Article 17 of the 1992 OECD Model Treaty the term 'athlete' was replaced by 'sportsman'. Though this change was effected so that the individuals covered by the Article were more accurately described, there remains a large grey area as to who is and who is not covered by the Article. The list in the Article itself, "an entertainer, such as a theatre, motion picture, radio or television artiste, or a musician, or as an sportsman, from his personal activities as such," is clearly not exhaustive. The Commentary, however, somewhat surprisingly, does rule out what it terms 'support staff', notably "cameramen for a film, producers, film directors, choreographers, technical staff, road crew for a pop group etc."[22] Film producers and directors, and for that matter top flight choreographers, are as mobile and earn as much as many well known actors. Indeed, it is not unknown for actors to become producers and directors.[23] Yet their exclusion from Article 17 means that their double taxation exposure is ruled by articles 7, 14 and 15. It would appear therefore that for example a film director could make a personal service company a valuable tool in his international tax planning.

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[22] Ibid., para. 3

[23] The Commentary recognised that an actor may direct his own show and in paragraph 4 provided the following solution: *"An individual may both direct a show and act in it, or may direct and produce a television programme or film and take a role in it. In such cases it is necessary to look at what the individual actually does in the State where the performance takes place. If his activities in that State are predominantly of a performing nature, the Article will apply to all the resulting income he derives in that State. If, however, the performing element is a negligible part of what he does in that State, the whole of the income will fall outside the Article. In other cases an apportionment should be necessary."*

As regards 'sportsmen', the Commentary states that the term includes golfers, jockeys, footballers, cricketers, tennis players and racing drivers, in addition to the participants in traditional athletic events like runners, jumpers, swimmers.[24] Players of billiards and snooker, chess and bridge, though they may consider themselves as competitive sportspeople, appear to be classified by Commentary as entertainers.[25] From a tax perspective the entertainer/sports person distinction is unimportant. If an individual falls within either classification he fall within Article 17. The 'support staff' exception noted in connections with 'entertainers', though not separately mentioned in relation to sportsmen, must equally apply. An exception that is specifically mentioned relating to both entertainers and sportspeople is impresarios. Income received by an impresario for arranging the appearance of an artiste or sportsman is outside the scope of the Article,[26] unless of course it is received on behalf of the artiste or sportsman in which case Article 17 fully applies.

4.4.4 Income Covered by Article 17

The type of income generated in the source country that is covered by Article 17 is the "income derived … as an entertainer… [or]… sportsman, from his personal activities as such…" exercised in the source state. This clearly covers the income earned by the performer for his performance in the source state. It is less clear whether it covers income from sponsorship, endorsements and personality

[24] Ibid., para. 5
[25] See ibid., para. 6

merchandising relating to the performance and, if so, whether it covers income from sponsorship, endorsements and personality merchandising in the source state unrelated to any performance, an issue addressed in Case Study IV in Chapter 5.

The Commentary provides some help on this point. It draws a distinction between those cases where the sponsorship and advertising fees which are directly linked to the public exhibition by the performer in the source country, to which Article 17 does apply, and those cases where they do not, to which Article 17 does not apply.

> *"Article 17 will apply to advertising or sponsorship income, etc. which is related directly or indirectly to performances or appearances in a given State. Similar income which could not be attributed to such performances or appearances would fall under the standard rules of Article 14 or Article 15, as appropriate. Payments received in the event of the cancellation of a performance are also outside the scope of Article 17, and fall under Articles 7, 14 or 15, as the case may be."*[27]

Sometimes the income from sponsorship, endorsements and personality merchandising is characterised as royalty income in the contractual documentation. This is particularly the case where the performer receives his fees based on the quantity of merchandise sold, rather than a fixed fee. Royalty income generated from the exploitation of intellectual property rights is covered by Article 12 of the OECD Model Convention, discussed below in section 4.5, and under Article 12 is not subject to taxation in the country of source. Moreover,

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[26] Ibid., para. 7

[27] Ibid., para. 9

if in respect of part of a performer's income Article 12 is applicable, then Article 17 is not applicable to that income. In general, however, as explained in the following section, income from general advertising and sponsorship fees fall outside the scope of Article 12.

4.4.5 Royalties: Article 12(1)

The tax advantage to be gained by a performer in successfully classifying certain income streams as royalties rather than payments for services is not only that Article 17 does not apply, but also that Article 12 applies instead.

Paragraph 1 of Article 12 of the 1992 OECD Model Convention reads as follows:

> *"Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State."*

The Commentary to Article 12 emphasizes that under paragraph 1, the exemption from tax in the State of source is not available when an intermediary, such as an agent or nominee, is interposed between the beneficiary and the payer, unless the beneficial owner is a resident of the other Contracting State.[28] Indeed, the text of

[28] See OECD 1992 Model Convention Commentary on Article 12 para. 4

the Model was amended in 1995 to clarify this point.[29] The Commentary invites countries to make this more explicit in their bilateral negotiations.[30]

4.4.6 Definition of Royalties: Article 12(2)

Given the absence of source country taxation of royalties under the OECD Model Treaty, it is important that there is a clear limit on the types of income that could fall within the term. Paragraph 2 of Article 12 provides a definition of 'royalties' as follows:

> *"The term 'royalties' as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience."*

This definition of the term 'royalties,' and close variations of it, has been subject to interpretation by the courts. The leading case is *Boulez v Commissioner*.[31]

The taxpayer was Pierre Boulez, the world-renowned music director and orchestra conductor. In 1969 he entered into a contract with CBS Records[32] to make

[29] Article 12 Paragraph 1 of the 1977 OECD Model Convention read: "Royalties arising in a Contracting State and paid to a resident of the other Contracting State shall be taxable only in that other State if such resident is the beneficial owner of the royalties."

[30] It must be said that this exemption from taxation in the source country is not always followed by the UK. In fact almost one half of the UK's double taxation treaties provide for taxation in the country of source, including a majority of the recent treaties, particularly those with developing countries. However, as discussed below in section 5.6.4, there is no source taxation of royalty income between the US and the UK under their bilateral double taxation treaty.

[31] 83 T.C. 584 (1984), aff'd, 810 F.2d 209 (D.C. Cir. 1986)

recordings of orchestral works in the US. At this time he was a resident of the Federal Republic of Germany and a US non-resident alien. The contract provided that the taxpayer would render his services exclusively to CBS[33] and that all recordings would be the property of CBS.[34] The taxpayer's compensation was to be based on a percentage of the sales receipts of the records made, described in the contract as 'royalties'.[35]

The taxpayer treated the income earned under the contract as royalties which, under the US-FRG Double Taxation Treaty then in force,[36] were not taxable in the country of source; in this case, the US. The treaty contained an Article on royalty income similar to that in the OECD Model Treaty.[37] The IRS nonetheless sought

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[32] This case has strong UK links. CBS Records was a division of CBS United Kingdom Ltd, which was a subsidiary of the US company CBS, Inc. In 1972, with the consent of CBS Records, the contract was assigned by Pierre Boulez to Beacon Concerts Ltd, an English company, which acted as Mr Boulez's agent and undertook to provide his services to CBS Records under the terms of the basic contract.

[33] Clause 1 of the contract provided: "We [CBS Records] hereby agree to engage and you [Boulez] agree to render your services exclusively for us as a producer and/or performer for the recording of musical and/or literary compositions for the purpose of making phonograph records." As quoted in *Boulez v CIR*, op. cit., p. 586

[34] Clause 1 of the contract provided: "All master recordings recorded hereunder and all matrices and phonograph records manufactured therefrom, together with the performances embodied thereon, shall be entirely our [CBS Records] property, free from any claims whatsoever by you [Boulez] or any person deriving any rights or interests from you." As quoted in *Boulez v CIR*, op. cit., p. 587

[35] "Under paragraph 7a of the contract, it was provided "For your services rendered hereunder and for the rights granted to us herein we will pay you the following royalties." There then followed an elaborate formula by which the petitioner was to be paid, based upon a percentage of the retail price derived by CBS Records from the sale of its phonograph records produced under the contract, with said percentage varying depending upon various factors..." Ibid.

[36] *Convention Between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation with Respect to Taxes on Income*, 5 U.S.T. (part 3) 2768, T.I.A.S. No. 3133. As amended by a Protocol, dated September 17, 1965, 16 U.S.T. (part 2) 1875, T.I.A.S. No. 5920

[37] Article VIII (1) provided "Royalties derived by a natural person resident in the Federal Republic or by a German company shall be exempt from tax by the United States." Article VIII (3) provide "The term "royalties", as used in this Article, (a) means any royalties, rentals or other amounts paid as consideration for the use of, or the right to use, copyrights, artistic or scientific works (including motion picture films, or films or tapes for radio or television broadcasting), patents,

to tax the taxpayer on the basis that his income did not consist of royalties as defined within the treaty, but rather was compensation for personal services performed in the US which fell in charge to tax in the US. The taxpayer petitioned to the Tax Court.

In setting out the principal questions of fact and law in the case Judge Korner said:

> *"Acknowledging that the provisions of the treaty take precedence over any conflicting provisions of the Internal Revenue Code of 1954 (sec. 7852(d); see also sec. 894), we must decide whether the payments received by petitioner in 1975 from CBS, Inc., constituted royalties or income from personal services within the meaning of that treaty. This issue, in turn, involves two facets:*
> *(1) Did petitioner intend and purport to license or convey to CBS Records, and did the latter agree to pay for, a property interest in the recordings he was engaged to make, which would give rise to royalties?*
> *(2) If so, did petitioner have a property interest in the recordings which he was capable of licensing or selling?"*[38]

Judge Korner considered the first of these questions to be purely factual, and turning on the intention of the parties to be ascertained by an examination the terms of the contract entered into between the taxpayer and CBS Records and together with any other relevant and material evidence. The second question, whether the taxpayer had a property interest which he could license or sell, Judge Korner considered to be a pure question of law.

designs, plans, secret processes or formulae, trademarks, or other like property or rights, or for industrial, commercial or scientific equipment, or for knowledge, experience or skill (know-how)" As quoted in *Boulez v CIR*, op. cit., p. 590

[38] *Boulez v CIR*, op. cit., p. 591

"The contract between the parties is by no means clear. On the one hand, the contract consistently refers to the compensation which petitioner is to be entitled to receive as 'royalties,' and such payments are tied directly to the proceeds which CBS Records was to receive from sales of recordings which petitioner was to make... On the other hand, the contract between petitioner and CBS Records is replete with language indicating that what was intended here was a contract for personal services. Most importantly, in the context of the present question, paragraph 4 of the contract ... makes it clear that CBS considered petitioner's services to be the essence of the contract: petitioner agreed not to perform for others with respect to similar recordings during the term of the contract, and for a period of 5 years thereafter, and he was required to 'acknowledge that your services are unique and extraordinary and that we shall be entitled to equitable relief to enforce the provision of this paragraph 4.'"[39]

Judge Korner then turned to the issue of licensing

"Under paragraph 5 of the contract ... it was agreed that the recordings, once made, should be entirely the property of CBS Records, 'free from any claims whatsoever by you or any person deriving any rights or interests from you.' Significantly, nowhere in the contract is there any language of conveyance of any alleged property right in the recordings by petitioner to CBS Records, nor any language indicating a licensing of any such purported right, other than the designation of petitioner's remuneration as being "royalties." The word "copyright" itself is never mentioned."[40]

Judge Korner concluded:

"Considered as a whole, therefore, and acknowledging that the contract is not perfectly clear on this point, we conclude that the weight of the evidence is that the parties intended a contract for personal services, rather than one involving the sale or licensing of any property rights which petitioner might have in the recordings which were to be made in the future."[41]

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[39] Ibid., p. 592/93
[40] Ibid., p. 593
[41] Ibid.

Having answered the first question in the negative, the second question would appear to be redundant. Nevertheless it was addressed by Judge Korner who concluded that the taxpayer had no licensable or transferable property rights in the recordings that he made for CBS Records.

The Tax Court thus held that under the effective double taxation treaty between the US and Germany, the payments to Pierre Boulez were not royalties exempt from US tax, but were compensation for personal services fully taxable in the US.

This decision, though anti-avoidance in nature, could also be used, in different circumstances, to secure a tax benefit which would otherwise be denied. This is addressed in Case Study IV in Chapter 5.[42]

This case also highlights national differences in the interpretation of double taxation treaties. On the same facts the German taxing authorities had decided that the payments were royalties. This result meant that Pierre Boulez was fully taxable on the payments by both countries. Under the US:German Treaty, payments were exempt from German tax only if the United States had the right to tax them. Double taxation resulted because the German authorities took the position that, because the payments were royalties, the United States did not have that right.[43] One consequence of the case was a provision in the Protocol pertaining to Article 12 in the US:Germany 1989 Treaty which reads as follows:

[42] See Chapter 5, section 5.5.3.1.
[43] See C. I. Kingson, 'Book Review: U.S. International Taxation, by Joel D. Kuntz & Robert J.

> *"Where an artiste resident in one Contracting State records a performance in the other Contracting State, has a copyrightable interest in the recording, and receives consideration for the right to use the recording based on the sale or public playing of such recording, then such consideration shall be governed by this Article."*[44]

This provision has no effect on how the US courts would interpret the definition of royalties generally. The Protocol applies to US:German circumstances only. In short, the *Boulez* case remains good law.

4.4.7 Limitation on Royalty Benefits: Article 12(3)

The exemption from taxation on royalties provided by Paragraph 1 of Article 12, not only demands a clear definition of royalty income, it also necessitates the drawing of a boundary around business activity beyond which the Article does not apply. The Article applies where royalties arising in one Contracting State accrue to a beneficial owner resident in the other Contracting State. It does not extend to circumstances in which the beneficial owner conducts business through a permanent establishment or fixed base in the Contracting State which is the source of the royalty income. This is addressed in Paragraph 3 of Article 12:

> *The provisions of paragraph 1 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right or*

Peroni,' 1992, 26 GW J. Int'l L. & Econ. 213, para. 12

[44] Final Protocol - August 29, 1989; Signatories: Germany, F.R., United States; Citations: 90 TNI 26-48; Doc 93-31206; Senate Treaty Doc. No. 101-10; Signed: August 29, 1989

property in respect of which the royalties are paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of Article 7[[45]] or Article 14, as the case may be, shall apply.

This is a very important provision from a tax planning point of view with regards to entertainers. For example, should a non-resident musician compose works in an apartment he owns in, say, New York he would be treated as carrying on business in the US through a permanent establishment or providing independent personal services from a fixed base, his apartment, and all his royalty income arising in the US would not be protected from US tax by Article 12 by virtue of Article 7. The case of *Simenon v CIR*[46] is instructive on this point. The US Tax Court held that the prolific Belgium writer Georges Simenon maintained an office at his US home that constituted a permanent establishment within the meaning of Article 7 from which he carried on the business of writing literary works and promoting the sale of rights therein to others for profit. For so long as he had the permanent establishment, even for part of a tax year, his US royalty income fell in charge to tax in the US.

[45] Article 7 of the OECD 1992 Model Convention is headed 'Business Profits' and paragraph 1 provides: *"The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment."* Article 5 of the Convention defines 'Permanent Establishment' thus:

1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

2. The term "permanent establishment" includes especially:

a) a place of management;

b) a branch;

c) an office;

d) a factory;

e) a workshop, and

f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

[46] 44 T.C. 820

The term 'fixed base' may be more applicable to sportspeople and entertainers 'permanent establishment,' for they are more likely to be viewed as providing independent personal services rather than carrying on a business in the source country. Though 'permanent establishment' is fully defined in Article 5 of the 1992 OECD Model Treaty, 'fixed base' is not defined at all. The Commentary advises that it was thought that the concept of permanent establishment should be reserved for commercial and industrial activities,[47] the term 'fixed base' being applicable to independent personal services. Though not defined, the Commentary states that the term would cover, for example, a physician's consulting room or the office of an architect or a lawyer.[48] The Commentary concludes that "[a] person performing independent personal services would probably not as a rule have premises of this kind in any other State than of his residence. But if there is in another State a centre of activity of a fixed or a permanent character, then that State should be entitled to tax the person's activities."[49]

In the Stefan Edberg case, discussed above in section 5.2.4, the IRS would have succeeded in claiming that all of his US source income fell in charge to US tax

[47] OECD 1992 Model Convention Commentary on Article 14 para. 4
[48] Ibid.
[49] Ibid.

without bringing it within Article 17, had they been able to establish that he had a fixed base in the US.[50]

4.4.8 Anti-Avoidance Provision on Royalties: Article 12(4)

The final paragraph of Article 12 is an anti-avoidance provision aimed at preventing the avoidance of tax in the source country by one connected party paying the other a higher royalty than could be justified on a commercial basis. Paragraph 4 provides:

> *"Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention."*

It is a fairly standard provision aimed at eliminating any benefits to be derived from what is effectively a transfer pricing arrangement between two connected parties.

[50] The Treasury Dept. Technical Explanation: 1996 U.S. Model Income Tax Convention, op. cit., para. 201 states: *"The term "fixed base" is not defined in the Convention, but its meaning is understood to be similar, but not identical, to that of the term "permanent establishment," as defined in Article 5 (Permanent Establishment)."*

4.5 RULES OF INTERPRETATION OF TREATIES

Double taxation treaties are international agreements entered into between sovereign states and as such are governed by public international law. With regard to the interpretation of treaties, the Vienna Convention on the Law of Treaties (1969)[51] sets out the international custom as follows:[52]

> *"Article 31*
> *General Rule of Interpretation*
> *1. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.*
> *2. The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:*
> *(a) any agreement relating to the treaty which was made between all the parties in connexion with the conclusion of the treaty;*
> *(b) any instrument which was made by one or more parties in connexion with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.*
> *3. There shall be taken into account, together with the context:*
> *(a) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;*
> *(b) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;*
> *(c) any relevant rules of international law applicable in the relations between the parties.*
> *4. A special meaning shall be given to a term if it is established that the parties so intended."*

This Article is wholly consistent with the rules on interpretation contained in the 1992 OECD Model Treaty. Article 3(2) of the Model Treaty provides that any term not defined in the Treaty shall, unless the context requires otherwise, have

[51] The Convention came into force on 27 January 1980.
[52] In Section 3: Interpretation Of Treaties

the meaning that it has at that time under the law of the Contracting State. Where the laws of the Contracting State give different meanings for the same term, the meaning applicable tax laws of that State shall prevail for the purposes of interpreting the Treaty.[53] Article 32 of the 1969 Vienna Convention on the Law of Treaties provides for supplementary means of interpretation:

> *"Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of article 31, or to determine the meaning when the interpretation according to article 31:*
> *(a) leaves the meaning ambiguous or obscure; or*
> *(b) leads to a result which is manifestly absurd or unreasonable."*

Article 33, the third and final article on the interpretation of treaties, addresses the issues of interpretation that arise where treaties are written in two or more languages, holding each text to be equally authoritative unless the parties have agreed that, in case of divergence, a particular text shall prevail.[54]

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[53] The full text of Article 3(2) reads: *"As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State."*

[54] Article 33 (the full text)
Interpretation Of Treaties Authenticated In Two Or More Languages
1. When a treaty has been authenticated in two or more languages, the text is equally authoritative in each language, unless the treaty provides or the parties agree that, in case of divergence, a particular text shall prevail.
2. A version of the treaty in a language other than one of those in which the text was authenticated shall be considered an authentic text only if the treaty so provides or the parties so agree.
3. The terms of the treaty are presumed to have the same meaning in each authentic text.
4. Except where a particular text prevails in accordance with paragraph 1, when a comparison of the authentic text discloses a difference of meaning which the application of articles 31 and 32 does not remove, the meaning which best reconciles the texts, having regard to the object and purpose of the treaty, shall be adopted.

Baker considers that the English courts have yet to formulate any specific approach to the interpretation of double taxation agreements.[55] He acknowledges that the courts have recognised the need to adopt a broad interpretative approach and have sanctioned the reference to *travaux préparatoires* as an aid to interpretation. However, Baker holds that judicial habits in statutory interpretation die hard and that the English courts have tended to adopt similar approaches to interpreting double taxation treaties as they have for other legislation. In support of his case he quotes the decision of *IRC v Commerzbank*.[56] It is valuable to examine this case as it relates to treaty interpretation, because it does shed light on the UK approach, though the author does not wholly agree with Baker's conclusion, for reasons set out after the discussion of the case.

IRC v Commerzbank was a case involving an appeal by the Revenue against two decisions of the special commissioners that the London branches of a German bank and a Brazilian bank were exempt from UK tax in respect of interest received from US corporations under the double tax Convention agreed between the UK and the US in 1945, as amended in 1966. Each bank claimed that the interest received from US corporations during the relevant periods was exempt from UK corporation tax by virtue of the Income and Corporation Taxes Act 1970, s. 497(1) and the UK:US double taxation Convention in force at the time.[57]

[55] P. Baker Double Taxation Agreements and International Tax Law London, Sweet & Maxwell (1991) pp. 18-19
[56] [1990] BTC 172
[57] As contained in the Double Taxation Relief (Taxes on Income) (United States of America) Order 1946, Art. XV, as amended by the Double Taxation Relief (Taxes on Income) (United States of America) Order 1966.

In each case the Revenue refused relief and the banks successfully appealed to the special commissioners.

The question of law was whether the exemption in the opening words of Art. XV applied if the recipient of such interest was the London branch of a corporation, such as a bank, organised under the laws of a country other than the US or the UK. Art. XV read as follows:

> *"Dividends and interest paid by a corporation of one Contracting Party shall be exempt from tax by the other Contracting Party except where the recipient is a citizen, resident or corporation of that other Contracting Party. This exemption shall not apply if the corporation paying such dividend or interest is a resident of the other Contracting Party."*

The Revenue accepted that the banks came within the terms of the exemption but contended that the intention of the Convention was to achieve reciprocity of effect in the US and the UK. This, they argued, would not be achieved if the exemption were available to the banks because in equivalent circumstances, under US law, interest paid by a UK company would not be exempt from US tax. This could be confidently asserted in view of the 1982 Court of Claims case of the *Great-West Life Assurance Company v The United States*[58] in which on similar facts,[59] and a

[58] 230 Ct. Cl. 477; 678 F.2d 180; 1982 U.S. Ct. Cl. LEXIS 261; 82-1 U.S. Tax Cas. (CCH) P9374; 49 A.F.T.R.2d (RIA) 1319

[59] The case concerned the 1951 US:Canada Supplemental Convention on Double Taxation which provided under Art. XII:

"1. Dividends and interest paid by a corporation organized under the laws of Canada to a recipient, [***10] other than a citizen or resident of the United States of America or a corporation organized under the laws of the United States of America, shall be exempt from all income taxes imposed by the United States of America.

2. Dividends and interest paid by a corporation organized under the laws of the United States of America whose business is not managed and controlled in Canada to a recipient, other than a

clear literal entitlement under the treaty,[60] the court refused to allow relief on the grounds that such was not the intention of the legislature.[61]

The Revenue further argued that the Convention, read as a whole, dealt almost exclusively with the right to tax, or waiver of the right to tax, citizens, residents and corporations of a contracting party, including corporations with a permanent establishment in, the territory of one or other of the contracting parties. They felt it would be surprising if, in the absence of express words to that effect, Art. XV were to be interpreted as waiving the right to tax a corporation of a non-contracting party with a permanent establishment in a host country.

The High Court dismissed the Revenue's appeal. Mummery J held that the natural and ordinary meaning of the words was that Art. XV exempted from UK tax interest which had been paid by US corporations. All interest coming from that source was exempted by the first sentence of Art. XV, except for those recipients expressly referred to in the exception, i.e. a recipient who was a citizen, resident or corporation of the UK. The banks were none of those things and

resident of Canada or a corporation whose business is managed and controlled in Canada, shall be exempt from all taxes imposed by Canada."

[60] The parties to the case both stipulated that each of the literal requirements of Article XII had been met: the amounts at issue received by Great-West were "interest"; each item of interest was paid by "a corporation organized under the laws of Canada"; and the recipient of interest was neither "a citizen or resident of the United States of America" nor "a corporation organized under the laws of the United States."

[61] Quoting the Supreme Court in *In re Ross,* 140 U. S. 453, 475 (1891) Judge Kashiwa said *"It is a canon of interpretation to so construe a law or a treaty as to give effect to the object designed, and for that purpose all of its provisions must be examined in the light of attendant and surrounding circumstances... The inquiry in all such cases is as to what was intended in the law by the legislature, and in the treaty by the contracting parties."* On applying this principle he said "Here, the Departments of State and Treasury apparently not only have so interpreted Article XII of the Canadian treaty [to deny the relief sought] but also negotiated other treaties on this basis."

Mummery J held that the Revenue could not expand the exception so that recipients, additional to those expressly mentioned, were not entitled to the exemption. Mummery J said that the clear words of Art. XV did not give rise to manifestly absurd or unreasonable, or even surprising, consequences for although the banks were not corporations of either contracting party, elements connected to the contracting parties were present. In short, the interest was paid by US corporations and the recipient in each case was the UK branch of the bank.

Finally, Mummery J was of the view that there was no indication in the purpose of the Convention, or in its surrounding circumstances, or in articles other than Art. XV to qualify its clear words. In referring to the US *Great-West Assurance* case, in which the tax exemption was denied by the court in respect of Canadian source interest received by a Canadian life assurance company doing business in the US, Mummery J said:

> *"That decision is of some interest as illustrating the basis on which the US taxes foreign corporations trading in the US but it is of no real assistance in these cases because it is clear from the report that different principles were applied by the court to the interpretation of that convention than an English court would have applied in accordance with the decision of the House of Lords in* Fothergill v Monarch Airlines Ltd.*[62] The [US] court was greatly influenced in its decision by the fact that the Departments of State and Treasury interpreted Art. XII of the Canadian Convention as not conferring the exemption claimed and had negotiated other treaties on that basis. As appears from the decision in* Fothergill v Monarch Airlines Ltd *no such principle is applied by the English courts to the provisions of a convention which had been incorporated into municipal law by primary or*

[62] [1981] AC 251

> *secondary legislation.[63] I do not, therefore, find the decision in Great West Life Assurance case as of much assistance in the present cases."*

Baker clearly regretted this approach. "The English High Court," he wrote, "while talking about a purposive interpretation, preferred to apply a literal interpretation." There is another and, in the view of this author, a preferred conclusion and it is simply this: *the words of the treaty were indeed clear*. A purposive approach to treaty interpretation should not involve the casting aside of the words of a treaty and the substituting of the same by terms and meanings not found in the treaty itself. This would lead to an intolerable degree of uncertainty in the law. It is true that the joint statement issued by the competent authorities, the UK Inland Revenue and the US IRS, had it been relied on would have given a different conclusion, and that Mummery J held that the joint statement did "not fall within the description of material to which recourse may be had as an aid to interpretation."[64] This, taken at face value, may appear to be a partial rejection of the purposive approach. This author, however, prefers the view of Professor Picciotto who felt that this "statement resulted from the Revenue's difficulty in [the] case: although the competent authorities' statement reflected what must have

[63] This case set out six principles for the interpretation of such international conventions, the first of which is "...that it is necessary to look first for a clear meaning of the words used in the relevant article of the Convention, bearing in mind that 'consideration of the purpose of an enactment is always a legitimate part of the process of interpretation'... If the provisions of a particular article are ambiguous, it may be possible to resolve that ambiguity by giving a purposive construction to the convention looking at it as a whole by reference to its language as set out in the relevant UK legislative instrument." Per Mummery J, op. cit., p.185

[64] [1990] BTC 172 p.192

been the intention of the drafters of the provision, it was contrary to its clear wording."[65]

The English courts have indeed formulated a specific approach to the interpretation of double taxation agreements. Their approach is purposive in nature, but the starting point is the words of the treaty itself. If such words give rise to ambiguity or manifestly absurd or unreasonable consequences recourse may be had to 'supplementary means of interpretation' including *travaux préparatoires*. As Mummery J himself stated in the Commerzbank case:

> *"It is necessary to look first for a clear meaning of the words used in the relevant article of the Convention, bearing in mind that 'consideration of the purpose of an enactment is always a legitimate part of the process of interpretation'... A strictly literal approach to interpretation is not appropriate in construing legislation which gives effect to or incorporates an international treaty... A literal interpretation may be obviously inconsistent with the purposes of the particular article or of the treaty as a whole. If the provisions of a particular article are ambiguous, it may be possible to resolve that ambiguity by giving a purposive construction to the convention looking at it as a whole by reference to its language as set out in the relevant UK legislative instrument."*

This was the approach adopted in the UK's most recent Court of Appeal decision involving the interpretation of a double taxation treaty. The 1998 case of *Memec plc v Inland Revenue Commissioners*[66] was concerned with the definition of the term 'dividend' as use in the double taxation agreement between the UK and

[65] S. Picciotto International Business Taxation London, Weidenfeld and Nicolson (1992) p.297
[66] [1998] BTC 251

Germany. In commenting on the appropriate approach to be adopted in interpreting the agreement, Peter Gibson LJ said:[67]

> *"[Counsel for the taxpayer] rightly cautioned us against interpreting the convention as though it had been drafted in Lincoln's Inn. He and [Counsel for the Inland Revenue] were at one in regarding the statement by Mummery J in* IR Commrs v Commerzbank AG[68] *as correctly summarising the approach to be adopted. That judge warned against a literal interpretation, particularly where it would be inconsistent with the purposes of the provision or treaty in question. He said that interpretation should take account of the fact that a convention is not designed to be construed exclusively by English judges but is addressed to a wider judicial audience... Mummery J also referred to the general principle of international law now embodied in Art. 31(1) of the Vienna Convention on the Law of Treaties that a treaty should be interpreted in good faith and in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose"*

The issue of the interpretation of double taxation treaties was most recently before the UK Special Commissioners in *Sportsman v IRC*.[69] The case concerned a professional sportsman domiciled in the UK who entered into a contract for his services with a sports team in France. He was not assessed to and did not pay French income tax for some of the years that he resided in France. The taxpayer argued that in those years that he did not pay tax, his employers should have withheld tax from his salary; thus, because this was French tax 'payable' under French law, he was entitled to set off the tax that should have been paid in France against his tax liability in the UK under the terms of the UK:France Double

[67] At p.260
[68] [1990] BTC 172; 63 TC 218 at p. 185–187; pp. 234–236
[69] Special Commissioners' Decision SPC 174, Simon's Weekly Tax Intelligence, Issue 47, p. 1605, Nov. 19, 1998

Taxation Treaty.[70] The taxpayer was relying on a literal interpretation of Article 24(a)(i) of the treaty which provides:

> *"French tax payable under the laws of France and in accordance with this Convention, whether directly or by deduction, on profits, income or chargeable gains from sources within France ... shall be allowed as a credit against any United Kingdom tax computed by reference to the same profits, income or chargeable gains by reference to which the French tax is computed"*

The Commissioners rejected the taxpayer's argument. They stated, in language consistent with that of Mummery J in *IR Commrs v Commerzbank AG*, that they were obliged to interpret a convention or treaty in good faith and in accordance with the ordinary meaning given to the terms of the treaty in their context and in the light of its object and purpose, in accordance with the Vienna Convention on the Law of Treaties of May 23, 1969. It was therefore necessary to look at the natural and ordinary meanings of the words in their context, giving regard to the purpose of the convention and avoiding a technical, legal interpretation or a literal approach. The treaty, they stated, had to be interpreted so as to avoid the inequities of double taxation and also to prevent tax evasion. In the present case, because no French tax had been paid or demanded or returns filed for the years in

[70] Signatories: France, United Kingdom; Citations: 92 TNI 89-36; Doc 92-30266; Signed: May 22, 1968; Title: 'Convention between the United Kingdom of Great Britain and Northern Ireland and France for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income.'
The Convention has been amended by Protocols signed (1) February 10, 1971; (2) May 14, 1973; (3) June 12, 1986; and (4) October 15, 1987

question, the commissioners held that the taxpayer could not receive credit for any tax in the United Kingdom.[71]

4.6 DOUBLE TAXATION RELIEF

One of the principal purposes of a double taxation treaty is the elimination of juridical double taxation.[72] This is achieved by the parties to the treaty, the Contracting States, agreeing on the allocation of fiscal jurisdiction over items of income and gains on the basis of how and where they arose and to whom they accrued. Some Articles of a treaty grant to one of the Contracting States an exclusive right to tax a category of income or gains. In such instances the relevant Article would usually state that the income or gains in question 'shall be taxable only' in a Contracting State. This precludes the other Contracting State from taxing the specified income or gains, thereby eliminating double taxation. An example, relevant to this work, of such an Article from the 1992 OECD Model Treaty is Article 12 under which royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State.

Some other Articles of a treaty do not grant to one of the Contracting States an exclusive right to tax a category of income or gains. In these instances the

[71] For the first exhaustive work on the 1968 UK:France Double Taxation Treaty see S. A. Hoquet McKee A Study of the Legal Effect of the Main Provisions of the Income Tax Treaty Between France and the United Kingdom Unpublished PhD thesis, City of London Polytechnic (1984)
[72] See section 4.2.

relevant Article would usually state that the income or gains in question 'may be taxed' in a Contracting State. This leaves the issue of double taxation unresolved, as the income or gains in question are potentially subject to tax in both Contracting States. Again, an example relevant to this work of such an Article from the 1992 OECD Model Treaty is Article 17, under which income derived by a resident of a Contracting State as an entertainer or sportsman, from his personal activities as such, exercised in the other Contracting State may be taxed in that other State. In order to resolve eliminate the double taxation that arises in the circumstances double taxation treaties contain an Article specifying the method or methods that may be used. In the OECD Treaty this is Article 23.

There are two principal methods employed for the elimination of double taxation arising under a treaty: one is known as 'the exemption method,' the other 'the credit method.' The double taxation relief is always applied by the State in which the taxpayer is resident. Under the exemption method the State of residence does not tax the income which may be taxed in other Contracting State under the terms of the treaty. That is, the income potentially subject to double taxation is simply not taxed in the State of residence. This method itself may be applied in two possible ways, known as 'full exemption' and 'exemption with progression.' Full exemption wholly ignores the income in question when computing the tax liability of the resident. Exemption with progression does not tax income in question, but it includes it when computing the tax liability of the taxpayer, in order to determine the appropriate marginal rate of tax to apply to the taxpayer's other income which does fall in charge to tax in the State of residence.

Under the credit method the State of residence calculates the taxpayer's liability on the basis of his total income including the income potentially in charge to double taxation. The State of residence then allows a credit against the taxpayer's liability for the tax paid in the other Contracting State. Again, this method may be applied in two possible ways, known as 'full credit' and 'ordinary credit.' The full credit approach, as the name implies, grants as a deduction from the taxpayer's liability the full amount of the tax paid in the other Contracting State. The ordinary credit approach limits the tax credit to the amount of tax the taxpayer would have paid on the income taxed in the other Contracting State had that income been subject to tax in the State of residence.

Both the US and the UK apply the ordinary credit method to relieve double taxation. This is reflected in Article 23 of the US:UK Double Taxation Treaty which provides for a foreign tax credit in the US on income taxed in the UK, and for a foreign tax credit in the UK on income taxed in the US, both credits limited by treaty, by reference each country's domestic legislation, to the equivalent domestic tax on foreign tax paid.[73]

[73] Article 23(1) of the US:UK Double Taxation Treaty states: *"In accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof), the United States shall allow to a resident or*

Mention should be made of a third method of dealing with double taxation known as the 'deduction method.' This treats the foreign tax paid as a production cost of the foreign income, an expense of the taxpayer, and reduces the taxpayer's taxable income by the amount of the foreign tax paid. The effect of the treatment is not an elimination of double taxation, but merely a reduction of it.

Switzerland uses the deduction method, together with the credit method and the exemption method, in relieving the double taxation of its residents, the specific method used, or the combination of methods used, depending on the nature of the income involved. The deduction method generally applies to dividends, interest and royalties.[74] Luxembourg uses a combination of credit method and exemption methods. For example, Article 23 of the Luxembourg:US Double Taxation Treaty, Paragraph 2 describes how Luxembourg will avoid double taxation under the Convention. Subparagraph 2(a) provides that where a Luxembourg resident derives income or owns capital that may be taxed in the United States, Luxembourg will exempt such income or capital from tax. Luxembourg, however, may, when calculating the amount of tax on the remaining income or capital of the resident, apply the same rates of tax as if the income or capital had not been exempted; that is, Luxembourg may apply exemption with progression.[75]

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national of the United States as a credit against the United States tax the appropriate amount of tax paid to the United Kingdom... " Article 23(2) contains similar provisions relating to the UK."

[74] See JCT Explanation: 1996 Switzerland Income Tax Treaty and Protocol; Countries: United States, Switzerland; Electronic Citation: 97 TNI 196-20; Document Number: Doc 97-27902 (70 pages); Official Citation: JCS-16-97 para. 223

[75] See Treasury Department Technical Explanation: 1996 Luxembourg Income Tax Treaty; Countries: United States; Luxembourg; Electronic Citation: 96 TNI 185-28; Document Number: Doc 96-25714 (105 pages) para. 273

4.7 TREATY SHOPPING

This section discusses the current tax minimisation opportunities of treaty shopping by sportspeople and entertainers. Treaty shopping may be described as the process by which a person who is not a resident of either Contracting State seeks benefits under the double taxation treaty between the two countries. For example, a non-resident performer may be able to secure these benefits by establishing in one of the Contracting States a company, trust or limited partnership (or other entity) which, as a resident of that country, would be entitled to the benefits under the treaty. It may then be possible for the third-country resident performer to repatriate funds to the third country from the company, trust or limited partnership under favorable tax conditions either through relaxed tax provisions in the distributing country or by passing the funds through other treaty countries (essentially, continuing the treaty shopping) until the funds can be repatriated under such favorable terms.

The essential conditions for treaty shopping are (1) the existence of a double taxation treaty with the country of source which treats favourably the type of income arising, say, copyright royalties; and either (2) attractive internal tax laws in the second Contracting State permitting a tax efficient repatriation of funds to the performer's country of residence; or (3) the existence of a similarly favourable double taxation treaty between the second Contracting State and a third

Contracting State which in turn has attractive internal tax laws permitting a tax efficient repatriation of funds to the performer's country of residence. Indeed, this process could pass through many countries each time taking advantage of existing bilateral treaties and possibly changing the nature of the income flow, say, from royalties through a service company to dividends.

The United States-Netherlands Double Taxation Convention 1948 was considered "probably the most notorious" of the US tax treaties for according third-country residents opportunities for treaty shopping in respect of US source income.[76] The absence of an anti-treaty shopping provision or limitation on benefits clause in the 1948 Treaty, coupled with the favourable (or lax) tax regime of the Netherlands,[77] effectively transformed the treaty from a strictly US:Netherlands convention to a multilateral treaty offering its benefits to the best advised taxpayers throughout the world. Companies that were located in countries lacking a US double taxation treaty would invest in the US through a Dutch holding company. This company operated as a conduit through which passive income payments, dividends, interest and royalties, were transferred from the US subsidiary to the Dutch holding company and then distributed tax efficiently, under the Dutch participation exemption,[78] to a third-country parent company. This was practice became so

[76] 'The U.S.-Netherlands Income Tax Treaty: Closing The Doors On The Treaty Shoppers' 17 Fordham Int'l L.J. 776 pp. 779-780

[77] Holland maintained an expansive network that extended tax benefits globally. Moreover, the Dutch tax authorities issue advanced tax rulings, enabling companies to predetermine their tax position and profits with certainty.

[78] The 'participation exemption' generally exempts a taxable Dutch company from corporate income tax on income (including dividends and stock gains) derived in connection with a 'participation' in another entity, including in many cases a foreign company. A participation may be deemed to exist on the basis of a 5-percent or more shareholding in the entity. Where the entity

common it was tagged 'the Dutch sandwich,'[79] the Netherlands being the filling between the bread of the US and the third (investing) country. The structure would often involve the offshore financial centre, the Netherlands Antilles.[80]

4.7.1 The OECD Model Treaty Approach

The OECD Model Treaty does not have a specific anti-treaty shopping provision or limitation on benefits clause, though the issue of treaty shopping is discussed in the Commentaries. The Commentaries express the view that taxpayers have always had the possibility, irrespective of double taxation conventions, to exploit both the differences in tax levels between countries and the tax advantages provided by various countries' taxation laws. It is, the Commentaries state, for each individual country to adopt provisions in their domestic laws to counter such manoeuvres, preserving these provisions when negotiating their bilateral double taxation treaties.[81] The Commentaries do recognise the specific abuse of a person

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is foreign, the entity must be subject to certain types of foreign tax law in order for the participation exemption to apply.

[79] 'The U.S.-Netherlands Income Tax Treaty: Closing The Doors On The Treaty Shoppers', op. cit., at p. 784

[80] *"For decades one of the most popular structures was the "Dutch sandwich," which involved a combination of tax base reduction and a tax haven. The term "Dutch sandwich" describes a chain of corporations linked together by a Netherlands corporation. For example, a foreign investor would create a Netherlands Antilles corporation, which in turn owned a Netherlands subsidiary, which in turn owned an Antilles creditor corporation. Channeling interest income received from a U.S. payor through those entities would enable the Antilles corporation and, finally, the third-country user to avoid U.S. withholding tax. The less complicated structure of the "open-faced sandwich" involved an Antilles company that owned a Netherlands subsidiary, which in turn owned a U.S. corporation. This structure was widely used by foreign investors as a holding company structure for U.S. investments in order not to take advantage of the U.S.-Netherlands Antilles tax convention."* S. M. Haug 'The United States Policy of Stringent Anti-Treaty-Shopping Provisions: A Comparative Analysis,' Vanderbilt Journal of Transnational Law, 29 Vand. J. Transnat'l L. 191, p.212-213

[81] OECD 1992 Model Convention – Commentary on Article 1 Concerning the Persons Covered by the Convention para. 7

(whether or not a resident of a Contracting State) acting through a legal entity created in a Contracting State essentially to obtain treaty benefits that would not otherwise be available.[82] Such a situation, the Commentaries say, is to a large extent dealt with by the OECD Model Treaty by the introduction of the concept of "beneficial owner" (in Articles 10, 11 and 12) and the special provisions for so-called artiste-companies (paragraph 2 of Article 17).[83]

Notwithstanding these remedies, the Commentaries acknowledge the concern expressed by OECD member countries that there had been a growing tendency toward the use of conduit companies to obtain treaty benefits not intended by the Contracting States in their bilateral negotiations.[84] The request by a number of member countries for the implementation of general and specific treaty provisions in the 1992 Model Treaty to counter the abuse was rejected for fear that certain bona fide economic activities that might be unintentionally disqualified by such provisions.

However, several suggested benchmark provisions were included in the Commentaries. These included a 'look-through' provision with the following wording:

> *"A company that is a resident of a Contracting State shall not be entitled to relief from taxation under this Convention with respect*

[82] Ibid., para. 9
[83] Ibid., para. 10
[84] As discussed in two reports from the Committee on Fiscal Affairs entitled "Double Taxation Conventions and the Use of Base Companies" and "Double Taxation Conventions and the Use of Conduit Companies".
See Ibid., para. 11

to any item of income, gains or profits if it is owned or controlled directly or through one or more companies, wherever resident, by persons who are not residents of a Contracting State."[85]

The Commentaries also suggested a more radical 'exclusion' provision, worded as follows:

"No provision of the Convention conferring an exemption from, or reduction of, tax shall apply to income received or paid by a company as defined under Section ... of the ... Act, or under any similar provision enacted by ... after the signature of the Convention."[86]

This provision would be most appropriately used where a State that has created special privileges in its tax law sought to prevent those privileges from being used 'improperly' in connection with tax treaties concluded by that State.

The Commentaries discussed (and rejected) a general subject-to-tax provision that provided that treaty benefits in the State of source would only granted only if the income in question is subject to tax in the State of residence.[87] The subject-to-tax approach was recognised as having certain merits, particularly in the case of States with a well-developed economic structure and a complex tax law. It was felt, however, that it would be necessary to supplement any provision of this kind

[85] OECD 1992 Model Convention – Commentary on Article 1 Concerning the Persons Covered by the Convention para. 13

[86] Ibid., para. 15

[87] *"Where income arising in a Contracting State is received by a company resident of the other Contracting State and one or more persons not resident in that other Contracting State*
a) have directly or indirectly or through one or more companies, wherever resident, a substantial interest in such company, in the form of a participation or otherwise, or
b) exercise directly or indirectly, alone or together, the management or control of such company, any provision of this Convention conferring an exemption from, or a reduction of, tax shall apply only to income that is subject to tax in the last-mentioned State under the ordinary rules of its tax

by inserting bona fide provisions in the treaty to provide for the necessary flexibility.[88]

4.7.2 The US Approach

The US Treasury Department strongly holds the view that tax treaties should include provisions that specifically prevent misuse of treaties by residents of third countries.[89] This is reflected in a Limitation on Benefits provision in the 1996 US Model Convention.[90] There is a similar, though shorter, provision in the 1981 US Model Convention.[91] All recent U.S. double taxation treaties now contain a comprehensive Limitation on Benefits provision, including the 1992 US:Netherlands Treaty.[92] The Limitation on Benefits provision in the US: Ireland Treaty[93] is very comprehensive in nature and, as it was adopted as recently as

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law." Ibid., para. 17

[88] Ibid., para. 18; See also para 21(a) which suggested that such a bona fide provision could take the following form: *"The foregoing provisions shall not apply where the company establish-es that the principal purpose of the company, the conduct of its business and the acquisition or maintenance by it of the shareholding or other property from which the income in question is derived, are motivated by sound business reasons and do not have as primary purpose the obtaining of any benefits under this Convention."*

[89] Treasury Dept. Technical Explanation: 1997 Ireland Income Tax Convention; Countries: United States; Ireland; Electronic Citation: 97 TNI 198-26; Document Number: Doc 97-28089 (105 pages); Title 'Department Of The Treasury Technical Explanation Of The Convention Between The Government Of The United States Of America And The Government Of Ireland For The Avoidance Of Double Taxation And The Prevention Of Fiscal Evasion With Respect To Taxes On Income And Capital Gains Signed At Dublin On July 28, 1997 And The Protocol Signed At Dublin On July 28, 1997' para. 292

[90] Signatories: United States Treasury Department; Citations: 96 TNI 186-16; Doc 96-25867; Signed: September 20, 1996, Article 22

[91] Signatories: United States Treasury Department; Citations: 85 TNI 42-33; Signed: June 16, 1981, Article 16

[92] Signatories: Netherlands, United States; Citations: 93 TNI 106-16; Doc 93-31463; Senate Treaty Doc. No. 103-6; Signed: December 18, 1992; In Force: December 31, 1993, Article 26

[93] Signatories: Ireland, United States; Citations: 97 TNI 147-39; Doc 97-22062; Senate Treaty Doc. No. 105-31; Signed: July 28, 1997; Title 'Convention Between The Government Of The United States Of America And The Government Of Ireland For The Avoidance Of Double Taxation And The Prevention Of Fiscal Evasion With Respect To Taxes On Income And Capital Gains'

1997, may be taken as reflecting the current thinking of the US Treasury in this area. The first three Paragraphs of the relevant provision in the US: Ireland Treaty, Article 23, will be used as a model for the following discussion.

The US takes the view that any treaty that provides benefits to *any* resident of a Contracting State effectively permits 'treaty shopping.' The US Treasury Department defines 'treaty shopping' as "the use, by residents of third states, of legal entities established in a Contracting State with a principal purpose to obtain the benefits of a tax treaty between the United States and the other Contracting State."[94] The problem with this definition as a basis for the formulation of an anti-avoidance provision is that the mischief is dependent on the motive, the taxpayer's 'principal purpose.' Determined to avoid the uncertainty of a subjective definition, Article 23 sets out a series of mechanical tests the application of which is designed to ascertain whether the taxpayer has a real business purpose for the structure adopted or has a sufficiently strong nexus to the Contracting State to warrant treaty benefits.[95]

Paragraph 1 of Article 23 provides that a resident of a Contracting State will be entitled to all the benefits of the Convention otherwise accorded to residents of a Contracting State only if the resident is a 'qualified person' as defined by the Article. Paragraph 2 sets out the categories of qualified persons. Because of its

[94] Treasury Dept. Technical Explanation: 1997 Ireland Income Tax Convention, op. cit., para. 293
[95] Ibid., para. 294

length, Paragraph 2 will be examined by sub-paragraph. The relevant subparagraphs of Paragraph 2 is reproduced in the footnotes.[96]

Subparagraph 2(a) provides that an individual is a qualifying person and consequently individual residents of a Contracting State will, under the limitation on provisions Article, be entitled to all treaty benefits. It is, of course, possible to engage in treaty shopping by using an individual resident in a Contracting State, rather than a corporate or other entity. A performer, for example could assign his intellectual property rights to an individual agent in a Contracting State so that that agent could receive royalty income under the relevant bilateral treaty free from tax in the source country. Such an arrangement would not be caught by Article 23. The 1996 US Model Convention seeks to counter such arrangements by the general requirement contained in other articles under which benefits may be denied where the recipient of the income is not its beneficial owner and the beneficial owner is not a resident of a Contracting State. By way of illustration,

[96] 2. A resident of a Contracting State is a qualified person for a fiscal year only if such resident is either:
a) an individual;
b) a qualified governmental entity;
c) a person other than an individual, if:
i) at least 50 percent of the beneficial interest in such person (or in the case of a company at least 50 percent of the aggregate vote and value of the company's shares) is owned, directly or indirectly, by qualified persons or residents or citizens of the United States, provided that such ownership test shall not be satisfied in the case of a chain of ownership unless it is satisfied by the last owners in the chain, and
ii) amounts paid or accrued by the person during its fiscal year:
a) to persons that are neither qualified persons nor residents or citizens of the United States, and
b) that are deductible for income tax purposes in that fiscal year in the person's State of residence (but not including arm's length payments in the ordinary course of business for (1) services or tangible property, and (2) payments in respect of financial obligations to a bank, provided that where such a bank is not a resident of either Contracting State such payment is attributable to a permanent establishment of such bank, and the permanent establishment is located in either Contracting State), do not exceed 50 percent of the gross income of the person;
[d) to e) omitted]

and following through the foregoing example, Paragraph 1 of Article 12 of the 1996 US Model Convention provides, in words similar to the same Paragraph and Article in the 1992 OECD Model Convention: "Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State may be taxed only in that other State."[97]

Subparagraph 2(b) provides that qualified governmental entity[98] which is a resident of a Contracting State is a qualified person for the purposes of Article 23. This has little relevance to this work and will not be explored further.

Subparagraph 2(c) provides a two-pronged test to any form of legal entity that is a resident of a Contracting State to determine whether it is a qualified person. The test relates to ownership and base erosion, and both prongs of the test must be satisfied. The ownership aspect of the test requires that at least 50 percent of the beneficial interest in the person (or, in the case of a company, at least 50 percent of the aggregate vote and value of the company's shares) must be owned by persons who are themselves qualified persons or who are residents or citizens of the United States. This ownership test shall not be satisfied in the case of a chain of ownership unless it is satisfied by the last owners in the chain. This is a reasonably straightforward test for companies, but it becomes more difficult for

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[97] As discussed above in section 5.2.5 Paragraph 1 of Article 12 of the 1992 OECD Model Convention reads: "Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State." There is no major significance to be attached to the different terminology 'may be taxed only' (US) compared to 'shall be taxable only' (OECD) given the purposive approach to the interpretation of tax treaties. See section [to be inserted].

[98] As defined in subparagraph 1(j) of Article 3 (Definitions) of the 1996 US Model Convention.

other forms of legal entities such as trusts. The US Treasury Department has stated that trusts may be entitled to benefits under this provision if they are treated as residents under Article 4 (Residence) of the 1996 US Model Treaty[99] and otherwise satisfy the requirements of this subparagraph, for which purposes the beneficial interests in a trust will be considered to be owned by its beneficiaries in

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[99] Article 4 of the 1996 US Model Treaty provides:
"1. Except as provided in this paragraph, for the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature.
a) The term "resident of a Contracting State" does not include any person who is liable to tax in that State in respect only of income from sources in that State or of profits attributable to a permanent establishment in that State.
b) A legal person organized under the laws of a Contracting State and that is generally exempt from tax in that State and is established and maintained in that State either:
i) exclusively for a religious, charitable, educational, scientific, or other similar purpose; or
ii) to provide pensions or other similar benefits to employees pursuant to a plan
is to be treated for purposes of this paragraph as a resident of that Contracting state.
c) A qualified governmental entity is to be treated as a resident of the Contracting State where it is established.
d) An item of income, profit or gain derived through an entity that is fiscally transparent under the laws of either Contracting State shall be considered to be derived by a resident of a State to the extent that the item is treated for purposes of the taxation law of such Contracting State as the income, profit or gain of a resident.
2. Where by reason of the provisions of paragraph 1, an individual is a resident of both Contracting States, then his status shall be determined as follows:
a) he shall be deemed to be a resident of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident of the State with which his personal and economic relations are closer (center of vital interests);
b) if the State in which he has his center of vital interests cannot be determined, or if he does not have a permanent home available to him in either State, he shall be deemed to be a resident of the State in which he has an habitual abode;
c) if he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident of the State of which he is a national;
d) if he is a national of both States or of neither of them, the competent authorities of the Contracting States shall endeavor to settle the question by mutual agreement.
3. Where by reason of the provisions of paragraph 1 a company is a resident of both Contracting States, then if it is created under the laws of one of the Contracting States or a political subdivision thereof, it shall be deemed to be a resident of that State.
4. Where by reason of the provisions of paragraph 1 a person other than an individual or a company is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavor to settle the question by mutual agreement and determine the mode of application of the Convention to such person."

proportion to each beneficiary's actuarial interest in the trust.[100] The second prong of the test under subparagraph 2(c), relating to base erosion, requires that amounts paid or accrued by a person during a taxable year, and deductible for tax purposes in that person's State of residence, to persons not entitled to benefits under paragraph 2 and not residents or citizens of the United States not constitute more than 50 percent of the person's gross income for that taxable year. The purpose of this second prong to the test would appear to be aimed at those situations where, say, a performer's intellectual property rights were owned by a Bahamian resident and licensed to an Irish company (owned by the Ireland resident performer) which, by exploiting these right internationally, enjoyed royalty income from the US. Under the base erosion test it would appear that if more than 50% of the royalty income enjoyed by the Irish company from the US were paid to the Bahamas under the licensing agreement, then provided that such payment were allowable for tax purposes in Ireland, the Irish company would cease to be a qualified person under Article 23, thereby entitling the US to tax the royalties at source.

Subparagraph 2(d) applies to publicly traded persons, such as unit trusts, subparagraph 2(e) applies to publicly traded companies and subparagraph 2(f)

[100] Treasury Dept. Technical Explanation: 1997 Ireland Income Tax Convention, op. cit., para. 306. The Explanation continues: *"The interest of a remainder beneficiary will be equal to 100 percent less the aggregate percentages held by income beneficiaries. A beneficiary's interest in a trust will not be considered to be owned by a person entitled to benefits under the provisions of paragraph 2 if it is not possible to determine the beneficiary's actuarial interest. Consequently, if it is not possible to determine the actuarial interest of any beneficiaries in a trust, the ownership test under clause (i) cannot be satisfied, unless all beneficiaries are persons entitled to benefits under the other subparagraphs of paragraph 2 or are residents or citizens of the United States."*

applies to tax exempt organizations. A discussion of these subparagraphs fall outside the scope of this work.

There are exceptions to the rule that the benefits of the Convention may only be enjoyed by a qualified person as defined by Paragraph 2 of Article 23. Paragraph 3(a) of the Article provides:

> *"A resident of a Contracting State that is not a qualified person shall be entitled to the benefits of this Convention with respect to an item of income derived from the other State, if:*
> *i) such resident is engaged in the active conduct of a trade or business in the first-mentioned State (other than the business of making or managing investments, unless such business is carried out by a bank or insurance company acting in the ordinary course of its business), and*
> *ii) the item of income is connected with or incidental to the trade or business in the first-mentioned State, provided that, where such item is connected with a trade or business in the first- mentioned State and such resident has an ownership interest in the activity in the other State that generated the income, the trade or business is substantial in relation to that activity."*

This is known as the Active Business Test and its purpose is to ensure that the limitation on benefits provision does not deprive bona fide tax residents of treaty benefits merely because they are owned by third-country residents. For example, an Irish unquoted film company engaged in the making of Irish light comedy movies could be owned by, say, a majority of Canadian shareholders. The company would have a genuine business purpose in being located in Ireland. As an Irish corporate resident, it would be subject to Irish corporation tax, subject to such tax breaks as the Irish government permits. Therefore, although it would fail the ownership prong of the test set out in Paragraph 2(c), and possibly the base erosion test as well, (as well as the publicly traded test not discussed in detail above), the company should really, on licensing films to the US, be treated for treaty purposes by the US in the same manner as other Irish corporate taxpayers. Put simply, this is not a case of tax avoidance which the limitation on benefits provision was designed to counter and consequently income earned in the US by the Irish company should be afforded the full benefits under the treaty. Paragraph 3 addresses this problem and the Irish company in the given example falls comfortably within its provisions.[101]

Considerable attention has been given to the Limitation on Benefits provision because it is likely to find a place, subject to minor modifications, in all future US double taxation treaties.[102] This, in turn, will affect the bilateral negotiations between all developed countries. This trend is not without its critics. The former International Tax Counsel at the Treasury Department, David Rosenbloom,[103]

[101] Paragraph 3(b) provides further clarification of 3(a) and provides: *"For the purposes of subparagraph a)ii),*

i) an item of income shall, in any case, be connected with a trade or business if the activity in the other State that generated the item of income is a line of business that forms a part of or is complementary to the trade or business conducted in the first- mentioned State by the income recipient;

ii) whether the trade or business of the resident in the first- mentioned State is substantial in relation to *the activity in the other State shall be determined based on all the relevant facts and circumstances. In any case, however, the trade or business will be deemed substantial if, for the preceding fiscal year, or for the average of the three preceding fiscal years, the asset value, the gross income and the payroll expense that are related to the trade or business in the first-mentioned State equals at least 7.5 percent of the asset value, the gross income and the payroll expense, respectively, that are related to the activity that generated the income in the other State, and the average of the three ratios exceeds 10 percent, provided that for the purposes of calculating the above ratios, there shall be taken into account only the resident's proportionate ownership interest in such trade, business or activities, whether held directly or indirectly."*

[102] Since 1981 a limitation-on-benefits Article has been inserted into every newly negotiated or renegotiated US Double Taxation Treaty.

[103] Mr. Rosenbloom was the International Tax Counsel at the Treasury Department during the

described the US attitude toward treaty shopping with the phrase "anything worth doing is worth overdoing."[104] Criticism has also come from business and trade organisations in the US. In their Recommendations to the Department of the Treasury on Limitation On Benefit Provisions, the National Foreign Trade Council (NFTC),[105] expressed their reservations thus:

> *"As a general proposition, the Institute believes that the United States appears to have overreacted to the "treaty-shopping" problem. Rules which seem both necessary and appropriate when the focus is on tax haven jurisdictions such as the Netherlands Antilles and the British Virgin Islands seem less needed and more intrusive on normal international economic relationships when applied in treaties entered into with the world's leading industrialized countries -- countries which generally have substantial economies and comprehensive tax systems. Because the application of comprehensive "treaty-shopping" rules to these countries is a new phenomenon, it is too early to have empirical evidence of the effects, but there are substantial grounds for concern that the present rules may have an undesirable inhibitive effect. At the same time it seems clear that, without altering the general purpose of the "treaty-shopping" provisions, they can be relaxed in a way which will afford more predictability and flexibility in structuring legitimate international corporate structures and transactions."*[106]

There is no evidence that these concerns have had an effect on the US Treasury in the drafting of Limitation on Benefits provisions. However, the NFTC make a valid point when asserting that it is too early to have empirical evidence of the effects of these provisions and should such evidence show in the future that US trading interests are being harmed, a degree of relaxation would in all probability

years 1977-1981. This information is drawn from S.M. Haug, op. cit.

[104] S. M. Haug, op. cit., p.198

[105] The National Foreign Trade Council is composed of US corporations engaged in all aspects of foreign trade and business. It has as its purpose the promotion of US foreign trade and business.

[106] March 17, 1993; Electronic Citation: 93 TNI 68-7; Microfiche Number: Doc 93-4313

follow. It will be recalled that one of the objectives of double taxation treaties is the encouragement of trade.[107]

4.8 UK:US DOUBLE TAXATION TREATY

The US:UK Double Taxation Treaty, formally known as the 'Convention Between The Government Of The United States Of America And The Government Of The United Kingdom Of Great Britain And Northern Ireland For The Avoidance Of Double Taxation And The Prevention Of Fiscal Evasion With Respect To Taxes On Income And Capital Gains,'[108] was signed in London on 31 December 1975. It has since been amended by an Exchange of Notes signed 13 April 1976 and Protocols signed on 26 August 1976 and 31 March 1977 and 15 March 1979.

4.8.1 Background to Article 17 of the UK:US Treaty

It is not surprising to discover that the first UK:US double taxation treaty,[109] adopted in 1945, contained a provision stipulating that athletes and entertainers were to be taxed by the country in which their performance took place. For two countries with such a developed sport and entertainment industry, sophisticated anti-avoidance provisions and a regular exchange of performers, the inclusion of

[107] See section 4.2 above.
[108] Citations: 85 TNI 27-21; Doc 93-30464; TIAS 9682; S. Exec. K, 94-2
[109] Signatories: United Kingdom, United States; Citations: 93 TNI 251-115; Doc 94-30292; TIAS 1546; Signed: April 16, 1945; In Force: July 25, 1946; Title: 'Agreement And Protocol For The

an embryonic Article 17 was to be expected. In short, the provision excluded non-resident athletes and entertainers from benefitting from the exemptions available under the personal services provision.[110] What is in retrospect surprising is that in the year following the adoption of the treaty, the provision relating to athletes and entertainers was deleted.[111] The deletion followed criticisms raised before the US Senate Foreign Relations Committee that the provision unfairly discriminated against one class of service providers, athletes and entertainers, in comparison with other high-income earners, such as executives and salespersons.[112]

The UK continued to use the athletes and entertainers provisions in their other bilateral tax treaties. For example, shortly after the aforementioned deletion in the provision in the UK:US treaty, the UK, in 1949, included an identical provision in their double taxation agreement with Sweden.[113] The US, in contrast, held to their position of not discriminating against any single class of service providers until 1970 when for the first time a specific provision that addressed the treatment of

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Avoidance Of Double Taxation And The Prevention Of Fiscal Evasion With Respect To Taxes On Income.'

[110] Article XI of the 1945 Treaty provided:

"1. An individual who is a resident of the United Kingdom shall be exempt from United States tax upon compensation for personal (including professional) services performed during the taxable year within the United States if (a) he is present within the United States for a period or periods not exceeding in the aggregate 183 days during such taxable year, and (b) such services are performed for or on behalf of a person resident in the United Kingdom.

2. [As 1. Substituting the US for the UK and vice-versa.]

3. The provisions of this Article shall not apply to the compensation, profits, emoluments or other remuneration of public entertainers such as stage, motion picture or radio artists, musicians and athletes."

[111] Protocol - June 6, 1946; Signatories: United Kingdom, United States; Citations: 93 TNI 251-115; Doc 94-30292; TIAS 1546; Signed: June 6, 1946; In Force: July 25, 1946

[112] See S. C. Evans 'U.S. Taxation Of International Athletes: A Reexamination Of The Artiste And Athlete Article In Tax Treaties,' 29 George Washington Journal of International Law & Economics 297, section III(A)(2) 'United States-United Kingdom Tax Treaty.'

[113] Signatories: Sweden, United Kingdom; Citations: 93 TNI 251-16; Doc 94-30192; Signed: March 30, 1949; In Force: September 16, 1949; Title: 'Agreement For The Avoidance Of

income earned by an athlete or entertainer was included in a treaty with the small Caribbean state of Trinidad and Tobago. The new provision excluded non-resident entertainers and athletes from benefitting from the exemptions available under the now separate independent and dependent personal services provisions, heretofore granted to them.

4.8.2 Article 17(1) of the UK:US Treaty

Article 17 of the current UK:US Double Taxation Convention,[114] adopted in 1975, and headed 'Artistes And Athletes,' reflects the changed US approach, though it differs in one significant respect to Article 17 in the OECD Model Treaty. Paragraph 1 of Article 17 of the UK:US Convention provides

> *"Notwithstanding the provisions of Articles 14 (Independent Personal Services) and 15 (Dependent Personal Services), income derived by entertainers, such as theatre, motion picture, radio or television artistes, and musicians, and by athletes, from their personal activities as such may be taxed in the Contracting State in which these activities are exercised, except where the amount of the gross receipts derived by an entertainer or athlete, including expenses reimbursed to him or borne on his behalf, from such activities do not exceed 15,000 United States dollars or its equivalent in pounds sterling in the tax year concerned."*

This Paragraph states the general rule that income derived by entertainers and athletes, for their personal activities as such, may be taxed in the Contracting

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Double Taxation And The Prevention Of Fiscal Evasion With Respect To Taxes On Income.'

[114] Signatories: United Kingdom, United States; Citations: 85 TNI 27-21; Doc 93-30464; TIAS 9682; S. Exec. K, 94-2; Signed: December 31, 1975; In Force: April 25, 1980; Title: 'The Convention between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and Capital Gains'

State where those services are exercised. This overrides the provisions of Article 14 and Article 15, relating to independent personal services and dependent personal services, respectively, under which, in general terms, a presence of more than 183 days in required in the source Contracting State before the individual is liable to tax in that country. This is broadly consistent with Article 17 of the OECD Model Treaty. The UK:US Treaty departs from the OECD Model Treaty in respect of its *de minimus* provision. Under the UK:US Treaty the income of the entertainer or athlete is only subject to tax in the source country where the gross receipts derived by him, including expenses reimbursed to him or borne on his behalf, in respect of such activities, exceed $15,000 or its equivalent in £ sterling for the tax year concerned.

This provision of the UK:US Treaty was subsequently reflected in the 1976 US Model Convention.[115] The U.S. Treasury Department included the $15,000 threshold to reflect the view that cultural exchanges should be encouraged, and that athletes should not be singled out for special adverse tax treatment.[116] In the 1996 US Model Convention[117] the threshold is increased to $20,000, though this has no effect on the existing UK:US Treaty. In the Senate Hearing on the UK:US Treaty representatives from the Joint Committee on Taxation envisaged that the new provision would apply primarily to popular concert and television performers

[115] Signatories: United States Treasury Department; Citations: 85 TNI 42-35; Signed: May 18, 1976

[116] B. Susser, Note, 'Achieving Parity in the Taxation of Non-resident Alien Entertainers,' 5 Cardozo Arts & Ent. L.J. 613, 629, 647 (1986), at 632 as quoted in S. C. Evans 'U.S. Taxation Of International Athletes: A Reexamination Of The Artiste And Athlete Article In Tax Treaties' op. cit.

who, even in the early 1970s obtained sums substantially in excess of $15,000 for a single or brief series of performances in either country.[118] In these cases under the treaty the entire amount would be fully subject to tax under the normal rules of the country in which the performance took place.

In computing the $15,000 limitation, expenses borne on behalf of the entertainer include any expenditures for travel, meals and lodging, payments to persons such as band members or agents, and other amounts which are generally related to the activities of the entertainer or athlete.[119] This rule includes expenses borne by persons in the Contracting State where services are performed or borne by persons in the other or any third State if borne on behalf of the entertainer or athlete.[120] This expansive interpretation of the sums to be included in arriving at the £15,000 threshold severely limits its applicability to international entertainers and athletes. There is a further anti-avoidance rule which limits it further still. In computing the $15,000 limitation, amounts paid in taxable years prior or subsequent to the year in which the services were performed are to be included in the determination

[117] Signatories: United States Treasury Department; Citations: 96 TNI 186-16; Doc 96-25867; Signed: September 20, 1996

[118] Transcript: 1977 Senate Hearing on 1975 U.K., 1976 Korea, and 1976 Philippine Income Tax Treaties; Countries: United States; Korea; Philippines; United Kingdom; Electronic Citation: 87 TNI 53-81; Official Citation: July 19-20, 1977; Title: 'Prepared Statement Of Paul Oosterhuis, Legislative Counsel, And David Brockway, Legislation Attorney, Staff Of The Joint Committee On Taxation.'

[119] Treasury Dept. Technical Explanation: 1975 U.K. Income Tax Treaty, 1976 Notes, and 1976 and 1977 Protocols; Countries: United States; United Kingdom; Electronic Citation: 87 TNI 53-81; Official Citation: July 19-20, 1977; Title 'Technical Explanation Of The Convention Between The Government Of The United States Of America And The Government Of The United Kingdom Of Great Britain And Northern Ireland For The Avoidance Of Double Taxation And The Prevention Of Fiscal Evasion With Respect To Taxes On Income And Capital Gains Signed At London, On December 31, 1975, As Amended By The Notes Exchanged At London On April 13, 1976, The Protocol Signed At London On August 26, 1976, And The Second Protocol Signed At London On March 31, 1977.'

of the amount of income attributable to the year in which the services were performed.[121]

The US Treasury's Technical Explanation of Article 17, comparable in purpose and status to the OECD Commentaries,[122] follows the OECD's definition of 'artiste' or 'athlete' insofar as "income derived from services rendered by producers, directors, technicians and others who are not artistes and athletes is taxable in accordance with the provisions of Article 14 (Independent Personal Services), or Article 15 (Dependent Personal Services), as the case may be."[123]

4.8.3 Article 17(2) of the UK:US Treaty

For the same reasons as discussed above, in 4.4.2, namely to combat a performer's use of service companies for tax minimisation purposes, Article 17 of the UK:US Treaty has a second Paragraph, though, as with Paragraph 1, it is in one significant respect it is different to that contained in the OECD Model Treaty. Paragraph 2 of Article 17 of the UK:US Convention provides

> *"Where income in respect of personal activities as such of an entertainer or athlete accrues not to that entertainer or athlete himself but to another person, that income may, notwithstanding the provisions of Articles 7 (Business Profits), 14 (Independent Personal Services), and 15 (Dependent Personal Services), be*

[120] Ibid.
[121] Ibid.
[122] A Technical Explanation refers to a report published by the Joint Committee on Taxation and the US Treasury explaining in detail the provisions of a particular treaty. This report is considered by the US Senate during the ratification process. A Technical Explanation constitutes the official interpretation of the treaty and may be considered by a court in applying the treaty.
[123] Ibid.

taxed in the Contracting State in which the activities of the entertainer or athlete are exercised, For the purposes of the preceding sentence, income of an entertainer or athlete shall be deemed not to accrue to another person if it is established that neither the entertainer or athlete, nor persons related thereto, participate directly or indirectly in the profits of such other person in any manner, including the receipt of deferred remuneration, bonuses, fees, dividends, partnership distributions or other distributions."

As discussed above in the absence of this paragraph a performer's personal service company could provide his services in a Contracting State and escape taxation with respect to those services under the provisions of Article 7 because the service company would not have a permanent establishment in the source country. The performer could simultaneously minimise the operation of Paragraph 1 of Article 17 by receiving a minimal salary while in the source country and arranging a compensation package payable over several years in a tax efficient manner. Paragraph 2 of Article 17 prevents such perceived abuse of the double taxation treaty by permitting the source country to tax the income of the service company as if it were the income of the performer. Where the second paragraph in the UK:US Treaty departs from that in the OECD Model Treaty is in its attempt to target only the personal service vehicle under the performer's control. Whereas it is sufficient under the OECD Model for the source country to apply taxation where income from performer's personal activities "accrues not to the entertainer or athlete himself but to another person," the UK:US Treaty stipulates that for the source country to apply taxation in such circumstances the "entertainer or athlete, ...[or] persons related thereto, [must] participate directly or indirectly in the profits of such other person."

This approach is consistent with the Reservation entered by the US to Paragraph 2 of Article 17 introduced by the OECD in 1977 and discussed above.[124] The purpose of the second paragraph from the US perspective is to prevent tax avoidance through the use of personal service corporations, or trusts, partnerships and other vehicles set up with the same aim. Under Paragraph 2, income is considered to accrue to the benefit of another person where that other person has control over or the right to gross income derived in respect of an entertainer or athlete's services as such.[125] This rule applies regardless of whether the other person is a "sham" corporation or conduit. As regards the reference to term 'persons related thereto,' the Technical Explanation expands the term beyond the provisions of Paragraph 5 of Article 9 (Related Enterprises).[126] For the purposes of Article 17, a person may be considered to be related to the entertainer or athlete if he is an employee or agent of the entertainer or athlete, or if he is regularly employed by the entertainer or athlete in an advisory capacity, such as his attorney, accountant, or investment advisor.[127] The categories of persons who may be considered related to the entertainer or athlete appears to be aimed at preventing the performer from paying wages, salaries, commissions and professional fees through the service company in what would otherwise be a tax efficient manner.

[124] See section 5.2.2.
[125] Article 17, Treasury Dept. Technical Explanation, op. cit.

4.8.4 Article 12 of the UK:US Treaty

The first two Paragraphs of Article 12 of the UK:US Treaty provide:

> *"(1) Royalties derived and beneficially owned by a resident of the United Kingdom shall be exempt from tax by the United States.*
> *(2) Royalties derived and beneficially owned by a resident of the United States shall be exempt from tax by the United Kingdom."*

The Paragraphs combined are equivalent in all material respects to Article 12(1) of the 1992 OECD Model Treaty. The OECD Model provides that royalties "shall be taxable only" in the State of Residence. The UK:US Treaty provides for exemption from tax in the State of Source. This is a difference of emphasis but the consequence of the provision is that royalties are taxable only in the State of Residence, as provided by the OECD Model. The two provisions are more directly similar with regard to the exemption applying only where the person deriving the royalties is both a resident of a Contracting State and the beneficial owner of the royalty.[128]

The definition of royalties, the equivalent to Article 12(2) of the OECD Model,[129] is set out in Article 12(3) of the UK:US Treaty.[130] There are two significant

[126] Article 9, para. 5 provides: *"For the purposes of this Convention, an enterprise is related to another enterprise if either enterprise directly or indirectly controls the other, or if any third person or persons (related to each other or acting together) control both."*
[127] Article 17, Treasury Dept. Technical Explanation, op. cit.
[128] Therefore, as stated in section 5.2.5, the exemption on the taxation of royalties in the Source State does not apply where an intermediary, such as an agent or nominee, who is a resident of a Contracting State collects or receives the royalties on behalf of a non-resident of that Contracting State.
[129] See section 5.2.6.
[130] Article 12(3) of the UK:US Treaty provides: *"The term "royalties" as used in this Article (a) means payments of any kind received as a consideration for the use of, or the right to use, any*

differences between the two provisions. First, consideration for the right to use cinematographic films or films or tapes used for radio or television broadcasting is specifically excluded from the definition of royalties by the UK:US Treaty. This contrasts starkly with the OECD Model which specifically includes "consideration for the use of ... cinematograph films"[131] in its definition of royalties. Secondly, the definition of royalties under the UK:US Treaty includes gains derived from the alienation[132] of defined intellectual property rights which are contingent on the productivity, use, or disposition of those rights. These are not included in the OECD Model definition.

The consequence of the first difference is that consideration for the right to use cinematographic films or films or tapes used for radio or television broadcasting is treated under the UK:US Treaty as business profits and falls under Article 7 of the Treaty.[133] Accordingly, any such consideration is exempt from tax unless it is attributable to a permanent establishment which the recipient maintains in the source country.[134] The consequence of the second difference is that gains derived

copyright of literary, artistic or scientific work (but not including cinematographic films or films or tapes used for radio or television broadcasting); any patent, trade mark, design or model, plan, secret formula or process, or other like right or property, or for information concerning industrial, commercial or scientific experience; and (b) shall include gains derived from the alienation of any such right or property which are contingent on the productivity, use, or disposition thereof; including the supply or assistance of an ancillary and subsidiary nature furnished as a means of enabling the application or enjoyment of any such right or property."

[131] For the full Article 12(2) see section 5.2.6.

[132] The includes sale, exchange or other disposition.

[133] For the avoidance of doubt Article 7(7) of the UK:US Treaty provides: *"For the purposes of this Convention, "business profits" includes ... the rental or licensing of cinematographic films for films or tapes used for radio or television broadcasting or from copyrights thereof."*

[134] Article 7(1) of the UK:US Treaty provides: *"The business profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the business profits of the enterprise may be taxed in that other*

from the alienation of defined intellectual property rights which are contingent on the productivity, use, or disposition of those rights fall under Article 12, treated as free of tax in the source country, rather than Article 13, potentially subject to tax in the source country.[135]

Paragraph 4 of Article 12,[136] the equivalent to Article 12(3) of the OECD Model,[137] provides that Paragraphs 1 and 2 will not apply if the royalty recipient, being a resident of one Contracting State, carries on business in the other Contracting State through a permanent establishment or performs in that other Contracting State personal services from a fixed base, and the right or property giving rise to the royalty is effectively connected with the permanent establishment or fixed base. Should this be the case, the royalty will be treated as business profits subject to Article 7, independent personal services income subject to Articles 14,[138] or artistes and athletes income subject to Article 17.

State but only so much of them as is attributable to that permanent establishment."

[135] Article 13, headed 'Capital Gains' of the UK:US Treaty provides: *"Except as provided in Article 8 (Shipping and Air Transport) of this Convention, each Contracting State may tax capital gains in accordance with the provisions of its domestic law."*

[136] The full text of Article 12(4) reads: *"The provisions of paragraphs (1) and (2) of this Article shall not apply if their person deriving the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which the royaities are paid is effectively connected with such permanent establishment or fixed base. In such a case, the provisions of Article 7 (Business Profits), Article 14 (Independent Personal Services), or Article 17 (Artistes and Athletes), as the case may be, shall apply."*

[137] See section 4.4.7.

[138] Similar to Article 14 of the 1992 OECD Model, Article 14 of the UK:US Treaty provides: *"Income derived by an individual who is a resident of one of the Contracting States from the performance of personal services in an independent capacity may be taxed in that State. Such income may also be taxed in the other Contracting State if:*

(a) the individual is present in that other State for a period or periods exceeding in the aggregate 183 days in the tax year concerned, but only so much thereof as is attributable to services performed in that State, or

(b) the individual has a fixed base regularly available to him in that other State for the purpose of

The last paragraph of Article 12, Paragraph 5,[139] the equivalent to Article 12(4) of the OECD Model,[140] provides that if excessive royalties are paid by virtue of a special relationship between the payer and the beneficial owner of the royalty (or between both of them and a third person), Paragraphs 1 and 2 shall not apply to the excessive portion of the payment, which consequently may be taxed in each Contracting State. This provision is similar in all material respects to Article 12(4) of the 1992 OECD Treaty.

4.8.5 Testing the UK:US Treaty – The Case of Stefan Edberg

The application of the provision of the UK:US Double Taxation Treaty as it pertained to the personal service income and endorsement income of a sportsman was recently before the US courts.[141] Stefan Edberg, the Swedish professional tennis player formerly ranked No. 1 in the world,[142] was resident in the UK in the years in question.[143] During this time he enjoyed substantial royalty income and endorsement fees for the use of his name and services in Europe and around the world, most notably in the US. He had eleven endorsement contracts, with such

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performing his activities, but only so much thereof as is attributable to services performed in that State."

[139] The full text of Article 12(5) reads: "*Where, owing to a special relationship between the payer and the person deriving the royalties or between both of them and some other person, the amount of the royalties paid exceeds for whatever reason the amount which would have been paid in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In that case, the excess part of the payments shall remain taxable according to the law of each Contracting State, due regard being had to the other provisions of this Convention.*"

[140] See section 5.2.8.

[141] Tax Court Petition Docket No. 15576-97 (July 21, 1997)

[142] Stefan Edberg held the world number one ranking in 1990 and won the U.S. Open singles title in 1991 and 1992.

multinational companies as Adidas, Volvo, and Fuji, each contract having varying royalty and personal services characteristics. Edberg determined his US-source income by allocating his worldwide endorsement income on the basis of days in the US to total days and allocated US-source income equally between taxable personal service income as a sportsman or athlete (Article 17) and non-taxable royalty income (Article 12). The IRS contended that the US-source income was materially understated and that 100 percent of the US-source income was personal service income subject to US taxation under Article 17. Edberg's petitioned the court with a robust litigating position. He argued that all of his US-source income was free from US tax under the UK:US Double Taxation Treaty, either as personal service income (Article 14) or royalty income (Article 12), rather than taxable as Artistes and Athletes income (Article 17). The case was settled on a no-change basis, the IRS settling for 'half the cake' rather than risking it all. It is considered that had the case proceeded to a decision, it would have been the leading authority on characterizing – either as royalty, personal service, or artiste and athlete income - the endorsement income of international sportspeople and entertainers.[144]

It is valuable to use the Edberg case to attempt to draw a line of demarcation between that income of a sports person or entertainer which falls to be treated as personal service income, not subject to tax in the country of source under Article

[143] The relevant taxable years were 1989, 1990, and 1991.

[144] For a full discussion of this case see J. J. Coneys, Jr. *'To Tax or Not To Tax: Is a Non-Resident Tennis Player's Endorsement Income Subject to Taxation in the United States?'* 9 Fordham Intellectual Property, Media & Entertainment Law Journal, Spring 1999, 885

14, and income which falls to be treated as artistes and athletes income which may be taxed in the country of source.

As stated above, the type of income generated in the source country that is covered by Article 17 is the income derived by an entertainer or sportsman "from his personal activities as such" exercised in the source state. Much turns on the term "as such." It is at once obvious that all of Edberg's endorsement income arose from his position as a leading international tennis player. His personal qualities, such as his reputation for integrity and his likable public personality, together with his photogenic features, no doubt affected the fees he could command, but the essence of his value to corporate principals resided in his fame as a top tennis player. In this sense all of his endorsement income could be said to have arisen from his position as a sportsman. Article 17, however, is not so all encompassing. In determining whether income falls under Article 17, the controlling factor is whether the income in question is predominantly attributable to the entertainment or sporting performance itself: the personal entertainment or sporting activity as such.

This is clear from the Technical Explanation of the Treasury Department to the 1996 U.S. Model Income Tax Convention,[145] and the OECD Commentaries referred to above. Having specifically acknowledged its agreement with

[145] Treasury Dept. Technical Explanation: 1996 U.S. Model Income Tax Convention; Countries: United States; Electronic Citation: 96 TNI 186-17; Document Number: Doc 96-25868 (151 pages)

paragraph 9 of the OECD Commentaries to Article 17,[146] the US Treasury's Technical Explanation goes on to state categorically, "[i]ncome derived from a Contracting State by a performer who is a resident of the other Contracting State from other than actual performance, such as royalties from record sales and payments for product endorsements, is not covered by this Article, but by other articles of the Convention, such as Article 12 (Royalties) or Article 14 (Independent Personal Services)."[147]

If the situation is so clear, it begs the question as to why the IRS sought to argue that all of Edberg's income came within Article 17, thereby falling in charge to US tax. The answer may be that whilst it is relatively easy to pronounce a general rule in this area, it is difficult to apply it to specific situations. Take, for example, Edberg's endorsement contracts with Adidas, the manufacturer and distributor of sportswear and equipment, and Wilson, the manufacturer and distributor of tennis frames, tennis balls, and other tennis related goods. Should Edberg have promoted these two companies by wearing or using their products in a tournament, the resulting income would have arisen from his 'sporting activity as

[146] Paragraph 9 of the OECD Commentaries to Article 17 states: "Besides fees for their actual appearances, artistes and sportsmen often receive income in the form of royalties or of sponsorship or advertising fees. In general, other Articles would apply whenever there was no direct link between the income and a public exhibition by the performer in the country concerned. Royalties for intellectual property rights will normally be covered by Article 12 rather than Article 17 (cf. paragraph 18 of the Commentary on Article 12), but in general advertising and sponsorship fees will fall outside the scope of Article 12. Article 17 will apply to advertising or sponsorship income, etc. which is related directly or indirectly to performances or appearances in a given State. Similar income which could not be attributed to such performances or appearances would fall under the standard rules of Article 14 or Article 15, as appropriate. Payments received in the event of the cancellation of a performance are also outside the scope of Article 17, and fall under Articles 7, 14 or 15, as the case may be."

[147] Treasury Dept. Technical Explanation: 1996 U.S. Model Income Tax Convention, op. cit., para. 229

such.' This is supported by the aforementioned paragraph 9 of the OECD Commentary on Article 17 and by the Technical Explanation of the US Treasury Department which states:

> *"For instance, a fee paid to a performer for endorsement of a performance in which the performer will participate would be considered to be so closely associated with the performance itself that it normally would fall within Article 17. Similarly, a sponsorship fee paid by a business in return for the right to attach its name to the performance would be so closely associated with the performance that it would fall under Article 17 as well."*[148]

So far, so good. The question is: where does one draw the line? It has been suggested that the paid personal appearances by a top tennis professional at a tournament function - working the crowd at a licensee's hospitality tent – would not fall with Article 17 as the appearance would not be directly tied to his tournament participation. The argument runs that the tennis professional would be able to make the appearance whether or not he was playing in the tournament.[149] The author follows the argument but disagrees with the conclusion. In his view playing in the tournament raises the value of appearing in the hospitality tent which provides a strong enough link between the performance 'as such' and the appearance to bring the appearance fees within Article 17. What is accepted is that there are arguments on both sides.

It is no doubt for this sort of reason, the broad grey area surrounding Article 17, that Edberg chose to allocate an arbitrary 50% of his US endorsement income to

[148] Ibid., para. 230
[149] See J. J. Coneys, Jr., op. cit.

Article 17. It is less clear how he would have sustained his litigation position that the whole of his US income fell within either Article 14 (personal service income) or Article 12 (royalty income). It is also difficult to see how the IRS would have sustained the position that the whole of the income fell within the Article 17. It is suspected that this was an attempt by the IRS to gain judicial authority for the widening of the boundaries of Article 17. In this instance they chose not to pursue the case, perhaps because with such non-sport related endorsees as Volvo and Fuji it was not the ideal test case. It would not be surprising to see a similar case arise, where the IRS's position is stronger, that goes to a decision before the Tax Court, and possibly beyond.

4.8.6 Renegotiating the UK:US Treaty

The UK and US governments announced plans on October 1 1998 to modernise the existing UK:US Double Taxation Treaty.[150] In simultaneous press releases the UK Inland Revenue and the US Treasury Department stated that the two governments have agreed to negotiate a new treaty to replace the existing one that has been in effect since 1975. "The two Governments have decided that [the Treaty] needs to be modernised to take account of developments in both countries'

[150] See G. Hardy, 'U.K.-U.S. Tax Treaty To Be Renegotiated,' 12 October 1998, 17 Tax Notes Intl 1109

tax systems and policies since then."[151] Official-level discussions were scheduled to commence in Washington in January 1999.[152]

The renegotiations are unlikely to have a major impact on Articles 17 and 12. The $15,000 threshold in Article 17 will almost certainly be raised. In the 1997 Treaty concluded between the US and Ireland the Article 17 threshold was fixed at $20,000, the same as the threshold in the 1996 US Model Convention. Raising the UK:US threshold by $5,000, or 33%, would in no way reflect 24 years of inflation (particularly not the 24 year inflation specific to the earning of sportspeople and entertainers), but there is no basis for believing that the UK threshold will be markedly higher Ireland's. Such disparity would only invite treaty shopping.

It is this area of treaty shopping that is expected to consume a considerable amount of negotiation time. The UK is one of the few remaining important trading partners of the US that does not have a modern Limitation on Benefits Article in the double taxation treaty with the US.[153] As discussed in the previous section, the US has a preference for a lengthy and prescriptive Limitation on Benefits Article. These have been major talking points in the renegotiation of the US treaties with Ireland, Luxembourg, the Netherlands and Switzerland. The UK has a preference for short, targeted, anti-avoidance provisions inserted in the

[151] Inland Revenue Press Release 126/98, 'Tax Treaty Negotiations With U.S. Announced.'
[152] Treasury Dept. News Release: 'U.S.-U.K. Income Tax Treaty Negotiations Announced,' Electronic Citation: 98 TNI 191-24; Document Number: Doc 98-29383 (1 page)
[153] See R. Berner & G. May, 'Refining the special relationship: Renegotiating the U.K.-U.S.

relevant treaty articles. [154] Cussons suggests that "[i]t will be interesting to see if the United Kingdom can invoke its special relationship with the United States to either avoid a limitation on benefits article completely, or negotiate a weaker version." [155]

4.9 TREATIES WITH OFFSHORE FINANCIAL CENTRES

Given that double taxation treaties serve to address the issue of juridical double taxation,[156] there is little need for offshore financial centres to enter such treaties as the level of direct taxes within their borders is either low or zero. From the perspective of the developed countries, entering any double taxation treaty with an offshore financial centre would re-open the very door to treaty shoppers that legislators, most notably in the US, have been trying to close.

4.9.1 Jersey:UK

Some offshore financial centres have a limited network of treaties usually with similar centres in the same geographic locality and those countries with which they have had had a long political association, usually an association of

income tax treaty,' Tax Management International Journal, 12 March 1999, Vol. 28, No. 3 Pg. 107-127

[154] See P. Cussons, 'The Renegotiation of the U.K.-U.S. Income Tax Treaty: A U.K. View,' 2 November 1998, 17 Tax Notes Int'l 1311

[155] Ibid.

[156] See section 5.0.2.

dependency. Jersey, for example, has treaties with Guernsey[157] and the United Kingdom.[158] It is valuable to take a closer look at the UK:Jersey Treaty for two reasons. First, for the example it provides of a double taxation convention involving an offshore financial centre; and, secondly, for the tax planning opportunities it appears to afford for sportspeople and entertainers. The treaty was signed in 1952 and covers income tax and corporation tax.[159]

Paragraph 2(2) of the treaty provides:

> *"Where under this Arrangement any income is exempt from tax in one of the territories if (with or without other conditions) it is subject to tax in the other territory, and that income is subject to tax in that other territory by reference to the amount thereof which is remitted to or received in that other territory, the exemption to be allowed under this Arrangement in the first-mentioned territory shall apply only to the amount so remitted or received."*

This provision is necessary because of the remittance basis of taxation in UK tax law, as explained in Chapter 1, section 1.6.5. It will be recalled that if a UK resident is not domiciled in the UK (or is a British, Commonwealth or Irish citizen not ordinarily resident in the UK) income from overseas possessions is taxed under Schedule D(V) on the amount of that income that is remitted to the

[157] Signatories: Guernsey, Jersey; Citations: 94 TNI 252-171; Doc 95-30023; Signed: July 11, 1956; In Force: July 11, 1956; Title 'Arrangement For The Avoidance Of Double Taxation And The Prevention Of Fiscal Evasion With Respect To Taxes On Income.'
[158] Signatories: Jersey, United Kingdom; Citations: 93 TNI 251-212; Doc 93-31612; Signed: June 24, 1952; In Force: June 24, 1952; Title: 'Arrangement For The Avoidance Of Double Taxation And The Prevention Of Fiscal Evasion With Respect To Taxes On Income'
[159] United Kingdom: Jersey, 'Arrangement For The Avoidance Of Double Taxation And The Prevention Of Fiscal Evasion With Respect To Taxes On Income,' op. cit., para. 1

UK.[160] Paragraph 2(2) limits the amount of the double taxation relief to the amount of such income so remitted.

Paragraph 3 of the Treaty provides that the industrial or commercial profits of a Contracting State enterprise shall not be subject to tax in the other Contracting State unless the enterprise is engaged in trade or business in the other Contracting State through a permanent establishment situated therein. If it is so engaged, tax may be imposed on those profits the other Contracting State but only on so much of them as is attributable to that permanent establishment. This is a standard provision and is not dissimilar to Article 7 of the 1992 OECD Model Treaty.

Paragraph 4 of the Treaty contains an anti-avoidance 'arm's length' provision. It provides that where an enterprise of one of the territories participates directly or indirectly in the management, control or capital of an enterprise of the other territory (or the same persons participate directly or indirectly in the management, control or capital of an enterprise of one of the territories and an enterprise of the other territory), then any profits which would but for these conditions have accrued to one of the enterprises but by reason of those conditions have not so accrued may be included in the profits of that enterprise and taxed accordingly.

The UK:Jersey Treaty combines in Paragraph 7 what are now Article 14 (Independent Personal Services), Article 15 (Dependent Personal Services) and

[160] ICTA 1988, s. 65

Article 17 (Artistes and Sportsmen) of the 1992 OECD Model Treaty. Paragraph 7 provides:

> *"(1) An individual who is a resident of the United Kingdom shall be exempt from Jersey tax on profits or remuneration in respect of personal (including professional) services performed within Jersey in any year of assessment if--*
> *(a) he is present within Jersey for a period or periods not exceeding in the aggregate 183 days during that year, and*
> *(b) the services are performed for or on behalf of a person resident in the United Kingdom, and*
> *(c) the profits or remuneration are subject to United Kingdom tax.*
> *(2) [As (1) with Jersey substituted for United Kingdom and vice versa]*
> *(3) The provisions of this paragraph shall not apply to the profits or remuneration of public entertainers such as stage, motion picture or radio artists, musicians and athletes."*

It is this provision that allows tax planning opportunities. As discussed above, in section 4.4.2, the absence of the equivalent to of Paragraph 2 to Article 17 in the 1992 OECD Model Treaty, permits the tax efficient use by a performer of a service company to provide his services. By using a service company, the performer would not be self-employed, but rather employed by his service company. Therefore Paragraph 7 would only apply to him in respect of his employment income. The gross income earned by the company would escape charge to tax in the source country under Paragraph 3 provided it did not have a permanent establishment in the source country.

Coupled with this opportunity is the absence of an anti-treaty shopping in the UK:Jersey Treaty. This raises the question of the degree to which a non-resident performer could make use of a Jersey service company in respect of his performances in the UK and use the UK:Jersey Treaty to receive his gross income free of UK taxation. This question turns on whether the UK:Jersey Treaty takes precedence over section 555 ICTA 1988, introduced by the Finance Act 1986, under which withholding tax must be applied to payments made to non-resident sportspeople and entertainers performing in the UK and their service companies.

The Inland Revenue has no doubt that tax must be withheld under the provisions, irrespective of the ultimate tax burden. Their publication FEU 50, a 'Payer's Guide' to assist those who make payments to non-resident performers (see Chapter 1, section 1.6.5), states: "Even if payments you withhold tax from may not ultimately be assessed on the recipient (for example, because they are protected by a Double Taxation Agreement) you must not exclude these payments from the scheme."[161]

There is doubt, however, over whether in the circumstances outlined above the Jersey-based service company ultimately escapes UK taxation. There are in essence two views. One, which favours the Revenue, argues that under s. 556(2) ICTA 1988 the income of a service company, wherever situated, is deemed to be that of the performer. As such, Paragraph 7(3) of the UK:Jersey Treaty is sufficient for the whole of the Jersey-based service company's income to fall in charge to UK taxation as the income of the performer. The other view is that the UK:Jersey Treaty provisions take priority over the s. 556(2) ICTA 1988 deeming provision because the provision did not specifically override UK treaty obligations. In these circumstances the absence of a permanent establishment of the Jersey-based company in the UK entitles it to the full benefit of Paragraph 3, which exempts it from tax in the UK.[162]

The UK has similar treaties, giving rise to similar issues, with the offshore financial centres of Guernsey,[163] the Isle of Man[164] and Belize,[165] entered into in 1947 when Belize, then British Honduras, was a UK colony.

4.9.2 The Netherlands Antilles: The Netherlands

Another offshore financial centre that has a Double Taxation Treaty with a similar centre in the same geographic locality and a country with which it has had a long political association is the Netherlands Antilles.[166] This OFC has a Double Taxation Treaty with, inter alia, Aruba and the Netherlands. Technically, the arrangement the Netherlands Antilles, Aruba and the Netherlands falls short of a Double Taxation Treaty. The three self-governing countries together form the

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[161] FEU 50 para. A8

[162] Both points of view are expertly discussed in D. Sandler The Taxation of International Entertainers and Athletes The Hague, Kluwer Law International (1995) pp 209-225.

[163] Signatories: Guernsey, United Kingdom; Citations: 93 TNI 251-211; Doc 93-31611; Signed: June 24, 1952; In Force: October 24, 1952; Title: 'Agreement For The Avoidance Of Double Taxation And The Prevention Of Fiscal Evasion With Respect To Taxes On Income.'

[164] Signatories: Isle of Man, United Kingdom; Citations: 93 TNI 123-39; Doc 93-31488; Signed: July 29, 1955; In Force: July 29, 1955; Title 'Arrangement For The Avoidance Of Double Taxation And The Prevention Of Fiscal Evasion With Respect To Taxes On Income.'

[165] Signatories: British Honduras (now Belize), United Kingdom; Citations: 93 TNI 251-194; Doc 94-30380; Signed: December 19, 1947; In Force: January 21, 1948; Title 'Arrangement For The Avoidance Of Double Taxation And The Prevention Of Fiscal Evasion With Respect To Taxes On Income.'

[166] The Netherlands Antilles consist of a group of islands off the coast of Venezuela that include Bonaire, Curacao, Saba, St. Eustalius and St. Martin.

Kingdom of the Netherlands,[167] and the 'treaty' is described as a 'Tax Arrangement For The Kingdom Of The Netherlands.'[168] Nevertheless, the Arrangement has the same effect as a double taxation treaty and will be referred to as such in this section.

One of the first notable characteristics of this treaty is that, in contrast to most double taxation treaties, it is trilateral in nature: the single treaty covers the Netherlands, the Netherlands Antilles and Aruba.

The treaty follows the usual rules regarding the taxation of an enterprise engaged in business in one of the other treaty countries, albeit in unfamiliar language. Article 5, Paragraph 1, provides:

> *"Profit attributed to an enterprise - not arising from income from immovable property - received by a resident of one of the countries shall be taxed if and in as far as the profit is attributed to a permanent establishment situated in that other country."*

Paragraph 2 of Article 5 stipulates that the profits attributed to a permanent establishment shall be adjusted to reflect the profit the permanent establishment should have enjoyed if it were an independent enterprise performing the same or similar activities under identical or similar circumstances. However, interest and

[167] Aruba, previously part of the Netherlands Antilles, became autonomous on 1 January 1986, though remaining within the Kingdom of the Netherlands.
[168] Signatories: Netherlands; Netherlands Antilles; Aruba (BRK); Citations: 98 TNI 9-37; Doc 98-1703; Signed: October 28, 1964; In Force: January 1, 1965; Title: 'Tax Arrangement For The Kingdom Of The Netherlands'

royalties arising between the enterprise and the permanent establishment are not taken into consideration in the computation of taxable profit.

The Article on entertainers and athletes, Article 9, though similar in intent to Article 17(1) of the OECD Model Treaty, differs in its execution. It provides:

> *"Profit attributed to an enterprise that is received by a resident of one of the countries in his function as a musician, artist or as an athlete in one of the other countries is deemed to be earned with the assistance of a permanent establishment within that other country."*

This is an interesting formulation of the rule that artistes and athletes may be taxed in the Contracting State in which their activities are exercised. It is, in effect, a deeming provision. Artistes and athletes under this Article are deemed to have a permanent establishment in the country in which they perform thereby triggering Article 5 which permits the source country to tax the profits of an enterprise attributable to a permanent establishment situated within in borders. This simple formulation would at first appear to be a very effective anti-avoidance provision for it seems to be equivalent not only to Article 17(1) of the OECD Model Treaty but also to Article 17(2), insofar as the "profit attributed to an enterprise" could be held to include the profits of the performer's service company. The term 'enterprises' is defined in Chapter I of the Treaty as "independent professional services,"[169] though from its context this clearly includes companies, for 'persons' is defined in the Treaty as "individuals and

[169] Tax Arrangement For The Kingdom Of The Netherlands, op. cit., Article 2(5)(a)

enterprises,"[170] and 'permanent establishment' is defined as "a fixed place of business through which the business of an enterprise - i.e. independent professional services - is carried out."[171] If therefore an enterprise includes both a personal and corporate trading vehicle, the Article as drafted prevents the effective use of a service company within the countries forming the Kingdom of the Netherlands.[172] It is submitted that Article 9 offer a potentially valuable lesson in drafting the Artistes and Athletes provision in double taxation treaties throughout the world.

It must be emphasised that Article 9 relates only to performances by artistes and sportspeople in the Netherlands, the Netherlands Antilles and Aruba. The Article in no way relates to the use by non-resident performers of an offshore service company or, more accurately, licensing company for the purposes of receiving royalty income in a tax efficient manner.

The Kingdom of the Netherlands Treaty follows established convention in its treatment of royalty income. Article 14(1) provides:

> *"Royalties received by a resident of one of the countries and payable by a resident of another country shall be taxed in the first mentioned country."*

[170] Ibid., Article 2(1)(b)
[171] Ibid., Article 2(1)(e)
[172] Paradoxically, for a treaty involving two offshore financial centres!

The definition of royalties is also similar to that in the OECD Model Treaty.[173] Obtaining royalty income without withholding taxes in the Netherlands Antilles from a conduit licensing company in the Netherlands has featured in tax minimisation plans for performers. The degree to which anti-treaty shopping and limitation on benefits provisions restrict such arrangements from UK and US perspective has been discussed above. The focus here will be on determining the extent to which offshore Netherlands Antilles companies may benefit under the Kingdom of the Netherlands Treaty.

As mentioned above, in another context, Chapter 1 of the Treaty defines 'persons' as "individuals and enterprises."[174] The term 'enterprises,' though defined as "independent professional services,"[175] from its context includes companies. 'Companies,' in turn, are defined as "corporate bodies, societies or corporations, other associations of individuals, public corporations and target capital."[176] Finally, he term 'resident of one of the countries' is defined as "a person who, under the taxation laws of one of the countries, has his residence or establishment located there."[177]

[173] Ibid., Article 14(2) *"The term 'royalties' as used in this article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of scientific, literary, theatrical or musical work, from a patent, trade mark, a design or model, a plan a secret formula or process, as well as for the use of, or the right to use, commercial or scientific equipment and for information concerning commercial or scientific experience. The term "royalties" does not mean royalties that, by virtue of article 4, are considered income from immovable property."*

[174] Ibid., Article 1(b)

[175] Ibid., Article 2(5)(a)

[176] Ibid., Article 1(c)

[177] Ibid., Article 1(d)

A company is resident under the taxation laws of the Netherlands Antilles if it is incorporated in the Netherlands Antilles, irrespective of the place of its effective management and control, or, if incorporated abroad, has its effective management and control located within the Netherlands Antilles.[178] 'Offshore companies' as a genus are not legally defined under Netherlands Antilles law, but they generally accepted to be companies incorporated in the Netherlands Antilles, owned by non-residents and deriving income from sources outside the Netherlands Antilles.[179]

There is no anti-treaty shopping or limitation on benefits provisions in the Kingdom of the Netherlands Treaty. Moreover, the Netherlands Antilles has no general anti-avoidance legislation. It follows that an offshore Netherlands Antilles company, being incorporated and therefore resident in the Netherlands, is entitled to all the benefits under the Kingdom of the Netherlands Treaty.

Returning specifically to the offshore Netherlands Antilles licensing company, which is specifically defined under the Netherlands Antilles legislation,[180] such companies are subject to tax at the rates of 2.4% to 3% unless otherwise provided

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[178] CCH International Tax Planning - Offshore Financial Centres Howarth International (1999) ANT 1-040(b)(2)

[179] Ibid., 1-060(a)

[180] "Offshore licensing companies" are defined in art 14A of the *National Ordinance on Profit Tax* 1940 (as amended) as follows:
"A corporation ..., which exclusively or almost exclusively makes it its business to acquire:
(a) Revenues derived from the alienation or leasing of the right to use copyrights, patents, designs, secret processes or formulae, trademarks and other analogous properties;
(b) Royalties, including rentals, in respect of motion picture films or for the use of industrial, commercial or scientific equipment as well as to the operation of a mine or a quarry or of any other extraction of natural resources and other immovable properties;

by treaty. The tax planning opportunities this provides for the royalty earning sportsman and entertainer is obvious, though such opportunities are subject to the anti-treaty shopping or limitation on benefits of the source countries within whose jurisdiction the royalties originally arise. This will be explored in more detail in the Case Studies in Chapter 4.

4.9.3 The British Virgin Islands: TheUnited States

Given the recent uncompromising stance of the US against treaty shopping, it comes as no surprise that they cancelled their double taxation convention with the Netherlands Antilles in 1987. The original Convention, between the US and the Kingdom of the Netherlands, was signed in 1948, and extended to the Netherlands Antilles in 1955. Some years earlier the US terminated their double taxation agreement with the British Virgin Islands (BVI) after less than two years.[181] This 1981 Convention replaced the then existing tax treaty entered into with the UK in 1945 and extended to the BVI in 1959. In his Letter of Submittal to the Senate, [182] President Regan emphasised that the new Convention took into account the modernization of tax treaties and was based primarily upon the US and the OECD model tax treaties published in 1977. Moreover, in order to reduce the use made of the proposed convention by third country residents, it deviated from the model

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(c) Considerations paid for technical assistance, received from outside the Netherlands Antilles. "

[181] Signatories: British Virgin Islands, United States; Citations: 94 TNI 252-178; Doc 94-30748; Senate Treaty Doc. No. 97-6; Signed: February 18, 1981; Status: Unperfected; Titile: 'The Convention Between The Government Of The United States Of America And The Government Of The British Virgin Islands For The Avoidance Of Double Taxation And The Prevention Of Fiscal Evasion With Respect To Taxes On Income, Together With A Related Note From The Government Of The British Virgin Islands, Signed At Washington On February 18, 1981'

treaties by placing, inter alia, a ceiling rate of tax at source dividends,[183] interest[184] and royalties[185] of 15%. In addition, in an Exchange of Notes the government of the BVI formally stated that they understood that the US would not have agreed to the Convention unless it was granted access to financial information in the BVI in order to prevent fraud or evasion of United States taxes, granted under Article 25 of the Convention,[186] and that any hindrance of such access, including any change in this area in the BVI's domestic legislation, would result in the US terminating the Convention.

These safeguards proved not to be sufficient in the anti-treaty shopping climate of the US. Six months after President Regan's Letter of Submittal to the Senate,[187] the Assistant Secretary of the Treasury for Tax Policy, John E. Chapoton, wrote to the Senate Committee on Foreign Relations expressing concern over the Convention.

> *"With respect to Cyprus and the British Virgin Islands, our desire to amend the treaties has come about as a result of our review of*

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[182] Dated 30 March 1981.
[183] British Virgin Islands: United States Unperfected 1981 Tax Convention, op. cit., Article 10
[184] British Virgin Islands: United States Unperfected 1981 Tax Convention, op. cit., Article 11
[185] British Virgin Islands: United States Unperfected 1981 Tax Convention, op. cit., Article 12
[186] Paragraph 1 of Article 25, headed 'Exchange Of Information And Administrative Assistance,' provided: *"The competent authorities of the Covered Jurisdictions shall exchange such information (being information available under the respective taxation laws of the Covered Jurisdictions) as is necessary for carrying out the provisions of this Convention or for the prevention of fraud or the administration of statutory provisions against legal avoidance in relation to the taxes which are the subject of this Convention. Any information so exchanged shall be treated as secret but may be disclosed to persons (including a court or administrative body) concerned with the assessment, collection, administration, enforcement or prosecution in respect of taxes which are the subject of this Convention. No information shall be exchanged which would disclose any trade, business, industrial or professional secret. Such persons shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial proceedings. No such information shall be disclosed to any third Jurisdiction for any purpose."*
[187] On September 15, 1981.

these treaties in preparation for hearings. Both of these jurisdictions are tax havens. The pending treaties with both were designed to prevent, or at least limit the extent to which residents of third countries can use these treaties, in conjunction with favorable internal law provisions in those jurisdictions, to receive U.S. treaty benefits. We have concluded, on the basis of our review of these treaties that the opportunities which potentially remain for such use are too great for us to tolerate... [I]f satisfactory negotiations are not concluded by early 1982, the Administration intends to serve notice of termination of the existing treaty in accordance with its terms. In such event, termination would be effective January 1, 1983."

The Senate Committee returned the BVI Convention to the President for re-negotiation, fully supporting the objective of a meaningful anti-treaty shopping provision and the termination of the existing treaty with the BVI if a more satisfactory agreement could not be achieved by the deadline specified. The negotiation proved unsuccessful, resulting in the termination of the treaty.

4.10 MULTILATERAL TAX TREATIES

Although the concept of a worldwide multilateral treaty was rejected as unachievable as long ago as 1928 by the League of Nations, as discussed in section 5.1 above, a limited number of multilateral Tax Treaties, usually based on political association, geographical area or a single issue, have been agreed over the years. An example of a multilateral treaty based on political association is the Kingdom Of The Netherlands Treaty discussed in section 5.7.2 above. An example of a multilateral treaty based on geographical area is the Tax Treaty of the Nordic Countries,[188] whose signatories are Denmark, Faroe Islands, Finland, Iceland, Norway and Sweden. The treaty is similar in most respect to a bilateral treaty, with the provisions of primary relevance to this work, 7, 14, 15 and 17, broadly following the OECD Model. Interestingly, Article 17 has an additional, third paragraph, which provides:

> *"The provisions of paragraphs 1 and 2 [which follow the OECD Model] do not apply to income attributed to the activities of an entertainer or athlete who is a resident of a Contracting State ... if the visit to the other Contracting State is supported primarily by public funding from the first State. In such case, income shall only be taxed in the first State."*

This is not a departure from the 1992 OECD Model. The Commentaries specifically state that countries are free to include a provision to exclude from the scope of Article 17 from events supported from public funds. The only stipulation of the Commentaries is that such an exemption should be based on clearly definable and objective criteria so as to ensure that it is granted.[189] It is true that the draft provision in the Commentaries refers to the performance being "wholly or mainly supported by public funds," whereas the Nordic Treaty refers to the performance being "primarily" supported by public funds. It could be argued that "wholly or mainly" is quantitative in nature, whereas "primarily" is qualitative in nature. However in the context of treaty interpretation, the Nordic

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[188] Signatories: Denmark, Faroe Islands, Finland, Iceland, Norway, Sweden [Nordic Countries]; Citations: 98 TNI 9-25; Doc 98-1713; Signed: September 23, 1996; Title: 'Convention Between The Nordic Countries For The Avoidance Of Double Taxation With Respect To Taxes On Income And On Capital.'

[189] OECD 1992 Model Convention Commentary on Article 17 para. 14

Treaty wording is not to be considered a material departure form the OECD text.[190]

An example of a multilateral treaty based on a single issue is the Multilateral Convention on Mutual Administrative Assistance in Tax Matters (MAAT), concluded by the member states of the Council of Europe and the member states of the OECD in 1988.[191] The MAAT provides for the multilateral exchange of information and mutual administrative assistance in recovering tax claims in participating countries. Article 1(2) of MAAT provides that the administrative assistance under the Treaty shall comprise the exchange of information, including simultaneous tax examinations and participation in tax examinations abroad,[192] the assistance in recovery, including measures of conservancy,[193] and the service of documents.[194] Moreover, it is provided that a party to the Treaty shall provide administrative assistance whether the person affected is a resident or national of the party State or of any other State. Thus information regarding transactions involving companies, trusts and individuals resident in offshore financial centres will be exchanged under the MAAT.[195]

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[190] See section 4.5

[191] Parties: OECD/CE; [Organization for Economic Cooperation and Development; Council of Europe]; Denmark; Finland; Iceland; Netherlands; Norway; Sweden; United States; Citations: 90 TNI 26-52; Doc 93-31219; Signed: January 25, 1988; In Force: April 1, 1995; Title: 'A Convention Negotiated By The Member States Of The Council Of Europe And The Organization For Economic Co-Operation And Development (OECD) On Mutual Administrative Assistance In Tax Matters.'

[192] Ibid., Article 1(2)(a)

[193] Ibid., Article 1(2)(b)

[194] Ibid., Article 1(2)(c)

[195] This is clear from the example set out in paragraph 21(a) of the Commentary to MAAT, which elucidates the provision that a person who is liable to tax in a Party State cannot prevent that Party State from obtaining assistance from another Party State on the grounds that he is not a national, or a resident, of one or other of the two Party States, as follows: For example, assume that States

The preamble to the MAAT opines that "the development of [the] international movement of persons, capital, goods and services - although highly beneficial in itself - has increased the possibilities of tax avoidance and evasion and therefore requires increasing cooperation among tax authorities." The Convention was the first multilateral tax treaty of its kind, and is open to ratification, acceptance, or approval by any of the member States of the Council of Europe or the OECD. It was to enter into force three months after the first five States have expressed their consent to be bound by its provisions. This occurred on 1 April 1995. The current signatories are Denmark, Finland, Iceland, Netherlands, Norway, Sweden and the United States.

The MAAT is the first multilateral tax treaty to which the United States is a party. It serves as a milestone in the development of international cooperation in the tax area and has the potential to create an effective network of parties providing administrative assistance to each other, thereby facilitating multinational enforcement of tax claims to reach new levels of sophistication.[196] This should not of itself inhibit legitimate international tax planning for sportspeople and entertainers, with or without the use of offshore financial centres. However, the

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A, B, and C but not States D and E have signed the Convention. A company in State D has branches in States A, B, and E. The branch in the latter State covers the market in State C through an independent third party. Under the proposed Convention, States A, B, and C can exchange information on prices paid to the State D company by the branches in States A and B and also as to the prices paid to the branch in State E by the independent party in State C, even though the branch in State E is neither a national nor a resident of any of the Parties to the Convention.

[196] S. C. Evans 'U.S. Taxation Of International Athletes: A Reexamination Of The Artiste And Athlete Article In Tax Treaties,' George Washington Journal of International Law & Economics, 29 GW J. Int'l L. & Econ. 297, section III(B) 'Multilateral Tax Treaties'

present anti-treaty shopping climate is such that multilateral cooperation under the MAAT Treaty may be seen by some as an extension of the anti-avoidance legislation of each of the signatory countries.

4.11 CRITIQUE OF ARTICLE 17

It has been suggested that the primary defects of Article 17 are its imprecision, its incompleteness, and its inconsistency.[197] The imprecision, it is argued, stems from the Article's failure to identify a specific method of computing the amount the athletes actually earned in each source country, other than by the domestic laws of each source country; the incompleteness is highlighted by the failure of the Article to take into account state taxes in a federal system of government, notably the US; and the inconsistency is demonstrated by the variations of Article 17 found in the various bilateral treaties.[198] These shortfalls, it has been contended, create serious burdens for both the non-resident athletes and entertainers, and the tax authorities in the areas of compliance, administration, and enforcement.[199] These burdens, in turn, the argument proceeds, result in negative consequences

[197] S. C. Evans, op. cit., section IV(A)(2) 'Shortcomings of the Artiste and Athlete Article '

[198] These inconsistencies occur not only between bilateral treaties featuring different countries. The US, for example, vary the threshold exemption amount from country to country.

[199] "*The U.S. tax treatment of the foreign athletes who participated in the 1994 World Cup, held in the United States, exemplifies the shortcomings and weaknesses of the Artiste and Athlete Article. From an international soccer player's perspective, payment of U.S. income tax was not a priority. As a result, a foreign athlete may not have complied with U.S. tax laws or may have understated earnings to fall within the threshold exemption amount under the applicable tax treaty. From the U.S. tax authorities' perspective, each non-resident athlete who competed and performed in a game potentially incurred federal income tax liability on earnings in the United States. To compute the U.S. tax liability of each foreign athlete, every applicable tax treaty with every country represented by a foreign athlete had to be analyzed because every article differs to some extent. The administrative burden of processing multiple individual tax returns, and the enforcement burden of dealing with athletes' noncompliance with tax laws compounded the*

for the source country. First, they may discourage athletes and entertainers from participating in performances held in particular countries, and, should this be the case, the Article would simultaneously defeat the country's interest in gaining prestige, recognition, and revenue associated with hosting international sporting and entertainment events. The argument proceeds to propose a twofold solution: (1) the Article should be contained in a multilateral agreement, not bilateral treaties; and (2) the Article should specifically delineate a uniform tax treatment of foreign athletes with no threshold exemption amount.[200]

The criticisms are not unsound, but they are based to a large degree on the premise that double taxation treaties in general, and Article 17 in particular, can achieve precision, completeness and consistency. This is difficult enough to achieve in a homogenous domestic tax system; it is virtually impossible in a bilateral treaty, based on a single model, between two countries with different tax systems. Tax legislation, certainly in common law countries, though it strives for consistency, tends to leave precision and completeness to the courts.

As regards the proposed solution, it is true that a multilateral agreement on Article 17 with a uniform tax treatment would render the choice of an athlete or entertainer as to where to perform a tax neutral one. Even if this is considered a desirable aim, which the author does not, the question arises as to why it should apply to the performances of sportsmen and entertainers, rather than any other

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difficulty of this task." S. C. Evans, op. cit., IV(A)(2) 'Effect of the Article's Shortcomings'

[200] For the full argument, persuasively presented, see S. C. Evans, op. cit.

international movement of goods and services.

The truth is that Article 17 has never been concerned with the elimination of double taxation, but rather the collecting of revenue in the country of source. Once this is recognised it is clear that any attempt to delineate a uniform tax treatment of foreign athletes through a multilateral Article 17 treaty would raise seemingly insurmountable issues of fiscal sovereignty. Countries use their tax system, inter alia, to attract (or discourage) the movement of specific goods and services. It is highly unlikely, and it is submitted undesirable, that countries surrender this sovereignty as it pertains to the taxing of non-resident performers in the interests of a uniform multilateral Article 17.

Taxation is a legitimate means of a nation state competing for resources, be they labour or capital.[201] In the case of attracting sporting or entertainment events this could include the waiving or rebating of taxation on the income of non-resident performers (no different, in essence, from the tax breaks for foreign companies setting up in industrial enterprise zones). Countries should be free in this area. It is an important constituent part of the nature of sovereignty. The delineation of a uniform tax treatment of foreign athletes in the form of a multilateral Article 17 would serve only to restrict a form of international competition for the services of athletes and entertainers.

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[201] "*Governments, aware of the mobility of investment capital, engage in international tax competition. They seek to make their own countries as favorable for investment as possible in order to enhance economic growth and promote employment.*" S. M. Haug, op. cit., p. 203

4.12 CONCLUSIONS

The issue of sovereignty should be a key component of discussions about double taxation treaties, just as it should inform the debate over 'harmful tax competition' discussed in Chapter 3. There is a difference, however, between applying political and economic pressure on offshore financial centres, as recommended by the leading reports on the 'harmful tax competition' debates,[202] and drafting bilateral tax treaties in such a way as to prevent third countries, whether OFCs or not, from benefitting under their provisions, the latter being a more legitimate activity.

The principal provisions affecting sportspeople and entertainers in double taxation treaties, Articles 12 and 17, have been through changes and now appear to be relatively fixed in their wording and application. The benefits under Article 12, however, will increasingly be strictly limited to members of the Contracting States. It is clear that limitation on benefits provisions are likely to become more prevalent in future tax treaties, if only because of the substantial influence in this area of the US.

[202] See Chapter 3, sections 3.7.1 and 3.7.2.

CHAPTER 5

CASE STUDIES

5.1 INTRODUCTION

This chapter seeks to consolidate chapters 1, 2, 3 and 4 by applying the relevant UK tax law, the US tax law and relevant double taxation treaties, as they apply to sportspeople and entertainers, together with the tax and regulatory framework of offshore financial centres, to original, individual case studies. The case studies explore the efficacy of using offshore financial centres in tax planning for the sports person or entertainer from a UK and US perspective. Each case study is original and the details of each case study have been designed to elucidate, confirm and expand the discussion in the previous chapters.

The first case study involves an actress, whose home is in an offshore financial centre, using an offshore service company for her work in the UK. It addresses a range of tax issues including residence, ordinary residence, the recognition and residence of the offshore company, the actress's possible role as a taxable UK resident agent of her offshore service company and the application of the anti-avoidance provision s. 739 icta 1988. Case Study II involves the actress using the offshore service company for her work in the US. As with Case Study I, this case study examines the consequences of the absence of a double taxation treaty between the country in which the performance takes place, in this case the US, and the country of residence of the supplier of the performance, the offshore service company. The case study addresses issues of the actress's residence, whether she could be held to be an employee of the US principal, whether the offshore company could be ignored as a sham, the application of withholding tax, and the US anti-avoidance provision s. 482 and 269A of the Internal Revenue Code 1986 (as amended).

Case Study III concerns a UK born, UK resident, but Jamaican domiciled, professional boxing champion seeking to use an offshore structure to defer taxation on his endorsement and personality merchandising income from the US. This case study includes a discussion of the law of domicile, tax planning ideas for using a UK service company in the US, consideration of how to maximise the royalty element of income generated, and a practical example of treaty shopping and the use of offshore limited partnerships for non-domiciliaries.

Case Study IV involves a UK based four-piece rock band, who are about to record a new album and tour the United States, and their manager. The tax consequences of composing the new tracks for the album offshore and recording offshore are considered in this case study. The UK:US Double Taxation Treaty is applied to income generated by the tour. The band members are discussed individually, to highlight different issues. For the non-domiciliaries, offshore trusts are considered for the holding of intellectual property rights.

5.2 CASE STUDY I

The first case study involves an actress resident in an offshore financial centre using an offshore service company for her work in the UK. A key aspect of this case study is the absence of a double taxation treaty between the UK and the performer's country of residence. Subsequent case studies will examine the operation of double taxation treaties in circumstances where the resident of a treaty country seeks to use an offshore vehicle in his or her tax planning strategy. Case Study I focuses on how the UK provisions apply an offshore financial centre resident supplying acting services through an offshore service company.

There is a long tradition of sportspeople and entertainers becoming residents of offshore financial centres. Tennis champions Bjorn Borg[1] and Boris Becker established tax residences in Monaco, a favoured offshore financial centre for successful performers. Formula One racing drivers Jacques Villeneuve and David Coulthard are Monaco residents.[2] The world famous tenor Luciano Pavarotti maintained in recent years that he was a resident of Monaco (though in 1999 the Italian appellate courts held him to be resident in Italy, resulting in a substantial

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[1] Z. Heller 'Bjorn Again' The Independent, 21 April 1991, The Sunday Review Page, p. 2. The article contained this familiar sketch of a performer's success: "*He carried on winning. And with his success came the usual things. There was fame - which travelled beyond the confines of the tennis circuit to make him not just a tennis star, but an international icon. (Nowadays, his name and face evoke the atmosphere of the Seventies just as surely as do those of John Travolta and Bianca Jagger.) There was money - although inevitably it was not the winnings but the endorsement contracts that brought in the really staggering sums. In fact there was enough money, finally, to send him scurrying away from Sweden to a tax haven in Monaco, where he set his parents up with a sports shop. And there was the terrible, lonely business of having to stay at the top.*"

[2] G. Donaldson 'F1 Drivers Grind It Out Amidst Monaco's Glitter' The Toronto Star, 22 May 1998

tax liability).[3] The Channel Islands are also a preferred offshore financial centres for performers. International golfers Ian Woosnam and Tony Jacklin are resident in Jersey, as are the TV broadcaster Alan Whicker, the pop star Gilbert O'Sullivan and the actor John Nettles.[4]

The use of the service or loan out company for performers is well established. This has been examined from a UK perspective in Chapter 1 and from a US perspective in Chapter 2. To summarise, a service company may be used to defer taxation, regularise a performer's income and defeat employee status. It also creates pension and other benefits, including limited liability.

5.2.1 The Actress and her Offshore Service Company

Carol is an actress, a national and resident in the Cayman Islands, who has recently landed a part in a London based long running soap opera. She has a Cayman incorporated service company, Caymanco Limited, a Cayman exempted company,[5] set up before this assignment, her first in the UK, which has contracted to loan out her services to the UK television company producing the soap opera, TVCo. TVCo agrees to pay Caymanco direct under the loan out contract, which stipulates that TVCo has the right to Carol's services for a period of two years cancellable at TVCo's option only. Under a separate contract between Caymanco and Carol, Caymanco agrees to pay Carol a salary in the UK that amounts to 50%

[3] 'Names & Faces' The Washington Post, April 28, 1999, p. C03
[4] J. Moir 'The Wad Squad' The Observer, 24 March 1996, The Observer Life Page, p.18

of the contract value. The remaining 50% will be retained and invested by Caymanco in a tax free environment.

5.2.2 Residence, Ordinary Residence and Domicile

The first question concerns Carol's residence. There can be little doubt that Carol will be treated as being UK resident from the day of her arrival in the UK. The Revenue, on the application of IR20,[6] will deem UK residence to arise by virtue of her two year contractual commitments in the UK.[7] Though IR20 has no force of law, there would be no common law basis on which to challenge this decision as by any ordinary use of the term, and in the absence of a statutory definition the ordinary usage of the term is the relevant test,[8] Carol would be 'resident' in the UK.

The second, and more contentious, question is whether Carol is ordinarily resident in the UK. Inland Revenue practice, as set out in IR20, would, prima facie, fail to treat Carol as ordinarily resident. IR20 states that a person will be treated as ordinarily resident in the UK, whether or not he or she works here, if it is clear that the person intends to stay for at least three years. The only exception to this rule is where the person buys accommodation or acquires accommodation on a lease of three years or more. Should this occur the person is deemed to be

[5] For details of the Cayman exempted company see Chapter 3, section 3.3.4.3.
[6] See Chapter 1, section 1.6.2. Technically, Carol should be treated as resident from 6 April of the first year in the UK, but by extra-statutory concession A11, the Revenue allow the tax year to be split enabling an individual to be resident in the UK for part of a tax year.

ordinarily resident from the beginning of the tax year in which the accommodation is brought or leased.[9] Carol's contract is for two years and, assuming she has no intention of remaining in the UK for a year after the expiry of her contract, and that she neither buys nor leases accommodation on the basis set out above, she will not be UK ordinarily resident during her contractual term. Under these same guidelines, even if Carol were to remain in the UK for a three year period, provided this was not her intention during the three year period and she had steered clear of the aforementioned accommodation rule, she would become ordinarily resident in the UK only from the beginning of the tax year commencing on the third anniversary of her arrival. This would leave the tax advantages of being not ordinarily resident in the UK during her two year contract unaffected.

It would be both unfair and unreasonable for the Inland Revenue to depart from their own published guidance notes. However, they are entitled to do so and they include in the preface to IR20 the proviso that "whether the guidance is appropriate in a particular case will depend on all the facts of that case." Should the Revenue choose to challenge Carol's not ordinarily resident status, they will find substantial case law support.

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[7] IR20, para. 3.7
[8] See *Levene v IRC* [1928] A.C. 217, discussed in Chapter 1, section 1.6.2.
[9] IR20, para. 3.9

The most relevant supporting case, albeit that it deals with a situation that was virtually the reverse of Carol's, is *Reed v Clark*.[10] In this case the taxpayer, Dave Clark, of the rock band the Dave Clark Five, sold the copyright of a collection of the band's recordings in December 1977 for US$450,000 and spent the 1978/79 fiscal year in the US in order to avoid tax in the UK on the receipt. The issue before the court was whether the taxpayer could be classed as resident or ordinarily resident in the UK in 1978–79, and therefore liable to pay income tax, even though he was in the USA throughout that year.

The Special Commissioners considered that he could not be so classed. They found that the taxpayer's business activities had previously taken him, and continued to take him, to America every year for varying periods. They further found that when the taxpayer left the UK on 3 April 1978, not returning until 2 May 1979, he had work ahead of him which could occupy him for 12 months in America and did so occupy him. It was the view of the Special Commissioners that on that visit the taxpayer established himself in a way which would have made him both resident and ordinarily resident in the US under UK tax rules.

The High Court agreed. Nicholls J, having quoted Lord Scarman's observations on the meaning of 'ordinary residence' in the House of Lords decision in *R. v*

[10] [1985] BTC 224

Barnet London Borough Council, Ex parte Shah,[11] set out and discussed in Chapter 1 section 1.6.3,[12] went on to say:

> *"In this case there was a distinct break in the pattern of Mr. Clark's life which lasted (as from the outset he intended) for just over a year. He ceased living in London and for that year he lived in or near Los Angeles, mostly in one fixed place of abode, and he worked from there. For that year Los Angeles was his headquarters. He did not visit this country at all. On the whole I do not think that he can be said to have left the United Kingdom for the purpose only of occasional residence abroad. In my judgment the conclusion of the Commissioners on this was correct."*[13]

If it is possible for an individual to become ordinarily resident under UK tax law for just one year's presence, this begs the question as to the applicability or reliability of IR20 in determining matters of ordinary residence. Counsel for the Crown in *Reed v Clark* put this very question to the Court, and received a rather brusque response from Nicholls J for his troubles.

> *"[I]n their conclusion the Commissioners found that Mr. Clark established himself in America in a way which would have made him resident and ordinarily resident there 'under United Kingdom tax rules'. Before me the submissions included controversy on whether this was a correct conclusion to draw from the contents of the Inland Revenue's published booklet (IR 20) on residents' and non-residents' liability to tax in the United Kingdom. Having regard to what I have said above I do not see how this booklet affects any matter I have to decide, and accordingly I propose to say nothing on this point."*[14]

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[11] [1983] 2 A.C. 309

[12] *"Unless, therefore, it can be shown that the statutory framework or the legal context in which the words are used requires a different meaning, I unhesitatingly subscribe to the view that 'ordinarily resident' refers to a man's abode in a particular place or country which he has adopted voluntarily and for settled purposes as part of the regular order of his life for the time being, whether of short or of long duration."* [1983] 2 A.C. 309 at p. 343

[13] [1985] BTC 224 at p. 247

[14] [1985] BTC 224 at p. 247

It is therefore not possible to be definitive about Carol's status regarding her ordinary residence. The application of the IR20 rules would render her not ordinarily resident in the UK. Case law, however, would appear to support the proposition that she became ordinarily resident in the UK at the commencement of the fiscal year in which she arrived in the UK, or, by concession, on the date of her arrival. Both positions will be examined as this Case Study assesses the effect of Caymanco on the exposure to UK taxation.

Finally, there is the question of Carol's domicile. The rules relating to an individual's domiciliary are set out in Chapter 1, section 1.6.4. A detailed review of these rules is unnecessary for this Case Study. Carol has a non-UK domicile. She is domiciled in the Cayman Islands.

5.2.3 Carol's Salary

Given Carol's UK residence and the fact that her employment duties are performed in the UK, the salary payable to her by Caymanco will fall in charge to UK taxation. Indeed, as Carol's employer, Caymanco would have to deduct from her salary income tax and national insurance contributions at source and pay the amounts deducted over to the Inland Revenue under the UK's Paye system, which does not discriminate between resident and non-resident companies where the duties are performed wholly in the UK. The three cases of Schedule E are explained in Chapter 1, section 1.6.5.3. If Carol is held to be ordinarily resident in the UK in addition to being resident in the UK, following the rule in *Reed v Clark*, she will fall in charge to tax under Case I. Should the Revenue follow their own guidance notes, as set out in IR20, and consequently hold that Carol is not ordinarily resident in the UK, she will fall in charge to tax under Case II. As discussed, there is today little practical difference between the two cases. Case III is not applicable because all of Carol's employment duties are performed in the UK. Therefore, even if Caymanco did not remit Carol's salary to the UK, she would still fall in charge to tax on it.[15] These are largely non-contentious issues. The key consideration is whether the payments by TVCo to Caymanco escape UK taxation.

5.2.4 The Recognition and Residence of Caymanco

It is, of course, central to the tax efficiency of the use of Caymanco as Carol's service company first that it is recognised by the UK Inland Revenue as a corporate entity and, secondly, that it is acknowledged to be not resident in the UK. The issue of corporate recognition was discussed in Chapter 3, section 3.3.3, and following this discussion it is safe to say that provided Caymanco was properly incorporated in accordance with the laws of the Cayman Islands the Inland Revenue will recognise its corporate status. This recognition may be adversely affected by the proposed new tax law set out in IR35 and promulgated in the 1999 budget. This is discussed below in section 5.2.7. For the present purposes, and as the law currently stands, it is accepted that the Revenue will

[15] The remittance basis only applies under Case III of Schedule E.

recognise Caymanco as a limited company and accord it all consequent rights and expect it to fulfil all consequent obligations.

The issue of Caymanco's residence requires a more detailed examination. Chapter 3, section 3.3.2, set out the liability of companies to UK corporation tax which may be summarised as follows: companies resident in the UK are subject to UK corporation tax on their worldwide profits and gains;[16] and non-resident companies are subject to UK corporation tax if they carry on a trade in the UK through a branch or agency.

Chapter 3, section 3.3.2, set out the history of company residence and explained why the established common law precedents remain relevant today even though the UK has moved to a largely statutory definition of company residence under which all companies incorporated in the UK are by that very fact resident in the UK.[17] For companies incorporated outside the UK the common law 'central management and control' test remains relevant, for such companies will be held to be UK resident if their central management and control is exercised in the UK. Lord Loreburn LC in *De Beers Consolidated Mines Ltd v Howe*[18] put it thus:

> *"A company resides, for the purposes of Income Tax, where its real business is carried on ... I regard that as the true rule; and the real business is carried on where the central management and control actually abides."*[19]

[16] ICTA 1988, s.6
[17] Section 66(1) Finance Act 1988.
[18] [1906] AC 455

For Caymanco to avoid being held to be UK resident, and consequently falling in charge to UK corporation tax on its worldwide profits, it will be necessary to demonstrate that the company's central management and control is exercised outside the UK. It will not be sufficient for Caymanco simply to have overseas directors who hold their board meetings outside the UK. It must also be evident as a matter of fact that such directors actually control and manage the affairs of Caymanco. There are many potential fiscally expensive pitfalls in this area.

A case in point is the setting up of an offshore company utilising the so-called 'Sark lark'. The 'Sark lark' involves an offshore company appointing directors resident in the small island of Sark in the Channel Islands. These directors take no interest in the affairs of the companies to which they have been appointed. They simply accept fees for serving as 'nominee' directors. One Sark resident was in 1997 the director of 2,400 companies.[20] In a 1999 case before the UK High Court in respect of his directorship of eight UK companies, whose original directors had been disqualified, this same individual accepted that he took no steps to monitor, supervise or control the people who were running the businesses, and that he had made no inquiries about the businesses, about their finances or about their dealings.[21]

[19] [1906] AC 455 at p. 458
[20] 'Treasure Island Mystery: 23,000 Firm's Are Run From Sark', The Observer, 21 September 1997 p.18
[21] 'Court Puts End To Sark 'Scandal'', The Guardian, 29 January 1999 p.9

Clearly should Caymanco have taken advantage of the 'Sark lark', the central management and control of the company would not be exercised in Sark. Rather the control would reside with he or she who took the management decisions and, as a matter of fact, controlled the company. Should this be Carol, Caymanco would become UK resident on the same day as she became UK resident.

Questions of company residence are questions of fact.[22] As such they are decided by the Commissioners. In the case of *Willson v Hooker*,[23] discussed in more detail below in section 5.2.5, the taxpayer contended that Ashvale Investments Ltd although registered in the Isle of Man was resident in the UK for corporation tax purposes. The Special Commissioners disposed of the contention thus:

> *"The test for residence in the case of companies was considered in* De Beers Consolidated Mines v Howe.[24] *If Ashvale Investments Ltd was considered to be resident in the UK for corporation tax purposes, then it was accepted that the assessment on Mr Willson as agent for the company was invalid. There was, however, no evidence whatsoever that:*
> *(i) The directors were resident in the UK;*
> *(ii) The beneficial shareholders were resident in the UK.*[25]
> *(iii) That the central management and control of the company lay in the hands of a person resident in the UK and that he/she exercised that control in the UK."*[26]

[22] In *John Hood & Company Limited v W.E. Magee* (1913-1921) 7 TC 327 Kenny J stated: "The test of residence is not where the company is registered, but where it keeps house and does its real business, and the real business is carried on where the central management and control actually abides (De Beers Consolidated Mines, Ltd. v. Howe ([1906] A.C. 455). The House of Lords has also decided in that Case that whether any particular case falls within that rule is a pure question of fact, to be determined on the scrutiny of the course of business or trading."
[23] [1995] BTC 461
[24] (1906) 5 TC 198
[25] The beneficial shareholder of the issued share capital of Ashvale Investments Ltd was, according to the accountants acting for the company, Plantation Investments SA whose registered office was located in Marbella, Spain.
[26] [1995] BTC 461, at p. 465

A suitable structure for Caymanco would be for the affairs of the company to be run by directors who are professionals and are aware of their need to monitor, supervise and control, be they attorneys, accountants or bank officials. These directors should themselves be resident in an offshore financial centre, possibly but not necessarily in Cayman.[27] The more developed offshore financial centres have a professional infrastructure to support the demands for these services.[28]

As suggested in Chapter 3,[29] offshore companies are best owned by offshore trusts, the essence of a trust being that the ownership and control of the trust assets, in this case Caymanco's shares, rest with the trustees. Non-resident trustee shareholders provide a strong prima facie case that central management and control does not reside in the jurisdiction in which the settlor or beneficiaries of the trust, Carol and, say, her family, reside.

5.2.5 Branch or Agency?

Assuming that the management structure of Caymanco accords with the requirements for non-UK residency discussed above, the issue arises as to whether Carol herself represents a branch or agency of Caymanco in the UK. If so, the profits attributable to her branch or agency fall in charge to UK taxation. Such profits would be the majority, if not all, of the consideration under the

[27] There is no obligation for a Cayman exempted company to have a Cayman resident director.
[28] Indeed, it will be recalled from Chapter 4, section 4.0, that one of the factors differentiating an offshore financial centre from a tax haven is that the former have a first class telecommunication

Caymanco-TVCo contract as it would be the branch or agency, that is, Carol, who performed the services under the contract.

There is a recent case where a UK resident individual was considered the agent of an offshore company for corporation tax purposes. In *Willson v Hooker*[30] the taxpayer had instructed a firm in the Isle of Man to arrange for the acquisition of an 'off the shelf' company, Ashvale Investments Ltd, whose first directors, secretary and shareholders were all resident outside the UK. The offshore company dealt in property and the taxpayer instructed surveyors and solicitors to effect the purchase and resale by the company of certain land in England. The Inland Revenue raised assessments on the taxpayer in respect of the profit from the transactions on the grounds that although the company was not resident in the UK, it was carrying on business in the UK through the agency of the taxpayer.[31] The taxpayer appealed to the general commissioners who found that he acted as an agent for a non-resident company and confirmed the assessments. The High Court was of the same view,[32] Sir John Vinelott stating:

> *"There can be no doubt that Mr Willson [the taxpayer] acted as agent for Ashvale in giving instructions to Mr Wardhaugh [the*

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systems, excellent transport facilities and a professional infrastructure of accountants, lawyers and administrators equal in quality and experience to their peers in mainland financial centres.

[29] See Chapter 3, section 3.4.4.1

[30] [1995] BTC 461

[31] The assessments were raised on the individual under s. 78(1) TMA 1970

[32] In fact by the time the case reached the High Court the question of law was not whether the taxpayer was an agent, but whether he was a 'regular agent' within the meaning of s. 78(1), taxpayer contending that he was not liable to tax as the company's agent because he came within the exception provided by the Taxes Management Act 1970, s. 82(1) of which provided that a non-resident person should not be chargeable in the name of an agent 'not being an authorised person carrying on the regular agency of the non-resident person'.

surveyor] and to the solicitors engaged in carrying through the purchase and resale on behalf of Ashvale."[33]

Carol's relationship with Caymanco, though similar in superficial terms with that in *Willson v Hooker*, is in reality quite different. The trade of Caymanco is supplying Carol's services. When she performs for TVCo she is not acting of behalf of Caymanco, she is fulfilling Caymanco's contractual obligation. Her position would be similar to Willson's if, say, she personally renegotiated the terms and conditions of her services directly with TVCo under the Caymanco-TVCo contract. To assert categorically, however, that provided Carol merely fulfils Caymanco's obligations under the original contract she could not be considered an agent of the company would be inconsistent with the decision in *IRC v Brackett*.[34]

The taxpayer, a chartered surveyor, made arrangements with the directors of a Jersey company, the shares in which were held in trust for members of the taxpayer's family, whereby the company was to assume the role of business consultant and employ the taxpayer for the purposes of giving advice to clients. The Revenue assessed the taxpayer to income tax in respect of the transfer of assets abroad provisions (then s. 478 ICTA 1970; now s.739 ICTA 1988) and, in the alternative, to corporation tax under the UK branch or agency provisions (s. 79 TMA 1970). The Special Commissioners allowed the appeal by the taxpayer against the s. 478 assessments, but upheld the s. 79 assessments. The High Court

[33] [1995] BTC 461 at p. 468
[34] [1986] STC 521

allowed the Crown's appeal on the sec. 478 assessment and dismissing the taxpayer's appeal on the sec. 79 assessment. The Courts reasoning regarding the charge to tax under s. 478 will be explored in the 'transfer of assets abroad' section, 5.2.6 below. As regards the issue of agency, Hoffman J said the following:

> *"I will however say in relation to s. 79 that there was in my judgment evidence before the Special Commissioners upon which they could properly find that Drishane [the Jersey company] was carrying on a trade in the UK within the meaning of sec. 246 of the Taxes Act. It is true that the conclusion of the contracts for the provision of Mr. Brackett's [the taxpayer's] services and a certain amount of administration took place in Jersey, but Mr. Brackett was permanently resident in the UK and his activities constituted, as the Special Commissioners said, the essential operations of the company's trade. Drishane was therefore liable to be assessed to corporation tax in the name of any branch or agent in the UK if such existed. Again, I think that there was evidence before the Special Commissioners on which they were entitled to find that Mr. Brackett constituted such a branch or agency. He was a UK resident and the sole UK resident by whom the company carried on its trade in the UK. For the purposes of sec. 79 I do not think that it is necessary that an agent should be a person who is empowered to enter into contractual relations on behalf of the non-resident company."*[35]

This case would provide a useful foundation on which the Revenue could base a claim that Carol is an agent for Caymanco and tax her accordingly. Such a claim, however, should be resisted. The principal activity of Drishane was 'to provide business consultancy services' so clearly the services of Mr Brackett, the sole business consultant, constituted 'the essential operations of the company's trade'. Caymanco's principal activity is not acting but rather the provision of Carol's services as an actress. Therefore, the argument would run, in contrast to Drishane and Mr Brackett, who sought to do the same thing, namely to provide business consultancy services, Caymanco and Carol do different things, the former provides the services of the latter.

It is acknowledged that this distinction is a fine one. It would profit Carol, from an anti-avoidance viewpoint, if Caymanco provided the services of more than one actress, preferably in more than one jurisdiction.

5.2.6 Section 739 ICTA 1988

The UK's most pervasive statutory anti-avoidance provision is section 739 ICTA 1988. This section, as set out in Chapter 3,[36] is aimed at preventing a tax benefit accruing to an individual who transfers assets abroad. Tax falls to be charged under s. 739 where:

a. the taxpayer is ordinarily resident in the UK;
b. he makes a transfer of assets;
c. income becomes payable to a person resident or domiciled outside the UK;
d. the income becomes so payable by virtue or in consequence of the transfer, either alone or in conjunction with associated operations;
e. the taxpayer or his spouse have power to enjoy the income or receive a capital sum; and
f. the motive defences in s.741 do not apply.

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[35] [1986] STC 521, at p. 540
[36] See Chapter 3, section 3.6.1.1

Clearly if Carol is deemed not to be ordinarily resident in the UK the provision has no applicability and need not be considered further. If, however, she is held to be ordinarily resident in the UK the balance of the provision need to be explored. Unless one can be held not to apply the full payment by TVCo to Caymanco will fall in charge to tax as if paid directly to Carol herself. Turning then to part b. above, it is necessary to ascertain whether Carol has made a transfer of assets and if so whether the transfer is caught by s. 739.

As explained in Chapter 3, section 3.6.1.1, the word 'assets', in the context of s. 739, is defined to include property or rights of any kind and the word 'transfer', in relation to rights, is deemed to include the creation of those rights.[37] To examine the meaning of these definitions in the context of Carol's relationship with Caymanco it is valuable to return to the case of *IRC v Brackett*,[38] the facts of which were set out in the previous section, 5.2.5, above. In this case the Revenue submitted that by entering into the contract of employment with the Jersey company Drishane, Mr.Brackett created rights vested in Drishane which were valuable and capable of being turned to account, and that by virtue of those rights, together with the associated operation of carrying on a trade as a business consultant, income became payable to Drishane. The Special Commissioners rejected this argument on three grounds. First, they held that Mr. Brackett's earning capacity was not an asset in respect of which rights could be transferred to

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[37] ICTA 1988, s.742(9)(b)
[38] [1986] STC 521

or created in favour of Drishane. Secondly, they held that the rights acquired by Drishane were not created by Mr. Brackett because they came into existence under a contract to which he was only one party. And thirdly, they held that the contract did not result in income in the sense of the profits or gains of the trade of business consultancy becoming payable to Drishane within the meaning of s. 739. All that became payable was the receipts of the trade. The profits, they said, arose in the hands of Drishane as a result of carrying on the business.

The High Court rejected each of these points on the ground that they reflected too narrow an interpretation of s. 739, Hoffman J concluding:

> *"I therefore respectfully disagree with each of the reasons given by the Special Commissioners for saying that there was no transfer of assets to Drishane and that no income thereby became payable. It has been said more than once that [s. 739] is a broad spectrum anti-avoidance provision which should not be narrowly or technically construed. In each of their three reasons I do not think that the Special Commissioners gave sufficient effect to that principle."*[39]

This would suggest that in granting Caymanco the right to contract on her behalf, Carol was involved in a transfer of assets, potentially falling within the provisions of s. 739. However, this transfer took place before Carol became ordinarily resident in the UK and this timeframe was at one time of crucial relevance. In the 1997 House of Lords of *IRC v Willoughby*,[40] as discussed in Chapter 3, section 3.6.1.1, it was held that s.739 did not apply in a situation where the relevant transfer was made when the taxpayer was not ordinarily resident in the UK,

[39] [1986] STC 521 at p. 539

notwithstanding that the taxpayer subsequently became ordinarily resident. In a pertinent comment on situations similar to Carol-Caymanco, Lord Nolan commented:

> *"I accept that in consequence the immigrant tax avoider who makes his dispositions before taking up residence in this country would escape liability under the section. I would for my part find it fruitless to speculate whether this consequence was foreseen and accepted, or arose through inadvertence. I would not, in any event, regard it as sufficiently astonishing in itself to cast doubt on what I have described as the natural meaning of the words used."*[41]

However, following this case, as discussed above, parliament enacted s.739(1A) introduced by the Finance Act 1997 which provided that nothing in the provisions should be taken to apply only if the taxpayer was ordinarily resident in the UK at the time when the transfer was made. The meaning and impact of this provision was discussed in Chapter 3, section 3.6.1.1. For the purposes of this Case Study it may be asserted that Carol will not escape the impact of s. 739 simply because she was not resident at the time of the 'transfer', the setting up and contracting with of Caymanco.

The final aspect that deserves attention under the second s. 739 criteria, the transfer of assets, relates to the situs of the asset transferred. Before entering the UK Carol transferred her employment rights to Caymanco. These rights at the time of transfer could not have been situated in the UK. No UK contract between Caymanco and TVCo existed at the time. The rights must have been situated in

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[40] [1997] BTC 393

[41] [1997] BTC 393 at p. 398

the Cayman Islands. Thus such transfer of assets as took place involved two legal personalities in a small Caribbean island some 4,500 miles from the UK. If the assets transferred were never situated in the UK, the question arises as to how they could be said to have been 'transferred abroad'. In one of the leading offshore tax planning publications, Clarke addresses this seeming paradox:

> *"The view is sometimes expressed that s. 739 does not apply if the assets transferred are already abroad when the transfer is made. Section 739 ... is headed 'Transfer of assets abroad' and s. 739(1) predicates income becoming payable to non-residents. Semantically it is difficult for assets to be transferred abroad if they are already abroad, and for income to become payable to non-residents if it is already so payable. However, commonsense indicates that such an interpretation of s 739 is unlikely to be right and a Special Commissioner so held in* IRC v Willoughby[[42]] *"*[43]

Until *Willoughby*, case law and academic opinion was less supportive of Dr Clarke's 'commonsense' approach than the quote indicates, but the Special Commissioners in Willoughby were firmly of the opinion that s. 739 could operate if the assets transferred were already abroad.[44] It may be concluded

[42] [1995] BTC 144

[43] G. Clarke Offshore Tax Planning (Fifth Edition) London, Butterworths (1998) p. 50

[44] The arguments of the taxpayer and the reasoning of the Special Commissioners were as follows: *"Mr Carnwath [counsel for the taxpayer] submits that s. 739 is ambiguous as to whether the assets transferred must be situated in the UK at the time of the transfer. He cites dicta in three cases in support of the view that the section only applies to transfers of assets abroad, that is, from the UK to overseas. The cases are* Vestey, Corbett's Executrices v IR Commrs *(1943) 25 TC 305 and* Lord Chetwode v IR Commrs *[1977] 1 WLR 248. He prays in aid statements by the Financial Secretary, H C Deb. Vol. 313, col. 678 and 685 and adopts as part of his argument the conclusion in Whiteman on Income Tax at para. 23-08 that a transfer from one overseas territory to another will not suffice (citing passages from Vestey in para. 23-09 to which Mr Carnwath refers). However, reading s. 739(1), the relevant words in my opinion leave this question open. The heading of Ch. III is 'Transfer of Assets Abroad'. This connotes primarily transfers from the UK, but I think not necessarily so. The material words in the section are, 'avoiding by individuals ordinarily resident in the United Kingdom of liability ... by means of transfers of assets by virtue ... of which ... income becomes payable to persons resident or domiciled outside the United Kingdom.' In my opinion, and I so hold, this language may be satisfied whether the assets are transferred from the UK to outside the UK or being outside the UK they are transferred to a person outside the UK." IRC v Willoughby & Anor.* [1995] BTC 144, at 162

therefore that Carol's transfer of her employment rights to Caymanco potentially fall within the ambit of s. 739.

The third and fourth criteria set out above is that income becomes payable to a person resident or domiciled outside the UK as a consequence of the transfer of assets. It is immediately apparent that fees becomes payable to Caymanco from TVCo as a consequences of Carol's employment contract with Caymanco, itself a transfer of assets. The only question is are these fees 'income' given that Caymanco will have its own trading expenses.

This issue, which has been explored above 5.2.5, arose in *IRC v Brackett,*[45] where it was held that 'income' includes net profits. Hoffman J said

> *"[I]n the context of... [s. 739]... the words 'income becomes payable to' are wide enough to include not only the case in which the payment to the non-resident has in itself the quality of income but also the case of payments to a non-resident trader from which, after deduction of expenses, the income will arise."*[46]

The fifth criteria for the application of s.739 is that the taxpayer or his or her spouse have power to enjoy the income payable to a person resident or domiciled outside the UK or the power to receive a capital sum. If Carol is shareholder of Caymanco or the beneficiary of a trust which itself holds shares in Caymanco, as suggested in section 5.2.4 above, or any variation thereof,[47] this criteria will be

[45] [1986] BTC 415
[46] Ibid., at 539
[47] An example of such a variation was at issue in the recent case of *IRC v Botnar* [1997] BTC 613. The taxpayer transferred shares into a settlement established in Liechtenstein. Under the settlement the taxpayer and his wife were 'excluded persons', incapable of taking any benefit

met. Even, if her children or other family members (excluding her spouse) owned the shares or were the beneficiaries of a trust which owned the shares, and Carol and her spouse were excluded from any benefit in respect of the 50% of the fees retained by Caymanco, the criteria would still be met, notwistanding the 1980 House of Lords' decision in *Vestey v IRC (Nos 1 and 2),*[48] which held that the charging provisions s.739 could only be applied to the taxpayer (or the taxpayer's spouse) who made the relevant transfer. The point is that Carol's salary itself represents the 'power to enjoy', and even though the salary falls in charge to UK tax and amounts to only 50% of the fees earned by Caymanco, under s. 739 the whole of Caymanco's income would fall to be assessed on Carol. This principle was established in *Lord Howard De Walden v CIR,*[49] in which the House of Lords held, applying FA 1936, s. 18 (now ICTA 1988, s. 739) that the whole income of the non-resident person fell in charge to tax on the UK transferee, notwithstanding that his 'power to enjoy' was limited to only a portion of this income.

Therefore, for Carol to escape the ambit of s. 739, again assuming she fails on the issue of not being ordinarily resident in the UK, she should enjoy no salary from Caymanco and the trust owning Caymanco should exclude Carol and her spouse from the list of beneficiaries or potential beneficiaries. For Caymanco to be

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under the settlement. The settlement also provided that the trustees had the power to transfer the capital of the trust to trustees of another settlement and the property transferred would cease to be held on the terms of the original settlement. The High Court found that the taxpayer and his wife had the 'power to enjoy' the income from the settled shares by virtue of the trustees' power to transfer the capital of the trust on terms such that the taxpayer and his wife would no longer be excluded persons.

[48] [1980] AC 1148

[49] (1941-1943) 25 TC 121

owned by, say an offshore discretionary settlement for Carol's children would not in any way make it less of a service company. It is simply that the service company would have been so structured as to pass on income and wealth to Carol's next generation in a tax efficient manner.

The sixth and last criteria the Carol-Caymanco arrangement would have to meet to fall within the charging provisions of s. 739 is that the motive defences in s.741 do not apply. It will be recalled from Chapter 3, section 3.6.1.1, that for the motive defences to apply the taxpayer must satisfy the Revenue that either (a) the purpose of avoiding liability to taxation was not the purpose or one of the purposes for which the transfer was effected; or (b) the transfer and any associated operations were bona fide commercial transactions and not designed for the purpose of avoiding liability to taxation.

As discussed above in this context, in Chapter 3, section 3.6.1.1, tax avoidance is seen by the courts as the taxpayer reducing his liability to tax without incurring the economic consequences that Parliament intended to be suffered by the taxpayer to qualify for such a tax reduction. This contrasts with tax mitigation which occurs when the taxpayer takes advantage of a fiscally attractive option afforded to him by the tax legislation, and in so doing genuinely suffers the economic consequences that Parliament intended for those taking advantage of the option.[50]

It is this contradistinction between tax avoidance and tax mitigation that enabled the taxpayer to succeed on the 714(a) defence in *Willoughby*.[51] Put briefly, in this case the taxpayer purchased a single personal portfolio bond with Royal Life Insurance International Ltd, a company managed, controlled and resident in the Isle of Man. In exchange Royal Life issued to him a number of policies of insurance linked to an offshore fund. The investments in the fund and any subsequent changes were to be decided by a fund adviser appointed by the taxpayer. The Court held that as the underlying investments were not owned by the taxpayer, who had no legal or equitable interest in them, he could not be described as having in substance all the advantages of direct personal ownership without the tax disadvantages. The taxpayer was therefore entitled to the protection afforded by s. 741(a).

Turning to the Case Study, the argument that Carol has suffered any of the economic consequences intended by Parliament for the tax advantage she or her family will enjoy will not bear close scrutiny. Consequently, a motive defence is likely to fail under 714(a). As regards 714(b), an argument could be put forward that the transfer of Carol's rights to Caymanco was bona fide commercial transactions and not designed for the purpose of avoiding liability to taxation, but such an argument is likely to fail particularly under the new purposive approach

[50] See Lord Nolan's speech in *IRC v Willoughby* [1997] 4 All ER 65, at 73
[51] *IRC v Willoughby* [1997] 4 All ER 65

to the interpretation of tax avoidance legislation (see Chapter 4, section 4.5.2) as enunciated by Lord Steyn in *IRC v McGuckian*.[52]

5.2.7 Other UK Considerations

The UK's withholding tax regime for entertainers and sportspeople, as explored in Chapter 1, section 1.6.5, has no applicability to Carol's taxation affairs as the provisions only apply to non-resident entertainers and sportspeople.[53] It was established in section 5.2.2 that Carol would be treated as being UK resident from the day of her arrival in the UK.

The question arises as to whether the legislative provisions based on IR35, considered in Chapter 1, section 1.7.2.1, would apply to the Carol-Caymanco-TVCo relationship. Clearly, one cannot be in any way definitive about the applicability of these provisions as they are still at the discussion stage, with April 2000 as the proposed date for implementation. However, the language of IR35 is such that legislative provisions based on it would appear to apply directly to the Carol-Caymanco-TVCo contractual arrangement. To recap, IR35 states that the UK government plans to bring forward legislation to tackle the 'tax avoidance' of using service companies, the proposed changes being aimed at those cases where the characteristics of employment are disguised through the use, inter alia, of a

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[52] [1997] 3 All ER 817

[53] ICTA 1988 s. 555(1) provides: *"Where a person who is an entertainer or sportsman of a prescribed description performs an activity of a prescribed description in the United Kingdom ("a*

service company.[54] The TVCo's contract for the acting services of Carol has all the characteristics of employment, changed only by the imposition of Caymanco.[55] In the past the courts have studiously refrained from lifting the corporate veil in tax cases.[56] This may be set to change should the proposals set out in IR35 reach the statute book, and as this case study indicates, the consequences may be more far reaching than the legislature currently envisage.

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relevant activity"), this Chapter shall apply if he is not resident in the United Kingdom in the year of assessment in which the relevant activity is performed."

[54] See IR35, 9 March 1999, Details, para. 3

[55] There is nothing in IR35 to suggest that an offshore company will be treated any differently than a UK company.

[56] Even in the seminal anti-avoidance case of *Furniss v Dawson* [1984] STC 153 (HL) it was never suggested that the company Dawson incorporated an in the Isle of Man, Greenjacket Investments Limited, should not be accorded its status as a separate personality in law.

5.3 CASE STUDY II: A US COMPARATIVE STUDY

This section, for comparative analysis purposes assumes the facts of the above Carol-Camanco Case Study to be the same, except that TVCo is a US company, renamed for the purposes of clarity TVUS, and Carol moves to the US in order to act in a New York soap opera. As with Case Study I, this case study examines the consequences of an absence of a double taxation treaty between, in this case, the US and the performer's country of residence, where the non-resident performer supplies her services through an offshore service company.

5.3.1 Carol's US Residence Status

The issue of Carol's residence is more easily dealt with from a US perspective. The US has no concept of ordinary residence. An alien is either resident in the US or not resident. The tests for US residence are set out in Chapter 2, section 2.2.1. Carol would fail the first test as she is not a lawful permanent resident of the US (that is, she does not hold a 'green card'). She would, however, be deemed to be a US resident alien individual under the substantial presence test. Her US residency would commence on the date of her arrival, ignoring any period of up to ten days, say a short reconnaissance trip prior to Caymanco agreeing the contractual terms, during which her tax home remained in the Cayman Islands.[57]

[57] This is illustrated in the IRS Publication 519 (1998), 'U.S. Tax Guide For Aliens', by the following example: "Ivan Ivanovich is a citizen of Russia. He came to the United States for the

5.3.2 Caymanco's US Residence Status

Similarly, the issue of Caymanco's residence is more easily determined under US tax law. As explained in Chapter 2, section 2.2.2, the US, unlike the UK, has no 'central management and control' test for company residence. A company is a US resident corporation if it is incorporated under the laws of any State in America. All other companies are treated as foreign corporations. On applying this rule it is clear that Caymanco is not resident in the US.

5.3.3 Carol's US Employee Status

As illustrated in Chapter 2, section 2.4, by means of the Revenue Ruling 74-331, it is possible for a performer whose services are provided by a foreign service company to be classified as an employee of the US principal who has contracted with the performer's service company. That is, it is possible for Carol to be deemed an employee of TVUS. The primary factor is the issue of control.

It will be recalled that in Example 1 of Revenue Ruling 74-331 the entertainer, E, was held not to be an employee of his Channel Islands service company, but rather an employee of X, the US person with whom CIC, E's service company,

first time on January 6, 1998, to attend a business meeting and returned to Russia on January 10, 1998. His tax home remained in Russia. On March 1, 1998, he moved to the United States and resided here for the rest of the year. Ivan is able to establish a closer connection to Russia for the period January 6-10. Thus, his residency starting date is March 1."

had contracted to provide E's services. The reasoning was that CIC did not in fact control the activities of E, who had the right of veto over any arrangements proposed by CIC for the performance of his services. CIC was considered to be no more than a booking agency. It was X who was considered to exercise the degree of control over the professional activities of E as to give rise to the employer-employee relationship.

The Revenue Ruling discussed the factors to be applied in determining the employer-employee relationship within the context of E and CIC and it is beneficial to recount them at this time so that they may be applied to the Carol's relationship with Caymanco. The Ruling initially set out the general position that for Federal income tax purposes an employer-employee relationship depends on an examination of all the facts and circumstances pertaining to the relationships among the parties. It then moved on to the context of E and CIC and made the following observations. If E were subject to the control and direction of CIC as to time, place, and manner of performance this, being the primarily test, would be indicative of an employee relationship. The case would be further strengthened if CIC were responsible for furnishing E with appropriate costumes, make-up, scripts, musical accompaniment, or the like. If E had an exclusive personal service contract of substantial duration, this would supply additional support. The CIC-E employer-employee argument is weakened by any right E may have to veto engagements arranged by CIC, or by E's salary being based principally on the net profits derived in respect of his performances. For an employer-employee relationship to exist CIC must bear customary business risks in connection with furnishing E's services. Several cases were quoted by the ruling in support of the foregoing propositions.[58]

The position the IRS are likely to adopt, on the evidence of Revenue Ruling 74-331, is one whereby Carol is classified as an employee of the US TVUS, rather than Caymanco, on the basis that control over the time, place, and manner of her performance, the primarily test, is more likely to rest with TVUS than Caymanco. Moreover, TVUS would be the party who furnishes Carol with appropriate costumes, make-up and scripts. (Although technically TVUS are more likely under the contractual terms to supply the costumes, make-up and scripts to Caymanco, who in turn would supply them to Carol, the IRS would argue the case of 'substance over form'.) Carol's salary structure with Caymanco, 50% of gross fees, further weakens her claim to be employed by Caymanco, so much so that her absence of a veto over, and the long term exclusive contract with, Caymanco, though in her favour, may be insufficient, on the basis set out in Revenue Ruling 74-331, to save her from being classified as an employee of TVCo.

However, whereas Revenue Rulings are a valuable guide to the considered views of the IRS on important tax issues, it is the courts who decide, and as set out in Chapter 2, section 2.6.1, the courts have shown a marked reluctance to ignore the

[58] *Bartels v. Birmingham*, 332 U.S. 126 (1947), 1947-2 C.B. 174; *Ringling Bros. Barnum and Bailey Combined Shows, Inc. v. Higgins*, 189 F.2d 865 (2d Cir. 1951); *Filipidis v. United States*, 71-1 U.S.T.C. 87,828 (Md. 1970), aff'd per curiam, 71-2 U.S.T.C. 87,830 (4th Cir. 1971); section 31.3401(c)-1(b) of the regulations; and Rev. Rul. 71-144, 1971-1 C.B. 285.

service provider's employment contract with his or her service or loan-out company provided proper legal documentation is in place. It will be recalled that in the 1991 case of *Sargent v Comm*,[59] a full analysis of which is in the aforementioned section of Chapter 2, the Court of Appeals rejected the IRS's contention that certain professional hockey players were employees of the club rather than their personal service corporations. Senior Judge Bogue stipulated that two requirements must be met before the personal service corporation, rather than the party to whom the services are contracted, is considered the employer of the player. First, the taxpayer must be a bona fide contractual employee of the PSC who must contractually have the right to control him, and secondly, a contract must exist between the PSC and the party to whom the services are contracted which recognizes the PSC's right to control the taxpayer.

This test was recently applied by the Tax Court in a 1995 case in which Senior Judge Irene F Scott, rewording the dictum of Senior Judge Bogue, said:

> *"Both this Court and the Court of Appeals for the Eighth Circuit, the circuit to which this case is appealable, have recognized two necessary criteria for a corporation rather than the service provider to be considered the true controller and, therefore, the true earner of the income. First, the service provider must be an employee of the corporation with the corporation having the right to direct or control his activities in some meaningful way.*[[60]] *Second, there must exist between the corporation and the entity using the services ... a contract or similar indicium recognizing the corporation's controlling position.*[[61]]"[62]

[59] 929 F.2d 1252 (8th Cir, 1991), reversing 93 TC 572 (1989)
[60] *Sargent v. Commissioner*, 929 F.2d 1252, 1256 (8th Cir. 1991), revg. on other grounds 93 T.C. 572 (1989); *Johnson v. Commissioner,* 78 T.C. 882, 891 (1982), affd. without published opinion 734 F.2d 20 (9th Cir. 1984).
[61] Sargent v. Commissioner, supra; Leavell v. Commissioner, 104 T.C. 140, 151- 152 (1995).
[62] Tax Analysts Citation: 1995 TNT 159-5; Parallel Citations: T.C. Memo. 1995-383

It appears at first that by inserting the term "in some meaningful way" in reference to the corporation's control over the service provider, Judge Scott was injecting a substance over form test into Judge Bogue's dictum. However, a more detailed analysis of the case leads to the conclusion that the term 'meaningful' has no broader meaning than 'contractual'.[63] Thus, it is submitted, that there is no material difference between the two formulations of the two-pronged test.

This is the two-pronged test that the US courts would apply to Carol's relationship with Caymanco to determine whether Carol is an employee of Caymanco or, as the IRS are more likely to argue, and employee of TVUS. Under the first prong, Carol's case is strong. She has a contract of employment with Caymanco and it would be consistent with such a contract that Cayamnco have the right to control her activities. For the avoidance of doubt such control should be written into the contract. To satisfy the second prong of the test it will be necessary for the contract between Caymanco and TVUS to recognise that the former has the right to control the activities of Carol. If these two criteria are met

[63] The case concerned a taxpayer who entered into an agreement with an insurance company, American Family, to sell insurance policies. Under the agreement, the commissions Isom earned were payable to him as an individual; the agreement was not transferable. The taxpayer incorporated a service company, IAI, in which he owned all of the stock and was the only compensated officer. All commission cheques were made payable to Isom and he assigned them to IAI. In applying the first prong of the abovementioned test, Judge Scott said: "Based on the evidence, we find that the corporation did not have control over petitioner in any meaningful sense. Only petitioner had the right to write and deliver insurance policies, represent American Family, and collect premiums and other moneys due under the agreement. American Family issued all of the checks to petitioner, and the amount of compensation due petitioner was determined under the employment agreement between petitioner and American Family, an agreement to which [IAI] was not a party. Petitioner had the right, and not [IAI], to terminate the agreement between himself and American Family. Therefore, the earner of the income was clearly petitioner and not [IAI]."

then, notwithstanding a possible IRS challenge, it is most likely that the courts would determine Carol to be an employee of Caymanco, not TVUS.

5.3.4 Carol's Salary and Payments to Caymanco

In provisions similar to those in the UK, under US tax law the salary payable to Carol by Caymanco will fall in charge to US taxation. Under section 3402(a)(1) of the Code the employer must deduct and withhold income tax from the gross amount of the employee's remuneration.[64] This applies to foreign corporations whether or not they are engaged in a trade or business within the US.[65] As in the UK element of the case study, this is a non-contentious issues. Again, the key consideration is whether the payments by TVUS to Caymanco escape US taxation.

As stated in Chapter 2, section 2.2.2, a foreign corporation, such as Caymanco, is liable to US corporation tax on its income and capital gains if it is engaged in trade or business within the US during the taxable year. The tax will be levied on that part of its taxable income and gains, after allowable deductions, which is effectively connected with the conduct of a trade or business within the United States.[66] By supplying Carol's services to TVUS, Caymanco is engaged in a US trade or business, "the term 'trade or business within the United States' includes

[64] In a process similar to the UK's PAYE, in the US the amount of tax is determined through procedures or tables given by the Secretary (Section 3402(a)(1)).
[65] Section 31.3401(a)-1(b)(7) of the Employment Tax Regulations.
[66] IRC s. 882(a)(1)

the performance of personal services within the United States at any time within the taxable year."[67] Moreover, the income derived by a foreign corporation, such as Caymanco, from the furnishing of personal services in the US constitutes income which is effectively connected with a trade or business in the US.[68] The effect of these two provisions is that all of Caymanco's profits from the supply of Carol to TVUS will fall in charge to US corporation tax.

Consequently, Caymanco will have to file a US tax return. It will be entitled to deductions for all its 'ordinary and necessary' business expenditure, as explained in Chapter 2, section 2.5, and as subsequently defined in section 2.5.1. Most importantly, the deductions will include Carol's salary.

5.3.5 Withholding Tax

As explained in Chapter 2, section 2.3.2, those circumstances that give rise to a withholding of tax on payments to non-resident aliens, also, under s. 1442 of the Code, give rise to a withholding tax of 30 percent in respect of foreign corporations. Caymanco, as discussed above, being a company incorporated in a non-US jurisdiction is a foreign corporation under US tax law.[69] It will be recalled that payments of 'items of fixed and determinable annual or periodical gains, profits, or income from sources within the United States'[70] attract the withholding tax, and that income from the performance of personal services is

[67] IRC s. 864(b).
[68] IRC s. 864(c).
[69] See Chapter 2, section 2.2.1.2.

considered by the US to be US source income.[71] It follows that under s. 1442 TVCO would have an obligation to withhold tax at 30% on the gross fees payable to Caymanco.

US withholding tax is generally not required on income which is effectively connected with the conduct of a US trade or business,[72] as set out in Chapter 2, section 2.3.1. However, this exception does not apply to income payable to a foreign corporation for the furnishing of services in the US of a more than 25% shareholder of such a corporation and who is designated, as in Carol's case, as the person who is required to render the specified services.[73] Such income is referred to as 'personal service contract income'.[74]

The 30% witholding tax applicable to the payments to Caymanco will be applied to its gross income. The tax withheld will be credited toward the tax liability of the company by the IRS. The amount by which the tax withheld exceeds Caymanco's year end tax liability will be repaid to Caymanco by the IRS.[75] Caymanco will not be able to enter a central withholding agreement to reduce the withholding tax as such agreements only apply to payments made to individuals.[76]

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[70] Except as otherwise provided in section 1441(c) of the Code.
[71] See Chapter 2, section 2.2.2.1.
[72] IRC s. 864(b).
[73] Treas. Reg. 1.1441.4
[74] IRC s. 543(a)(7).
[75] For more detail of this process see F. Feingold 'Tax Planning and Pitfalls for International Entertainers' International Bar Association, Barcelona, September 27, 1999
[76] Ibid., p. 3

The Caymanco structure, potentially tax effective in the UK, gives rise to significant tax disadvantages in the US, certainly from the perspective of the timing of tax payments. This stems from the fact that the UK withholding tax system applies to non-resident sportspeople and entertainers and their service companies. However, once the performer is UK resident the UK does not have a specific measure to withhold tax from his or her non-resident service company. The US, in contrast, has specific legislative measures to withhold tax from foreign corporation providing personal services in the US.

In order to test some of the other US anti-avoidance provisions in this non-treaty case study, it will be assumed that Caymanco establishes a US subsidiary, Caymanco Inc, to which it licenses the right to provide Carol's services in the US. For the balance of this case study it is Caymanco Inc that contracts with TVUS.

5.3.6 Could Caymanco Inc be deemed a Sham?

A company will be treated as a sham and therefore disregarded for tax purposes where the formalities regarding incorporation are neglected or where the company performs no 'meaningful business function' (see Chapter 2, section 2.6.1). For the purposes of this case study it is assumed that Caymanco Inc fully complied with the formalities regarding incorporation. What remains to be addressed is whether it performs a meaningful business function. Caymanco Inc will be deemed to performs a meaningful business function if it satisfies one of the two tests set out by the Supreme Court in *Moline Properties v. Commissioner*:[77] (1) the corporation is formed for a purpose equivalent to a business activity; or (2) the incorporation is followed by the carrying on of a business. Substantial case law has held that the amount of business activity that satisfies this test may be minimal.[78]

Caymanco Inc first contracted with Caymanco for the right to control and supply Carol's acting services. It then contracted with TVCO to supply Carol's services. It receives fees under the contract with TVCO and pays a salary under its contract with Carol. Provided the legal documentation is in order, it is consistent with the authorities that Caymanco Inc performs a meaningful business purpose and therefore cannot be held to be a sham for US tax purposes.

5.3.7 Section 482

Assuming Caymanco Inc is not deemed a sham, it remains open to the IRS to seek to apply the anti-avoidance provision of s. 482 of the Code. This provision is set out in Chapter 2, section 2.6.1, as part of the analysis of *Sargent v Comm.*[79] Section 482 provides that in any case of two or more organizations, trades or businesses (whether or not incorporated, whether or not organized in the US, and

[77] 319 U.S. 436 (1943)
[78] See *Sparks Farm, Inc. v. Commissioner*, 56 Tax Ct. Mem. Dec. (CCH) 464, 472 (1988); *Hospital Corp. of America*, 81 Tax Ct. at 579; *Strong v. Commissioner*, 66 Tax Ct. 12, 24 (1976), aff'd without pub. opin., 553 F.2d 94 (2d Cir. 1977); *Harrison Property Management Co., Inc. v. U.S.*, 475 F.2d 623, 626-27 (Ct. Cl. 1973); *Paymer v. Commissioner*, 150 F.2d 334, 336-37 (2d Cir. 1945)
[79] 929 F.2d 1252 (8th Cir, 1991), reversing 93 TC 572 (1989)

whether or not affiliated) owned or controlled directly or indirectly by the same interests, the IRS[80] may distribute, apportion or allocate gross income, deductions, credits, or allowances between or among such organizations, trades or businesses if it is determined that such distribution, apportionment or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.[81]

Section 482 gives the IRS a formidable anti-avoidance tool. It is in essence a legislative enactment of the doctrine of 'substance over form. In *Philip Bros. Chemicals, Inc. v. Commissioner*,[82] the Court of Appeals stated:

> *"Section 482 was designed to grant the Commissioner authority to reallocate income among controlled businesses ... The statute rests on the well-settled policy that income is taxable under ... the ... Code to the party who earns it and that it is economic reality rather than legal formality which determines who earns income. Income-splitting devices designed to save taxes cannot be used to undermine the established principal that income is to be taxed to its real owner."*

Applying this broad interpretation of s. 482 to the case study without the benefit of case law pertaining specifically to service companies might lead to the conclusion that under this provision the IRS would reclassify Caymanco Inc's income as Carol income for the purpose of income taxes. However, the courts have been reluctant to uphold the use s. 482 in service company cases, as is

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[80] Technically, 'the Secretary of the Treasury or his delegate'.
[81] In *Foglesong vCommissioner* 77 T.C. 1102 it was held, following remand from the Seventh Circuit Court of Appeals (Foglesong v. Commissioner, 621 F.2d 865 (1980), revg. and remanding T.C. Memo. 1976-294) that s. 482 may be employed to allocate income between a corporation and its controlling shareholder/employee where financial relations between them fail to reflect arm'slength dealings between uncontrolled parties.

illustrated by the decision in *Keller v. Commissioner*,[83] discussed in Chapter 2, section 2.6.3, in which the Tax Court and the appellate court denied the IRS's attempt to use s. 482 to shift to the taxpayer all of the income earned by his personal service corporation. To allow such a reclassification, the courts felt, "would be to render [the PSC] a nullity for Federal income tax purposes."[84] The court continued: "The policy favoring the recognition of corporations as entities independent of their shareholders requires that we not ignore the corporate form so long as the corporation actually conducts business."[85] This view is supported in *Fatland v Commissioner*,[86] in which it was stated that "the assignment of income doctrine has no place in the personal service context as long as even minimum respect is given to the corporate entity."[87]

Section 482 is primarily applied to transactions between commonly controlled businesses that do not reflect arm's length pricing. Its applicability to service companies is broadly limited to where a PSC pays little or no salary to its controlling shareholder-employee. Section 482 allows the Commissioner to impute a higher salary and, therefore, impose a higher tax on the shareholder-employee. [88] This does not entirely rule out an adjustment to Carol's taxable salary under the provision as she earns 'only' 50% of the gross fees paid to Caymanco Inc. Much would depend on the amount of work Caymanco Inc could

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[82] 435 F.2d 53, 57 (2d Cir. 1970), affg. 52 T.C. 240 (1969)
[83] 77 T.C. 1014 (1981), affd. 723 F.2d 58 (10th Cir. 1983)
[84] Ibid., p. 1031
[85] Ibid.
[86] 48 Tax Ct. Mem. Dec. (CCH) 1107 (1984)
[87] Ibid., at 1112
[88] M. LaFrance 'The Separate Tax Status of Loan-Out Corporations' Vanderbilt Law Review, 48

demonstrate that it undertakes to fulfil its contract with TVCO and the amount of expenditure that it bears in the process.

5.3.8 Section 269A

The response of Congress to decisions like *Keller*[89] was the introduction of s. 269A (see Chapter 3, section 3.5.3). The provision enables the IRS to reallocate income from a personal service corporation to the service-provider owner if substantially all of the services are performed for one other entity, and if the principal purpose for forming the PSC or the principal use of the PSC is to avoid or evade Federal income tax.

Applying this two-pronged test to Carol and Caymanco Inc has its difficulties. The first prong may be dealt with easily. Section 269A is prima facie applicable as substantially all of Carol's services are provided by Caymanco Inc to TVUS. It is the second prong of the test that gives rise to problems for one must determine whether the principal purpose for forming Caymanco Inc or the principal use of Caymanco Inc is the avoidance or evasion of Federal income tax. This contrasts sharply with, say, the motive defence under the UK's s. 739 where the taxpayer has to satisfy the courts that the purpose of avoiding liability to taxation was not the purpose *or one of the purposes* for which the transfer was effected. It is the

Vand. L. Rev. 879 p. 914

[89] *Keller v. Commissioner*, 77 T.C. 1014 (1981), affd. 723 F.2d 58 (10th Cir. 1983)

emphasis on the *principal* purpose that make this anti-avoidance provision so easy to avoid.[90]

It will be recalled that in *Leavell v Commissioner*[91] section 269A was not applied as the IRS accepted that the primary purpose of creating the PSC was to give the taxpayer, a hockey player, the flexibility to act as a free agent.[92] It has even been suggested in the context of s. 269A that "the limited liability enjoyed by corporations offers one substantial (and extremely common) reason to incorporate."[93]

It is not absolutely clear whether Carol would succeed in claiming that the principal purpose for forming the PSC or the principal use of the PSC was not to avoid or evade Federal income tax, given the circumstances giving rise to its incorporation. It would interesting to test whether the avoidance of economic double taxation constitutes the avoidance of Federal income tax in the context of s. 269A.

[90] See the discussion on this point in Chapter 2, section 2.2.5.3
[91] Tax Analysts Citation: 1995 TNT 20-15; Parallel Citations: 104 T.C. 140
[92] See Chapter 2, section 2.2.5.3
[93] M. LaFrance, op. cit., p. 923

5.4 CASE STUDY III

This third case study concerns a Jamaican domiciled, UK resident professional boxing champion seeking to use an offshore structure to defer taxation on his endorsement and personality merchandising income from overseas, particularly from the US.

5.4.1 The Middleweight Champion of the World

Rupert is the middleweight boxing champion of the world. He was born in the UK of Jamaican parents. As a boxing champion Rupert has income from several sources. He earns income from his boxing contest, usually held in the US, and from the endorsement of products, personality merchandising and personal appearances in the UK, the US and worldwide.

At the top level of the sport of boxing the income for performers is considerable. The top two earning individuals in sport in the UK in 1997 were both boxers: Lennox Lewis, the WBC Heavyweight Champion, with £6.4 million;[94] and 'Prince' Naseem Hamed, the WBO Featherweight Champion, £5.8 million.[95] This high income is not confined to earnings in the ring. Former US Heavyweight Champion George Foreman earned more money from endorsements in 1996 ($5

[94] P. Nichols *'The Wages of Sport'* Financial Times 14 November 1997
[95] Ibid.

million) than he did from boxing ($3 million).[96] Nor is this phenomenon limited to US boxing personalities. Naseem Hamed, for example, earns some £500,000 per annum from his Adidas sportswear endorsement contract alone.[97]

The tax planning strategy for Rupert is to create an offshore vehicle that will earn his non-UK endorsement and personality merchandising income in a tax free environment, thereby allowing Rupert make use of his status as a non-UK domiciliary to fall in charge to tax on royalty income on a remittance only basis (and to escape the ambit of s. 739).

5.4.2 Rupert's Domicile

The sine qua non of the proposed international tax planning strategy for Rupert is that he is not domiciled in the UK. The Inland Revenue have been increasingly faced with this issue in respect of sportspeople and entertainers in recent times.[98] As the children of Afro-Caribbean immigrants of the 1960's reach adulthood their domicile remains the same as their parents. Should they anticipate enjoying overseas income, there is little incentive for them to exercise an English domicile of choice.

[96] See J. T. Davies Forbes Richest People New York John Wiley and Sons (1997)
[97] P. Nichols, op. cit.
[98] For example, just staying with the sport of the case study, 11 of the 29 British based boxing champions in 1998 were of Afro-Caribbean descent. B. J. Hugman The British Boxing Board of Control Yearbook 1998 Harpenden, Queen Anne Press (1997)

The law of domicile as it pertains to taxation was set out in Chapter 1, section 1.6.4. It will be recalled that the term 'domicile' refers to an individual's natural or permanent home.[99] All individuals acquire a domicile of origin at birth,[100] being the domicile of the father, unless the parents are unmarried, in which case it the domicile of the mother.[101] Thus Rupert's domicile of origin, though he was born in the UK, is Jamaican.

One of the five legal principles identified in Chapter 1 as being fundamental to the determination of an individual's domicile was that a change of domicile may never be presumed. Put simply, this means that it is difficult for an individual to change his domicile, particularly a domicile of origin to a domicile of choice. This is clear from the cases analysed in Chapter 1. In *Udny v Udny*[102] it was doubted whether residence in London for 32 years gave rise to an English domicile of choice, supplanting Colonel Udny's Scottish domicile of origin. In *IRC v Cohen*[103] the taxpayer, who left England for Australia aged 18, returning when he was 50 was held to have not lost his English domicile of origin. Finally, in *Bell v. Kennedy*,[104] the taxpayer's decision to sail away from Jamaica with the intention of never returning was held to be insufficient on its own to extinguish his Jamaican domicile.

[99] *Whicker v Hume* (1858) 7 HL cas 124
[100] *Henderson v Henderson* [1965] 1 All E.R. 179
[101] *Udny v Udny* (1868) LR 1 Sc & Div 307
[102] (1868) LR 1 Sc & Div 307
[103] (1937) 21 TC 301
[104] 1 S. & D. 307

These cases tend to support the proposition that Rupert has not acquired an English domicile. The position is further strengthened by the fact that the onus is on the Inland Revenue to prove that Rupert has abandoned his domicile of origin, as the burden of proof in domicile cases is on he who asserts that the domicile has changed.[105] As regards the standard of proof, it is clear that, first, unless the 'judicial conscience'[106] is satisfied by evidence of change, the domicile of origin persists; and secondly, that the acquisition of a domicile of choice is a serious matter not to be lightly inferred.[107] In *Buswell v CIR*[108] the Revenue sought unsuccessfully to rely on a form signed by the taxpayer stating that he intended to remain permanently in the UK. The Court of Appeal held that the signed form did not show sufficient intent to change the taxpayer's Transvaal domicile of origin to an English domicile of choice.[109]

This case study continues on the basis, supported by the aforestated case law, that Rupert has a non-UK domicile.

[105] In *In the Estate of Fuld (No 3)* [1968] P 675 at p. 682, Scarman J (as he then was) said: *"It is beyond doubt that the burden of proving the abandonment of a domicile of origin and the acquisition of a domicile of choice is upon the party asserting the change."*
[106] For 'judicial conscience' may be substituted 'balance of probabilities'. See judgment of Orr L.J. in *Buswell v CIR* (1965-1975) 49 TC 334
[107] *In the Estate of Fuld (No 3)*, op. cit., at p. 686
[108] (1965-1975) 49 TC 334
[109] Stamp L.J. : *"I am, however, prepared to assume that the Appellant did in truth, at the moment of time when he signed the form P.86, 'propose to remain permanently in the United Kingdom'. It does not, however, follow that he had then that settled intention so to remain which is to be shown*

5.4.3 Rupert Limited

Of Rupert's sources of income, his boxing contest purses are the most difficult for which to establish any meaningful offshore tax planning strategy. Such income clearly arises from Rupert's personal services and, as such, an offshore service company, for example, would serve little purpose. From a UK perspective the anti-avoidance provision s. 739 would apply so as to bring all income of the offshore company, subject to allowable expenditure, in charge to UK tax as if earned directly by Rupert under Schedule D(II). Section 743(3) will not relieve such income from UK tax as Schedule D(II) taxes on an arising basis, as opposed to a remittance basis, irrespective of the domicile of the taxpayer. From the perspective of the US, where most of the fight income will be generated, an offshore service company, if recognised,[110] would be subject to 30% withholding tax under s. 1442 of the Internal Revenue Code,[111] as occurred to Caymanco in the previous Case study.[112]

These restrictions do not, of course, argue against the creation of a UK service company for Rupert's boxing income. The incorporation of Rupert Limited (R

in order to show the abandonment of a domicile of origin by the establishment of a domicile of choice. " Ibid. at p. [to be inserted]

110 In the 1964 case of *Johansson v United States* 336 F.2d 809, 813 (5th Cir. 1964), the professional boxer Ingemar Johansson had formed a Swiss service company for his World Heavyweight Boxing Championship contest with Floyd Patterson in the United States. The US courts found that the corporation was a sham, merely a 'controlled depository and conduit' for tax avoidance purposes. See Chapter 3, section 3.1.5.2.

111 See Chapter 3, section 3.1.2.2.

112 See Case Study I, section 6.1.8.4.

Ltd) in England and Wales[113] as the trading vehicle for Rupert's boxing activities is reasonably standard, non-contentious tax planning, as discussed in Chapter 1, section 1.7. The tax advantages include a reduced tax rate, the opportunities to regularise personal income and consequently personal income tax, thereby both reducing and delaying the payment of tax. Non-tax benefits includes limited liability.

In granting to R Ltd the right to supply his boxing services, Rupert should make no distinction between the boxing in the UK and boxing in the US (or elsewhere). Though most international tax planning schemes seek to trap overseas earnings in offshore structures, that is not sought in the tax strategy for Rupert in respect of his boxing income as there is no advantage in so doing.

The receipt of boxing income arising in the US by R Ltd will be subject to withholding tax under Article 17 of the UK:US Double Taxation Treaty.[114] The fact that R Ltd enjoys the income rather than Rupert himself does not avoid the withholding tax, it is merely applied to the company instead. Article 17(2) is clear on this point.[115] The US withholding tax will be relieved in the UK by

[113] UK companies are incorporated in England and Wales, Scotland or Northern Ireland.
[114] Art. 17(1) *"Notwithstanding the provisions of Article 14 (Independent personal services) and 15 (Dependent personal services), income derived by entertainers, such as theatre, motion picture, radio or television artistes, and musicians, and by athletes, from their personal activities as such may be taxed in the Contracting State in which these activities are exercised, except where the amount of the gross receipts derived by an entertainer or athlete, including expenses reimbursed to him or borne on his behalf, from such activities do not exceed 15,000 United States dollars or its equivalent in pounds sterling in the year concerned."*
[115] Art. 17(2) *"Where income in respect of personal activities as such of an entertainer or athlete accrues not to that entertainer or athlete himself but to another person, that income may, notwithstanding the provisions of Articles 7 (Business profits), 14 (Independent personal services),*

means of a tax credit under the Elimination Of Double Taxation provision contained in Article 23 of the UK:US Double Taxation Treaty.[116]

Notwithstanding this double taxation relief, it is important that care is taken over the tax planning for R Ltd. The US, as stated, will generally apply a withholding tax rate of 30% on the gross income earned by R Ltd from fight purses in the US. However the UK relief is limited to an amount equal to the corporation tax 'attributable to the income or gain'.[117] The problem becomes apparent when comparing the US withholding rate to the UK corporation tax rate (which is, of course applied to taxable profits as opposed to gross income). The general rate of corporation tax for the 1999 financial year (the year beginning on 1 April 1999) is 30%.[118] The 'small companies' rate'[119] for the 1998 financial years is 20%.[120] Whilst some deductions, such as charges on income and management expenses, may be allocated in whole or in part against the UK element of the company's

and 15 (Dependent personal services), be taxed in the Contracting State in which the activities of the entertainer or athlete are exercised..."

[116] The relevant provision in Article 23 of the US:UK Double Taxation Treaty, para. 2(a), states:
"(2) Subject to the provisions of the law of the United Kingdom regarding the allowance as a credit against United Kingdom tax payable in a territory outside the United Kingdom (as it may be amended from time to time without changing the general principle hereof):
(a) United States tax payable under the laws of the United States an in accordance with the present Convention, whether directly or by deduction, on profits or income from sources within the United States (excluding in the case of a dividend, tax payable in respect of the profits out of which the dividend is paid) shall be allowed as a credit against any United Kingdom tax computed by reference to the same profits or income by reference to which the United States tax is computed"

[117] ICTA 1988, s. 797(1) and (2)

[118] FA 1998, s. 29

[119] The 'small companies' rate' is a lower rate of corporation tax that applies to a UK company's 'basic profits' (i.e. taxable income and gains) (ICTA 1988, s. 13(1) and (8)) if a company's taxable profits do not exceed the specified lower profits limit, which for the financial year 1999 is 300,000. Above this limit the full rate is charge subject to 'small companies marginal relief' which reduces the overall effective tax rate until, for the financial year 1999, taxable profits exceed £1,500,000, after which the full rate of corporation tax is applied on the whole taxable profits without relief.

profits, thereby maximising the corporation tax attributable to its foreign profits,[121] it will still be more than likely that the remaining corporation tax attributable to foreign profits will be less than the foreign tax withheld. This would result in effective double taxation of the unrelieved element of the US fight purse income.

R Ltd, as Caymanco in Case Study II, will not be able to enter a central withholding agreement to reduce the withholding tax as such agreements only apply to payments made to individuals. However, there are other methods in this case to effectively reduce the withholding tax. The US fight purses could distinguish between fees payable to R Ltd for Rupert's training and other fight preparation outside the US, and fees payable to R Ltd for Rupert's US fights themselves. Only the fight fees would attract the US withholding tax. The training and other fight preparation would not involve the supply of personal services in the US.

The training fees should be nonrefundable. Otherwise it could be argued by the US authorities that both fees in reality pertain to a single event, the boxing contest, and consequently withholding tax should be applied to the total amount paid. This places a financial risk on the promoter. That is, he would be liable for

[120] FA 1998, s. 29
[121] ICTA 1988, s. 797(3)

the training fees even if the fight were cancelled. The risk, however, is an insurable one, and the associated cost could be built into the promotion itself.[122]

5.4.4 Royalty Income

The income Rupert earns from the endorsement of products and personality merchandising may be suitable for offshore tax planning if such income is in the form of royalties. As substantially all such royalties arise in tax treaty countries, it is appropriate to take the definition of royalties from tax treaties. Section 4.4.6 of Chapter 4 set out the 1992 OECD Model Treaty definition of 'royalties' as follows:

> *"The term 'royalties' as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience."*[123]

The 1996 US Model Treaty defines 'royalties' as:

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[122] This is wholly practical proposal. Indeed, the celebrated case between the flamboyant boxing promoter Don King and Lloyds of London involved such a policy. See A. Geller 'Round After Round, Gov't Can't Deliver KO' The New York Post, July 10, 1998, p. 6: *"July 9, 1998 - King is acquitted of nine counts of wire fraud at his second trial on charges of faking a contract to cheat* ***Lloyd's*** *of London out of $350,000. The jury is unable to reach a verdict against King's company,* ***Don King*** *Productions. The prosecution says King faked the contract after a 1991 fight between Julio Cesar Chavez and Harold Brazier was canceled because Chavez was injured in training. The contract allegedly said King paid Chavez $350,000 in nonrefundable* ***training fees.*** *The contract bore Chavez's signature, but had an added rider claiming King had paid him $350,000 in 'nonrefundable training expenses.' Chavez, a former World Boxing Council super lightweight champion, said he never signed a doctored contract. He testified that King paid him only $80,000 to train for Brazier and never told him about an insurance claim."*

[123] 1992 OECD Model Treaty, Art. 12 (2)

"(a) any consideration for the use of, or the right to use, any copyright of literary, artistic, scientific or other work (including computer software, cinematographic films, audio or video tapes or disks, and other means of image or sound reproduction), any patent, trademark, design or model, plan, secret formula or process, or other like right or property, or for information concerning industrial, commercial, or scientific experience; and (b) gain derived from the alienation of any property described in subparagraph (a), provided that such gain is contingent on the productivity, use, or disposition of the property."[124]

It will be seen that consideration for the use of a trademark clearly falls within the definition of royalties under both model treaties. This is consistent with the individual bilateral treaties concluded by the US and OECD member countries.[125] It follows that arguably the best method Rupert could use to ensure that the endorsement and personality merchandising income he will generate will be treated as royalty income would be by registering his own trademark.

Once registered, the trademark would be the means by which Rupert would endorse a product. Ideally, the trademark should consist of a logo designed around Rupert's name. The use of the trademark would signify Rupert's endorsement. The manufacturer would pay Rupert a royalty for the right to use the trademark on the manufactured goods. The same system would operate with personality merchandising. The trademark would be prominently displayed on all official Rupert merchandising. Again, the merchandising companies would pay Rupert a

[124] US Model Treaty, Art. 12 (2)

[125] It will be recalled from Chapter 4, section 4.8.4, that the US:UK Double taxation Treaty excludes from its definition of royalties consideration for the right to use cinematographic films or films or tapes used for radio or television broadcasting. This is not relevant to this case study.

royalty for the right to display the trademark on the merchandise, be they T-shirts, baseball caps or posters.

5.4.5 Personal Appearances in the US

In addition to the income from endorsements and personality merchandising, Rupert will receive money for making personal appearances. Where these appearances are in the US to support a product range he is endorsing or to launch a range of personality merchandise, the temptation will be to seek to characterise the income generated as royalties, so that it may enjoy favourable tax treatment. This temptation should be resisted. It is the payment for the use of the trademark on products that may properly be termed 'royalties', not payment for a personal appearance to promote the products (or the trademark). R Ltd should supply Rupert's personal appearance services along with his boxing services.

The distinction between personal service income and royalty income is considered in detail in Case Study III in the context of a touring rock band. Case Study III also addresses which Article under the UK:US Double Taxation Treaty is the most applicable to for payments for the personal appearances of performers, be it Article 7, Article 12, Article 14, Article 15 or Article 17. This discussion, not set out here to avoid duplication, is equally relevant to Rupert's non-boxing personal appearances in the US.

Returning to this case study, it is recommended that while R Ltd serves as vehicle for Rupert's income from boxing and personal appearances, a separate offshore vehicle is created for the earning of overseas (non-UK) royalties, as explained in the next section. [126]

5.4.6 Registering as a Trademark

The tax strategy for Rupert is to earn the royalty income free of withholding tax and isolate the income in an offshore financial centre with low or nil income tax. This is achieved by having an offshore vehicle register Rupert's trademark worldwide, excluding the UK. The UK is excluded to maintain the integrity of the s. 743(3) exemption discussed below. R Ltd may register and exploit the trademark in the UK. Once the offshore vehicle has registered the international trademark[127] it becomes legally entitled to the income generated by the exploitation of the trademark.

One problem arises immediately, and it is this: the biggest market for the exploitation of the trademark (outside of, and probably including, the UK) is the US, which has no royalty exempting double taxation treaties with offshore financial centres.[128] Thus the US would withhold 30% tax on royalties paid to Rupert's offshore vehicle. This contrasts with the complete absence of US withholding taxes if the royalties were paid to Rupert direct, or to his UK

[126] See section 5.3.6.
[127] Technically, the trademark will have to be separately registered in each country.

licensing company, under Article 12 of the UK:US Treaty,[129] though such income would, of course, fall in charge to UK tax.

For Rupert to avoid US withholding tax and UK income tax, the OFC trademark holding vehicle would have to license a vehicle (say, for the sake of simplicity, a company, TCo) in a country with an international network of double taxation treaties. TCo's chosen country of residence should have treaties with countries, most notably the US, under which no withholding tax is applied to royalties, and at the same time have a domestic tax system that does not apply withholding tax to royalties paid to non-treaty countries. Under the trademark licence TCo would have the right to exploit Rupert's trademark internationally for say a payment to the trademark owner, the offshore vehicle, of 95% of the royalty income so generated. This, at the first level of analysis, would permit US source royalties to reach Rupert's offshore vehicle virtually free of tax. The only tax payable would be on TCo's 5% profit, less allowable expenses.

5.4.7 Finding a Home for TCo

The criteria for TCo's country of residence, as set out in the previous section, is twofold: (1) it must have treaties with countries, most notably the US, under which no withholding tax is applied to royalties; and (2) it must have a domestic tax system that does not apply withholding tax to royalties paid to non-treaty

[128] With the exception of Cyprus, see section 6.2.6 below.
[129] Article 12(1) of the UK:US Treaty provides: *"Royalties derived and beneficially owned by a*

countries.

Traditionally, Cyprus has served as a tax efficient host for companies such as TCo. Cypriot offshore companies, taxed at a maximum of 4.25%, enjoy the benefits of Cyprus' network of double taxation treaties,[130] and suffer no withholding tax on the payment of trademark royalties overseas. The 1984 US:Cyprus Double Taxation Treaty[131] significantly affected the desirability of Cyprus as the ideal jurisdiction in which to establish a conduit licensing company for US royalties. The Treaty contained, for the first time in a US:Cyprus Convention, a Limitation on Benefits Article. Under the Article a Cypriot company, partnership or trust is not entitled to the benefit of the Treaty unless more than 75% of the beneficial interest in the company, partnership or trust is owned, directly or indirectly, by residents of Cyprus.[132]

resident of the United Kingdom shall be exempt from tax by the United States."

[130] Cyprus has current double taxation treaties with Austria, Italy, Bulgaria, Kuwait, Canada, Malta, China, Norway, Czech Republic, Poland, Denmark, Romania, Egypt, France, Slovakia, Germany, Sweden, Greece, Syrian, Arab Republic, Hungary, United Kingdom, India, United States, Ireland, Yugoslavia, Russia and CIS Republics. Source CCH 'International Tax Offshore Centres' Sydney, CCH Australia Limited (1999) [CD Rom 6/1999]

[131] Signatories: Cyprus, United States; Citations: 89 TNI 18-1; Doc 93-31062; TIAS 10965; Senate Treaty Doc. No. 98-32; Signed: March 19, 1984; In Force: December 31, 1985; Title 'The Convention between the United States of America and Cyprus for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income'.

[132] Article 26(1)(a)-(b) of the 1984 US:Cyprus Treaty provides:

"A person (other than an individual) which is a resident of a Contracting State shall not be entitled under this Convention to relief from taxation in the other Contracting State unless
a) more than 75 percent of the beneficial interest in such person (or in the case of a corporation, more than 75 percent of the number of shares of each class of the corporation's shares) is owned, directly or indirectly, by one or more individual residents of the first-mentioned Contracting State; and
b) the gross income of such person is not used in substantial part, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons who are residents of a State other than a Contracting State and who are not citizens of the United States."

The Republic of Ireland, too, enjoyed a status similar to Cyprus for the same reasons. However, the 1997 US: Ireland Treaty,[133] discussed in Chapter 4, section 4.7.2, contained a Limitation on Benefits Article more comprehensive than that found in the US:Cyprus Treaty, significantly reducing its suitability as the residence of TCo.

Taking these two Limitation on Benefits Articles together one can see the development of the legislative approach to anti-treaty shopping in the US. It would be possible to avoid the impact of the US:Cyprus Article by ensuring that the Cypriot TCo is more than 75% beneficially owned by residents of Cyprus. This would not necessarily harm Rupert's financial interests. TCo Cyprus would have to collect and bank royalties, pay royalties to the offshore trademark owner, maintain accounting records, prepare financial statements and tax computations, and in all other ways fulfil the obligations of the trademark licence agreement and Cypriot company law. If TCo Cyprus were independently owned, the retained 5% of the royalties (less expenses) would simply represent the directors' fees for administering the arrangement. With the 75% rule satisfied, the US under the terms of the US:Cyprus Treaty, would have no basis to apply withholding tax to the royalties.

In contrast, under US:Ireland Treaty the extensive Limitation on Benefits Article

[133] Signatories: Ireland, United States; Citations: 97 TNI 147-39; Doc 97-22062; Senate Treaty Doc. No. 105-31; Signed: July 28, 1997; Title 'Convention Between The Government Of The United States Of America And The Government Of Ireland For The Avoidance Of Double

contains a base erosion test (see Chapter 4, section 4.7.2). Under this test treaty benefits are denied where the amounts paid by a person during a taxable year, and deductible for tax purposes in that person's State of residence, to persons not entitled to treaty benefits constitute more than 50% of the person's gross income for that taxable year. This would clearly catch the 95% payable by the Irish TCo to the offshore trademark owner.[134]

For illustrative purposes, notwithstanding the possible applicability of Cyprus under the conditions discussed above, a third, separate country is sought that satisfies the conditions (1) and (2). By a process of elimination, having reviewed many individual bilateral tax treaties involving the US and the domestic tax legislation of the other Contracting States, the essence of treaty shopping, the author would propose Norway[135] as the country of residence for TCo (NorwayCo). The US:Norway Double Taxation Treaty currently in force was signed on 3 December 1971.[136] Article 10(1) provides that "[r]oyalties derived from sources within one of the Contracting States by a resident of the other Contracting State shall be exempt from tax by the first-mentioned Contracting State." The Treaty does not contain a Limitation on Benefits Article. From the

Taxation And The Prevention Of Fiscal Evasion With Respect To Taxes On Income And Capital Gains'

[134] It is also considered that the Irish TCo would fail the Active Business Test.

[135] It is not proposed to examine the corporate state structure of Norway, other than to state that all companies incorporated in Norway are by that very fact incorporated in Norway and that all trading profits and income are subject to the a single national rate of corporate income tax of 28%.

[136] Signatories: Norway, United States; Citations: 86 TNI 19-36; Doc 93-30453; TIAS 7474; S. Exec. D, 92-2; Signed: December 3, 1971; In Force: November 29, 1972; Title 'The Convention between the United States of America and the Kingdom of Norway for the Avoidance of Double Taxation and the Prevention of fiscal Evasion with respect to Taxes on Income and Property'.

domestic tax perspective, there is no Norwegian withholding tax on royalties paid overseas.[137] So the 95% royalty payment to the offshore registered owner of Rupert's trademark worldwide may be effected tax efficiently (subject to the unilateral US treaty override discussed in section 5.4.8 below).

Finally it should be understood that Norway has been chosen for the residence of TCo with specific regard to royalties arising in the US. Norway may not be as beneficial as a conduit location for royalties arising in other jurisdictions. It may therefore be necessary to have several TCo companies, each resident in a jurisdiction most tax efficient for the royal income that will be generated under the licence granted by the offshore registered owner of Rupert's worldwide trademark.

5.4.8 US Treaty Override

The US has enacted domestic legislation that overrides their tax treaty obligations. The 1986 US Tax Reform Act introduced a new s. 884 of the Internal Revenue Code. Section 884(e)(1) states that "no treaty between the United States and a foreign country shall exempt any foreign corporation from the tax imposed ... unless - (A) such treaty is an income tax treaty, and (B) such foreign corporation is a qualified resident of such foreign country." One of the tests that establishes whether a corporation is a qualified resident is the 50% foreign ownership test or

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[137] See CCH 'Norway', para. 12 in 'International Tax Corporations' Sydney, CCH Australia Limited (1999) [CD Rom 6/1999]

50% percent base erosion (conduit) test.[138] To qualify the taxpayer corporation must meet either the foreign ownership or the base erosion test.[139]

Applying this test to NorwayCo, it is clear that it fails the base erosion test, as more than 50% of the royalties earned by the company are paid to JerseyLP, a resident of a non-tax treaty country, pursuant to their trademark licensing agreement. However, as stated in section 5.3.6 in respect of a possible Cypriot residence for TCo, if, say, 51% of TCo Norway were independently owned by Norwegians, their proportion of the retained 5% of the royalties (less expenses) could serves to represent the cost of administering the arrangement.

5.4.9 Sections 739 and Section 743(3)

The pervasive nature of the anti-avoidance provision section 739 was set out in Chapter 3[140] and explored in detail in the Case Study I, section 5.2.6. The provision is aimed at preventing a tax benefit accruing to an individual ordinarily resident in the UK who transfers assets abroad. In short, under the provision, the income paid to a non-UK resident person as a result of the transfer is taxable in the hands of the ordinarily resident UK transferor. The international tax planning strategy proposed for Rupert is predicated on the basis that s. 739 does not apply because his non-UK domiciliary status. Reliance is placed the exemption contained in s. 743(3).

[138] I.R.C. 884 (e)(4)(A); see also Treas. Reg. 1.884-5(a)(1), (b)(1), (c).
[139] I.R.C. 884(e)(4)(A)(i), (ii).

Section 743(3) provides:

> *"An individual who is domiciled outside the United Kingdom shall not be chargeable to tax in respect of any income deemed to be his by virtue of [section 739] if he would not, by reason of his being so domiciled, have been chargeable to tax in respect of it if it had in fact been his income."*

Applying this provision to Rupert's case, the argument for the non-applicability of s. 739 runs thus. Rupert is domiciled outside the UK. Foreign royalty income is classified by the UK income tax schedular system[141] as income from overseas possessions, taxable under Schedule D(V). Non-UK domiciled individuals are taxed under Schedule D(V) on a remittance basis;[142] that is, UK tax only arises on the foreign royalties that are remitted to the UK.[143] If the foreign royalties become payable to a 'person domiciled outside the UK', for example an offshore company, trust or limited partnership set up by Rupert, s.739 is triggered. However, if the offshore vehicle does not remit the royalties to the UK, s. 743(3) comes into effect. Rupert, being an individual who is domiciled outside the United Kingdom, will not be chargeable to tax in respect of the royalties deemed to be his by virtue of s. 739 because he would not, by reason of his being non-UK domiciled, have been chargeable to tax in respect of non-UK remitted royalties if they had in fact been his income.

Clarke puts the provision into its historical context thus:

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[140] See Chapter 4, section 3.6.1.1

[141] See Chapter 1, section 1.1.

[142] ICTA 1988, s. 65

> *"Until 1981, non-domiciled transferors were potentially liable in respect of foreign-source income under s. 739 for the section predicates that the income is received in the UK.*[144] *But a relaxation was introduced in 1981 and now a non-domiciliary is relieved from tax on such income as it would not be chargeable had it in fact accrued to him (TA 1988, s. 743(3)). This ... effectively ... introduces the remittance basis, applying if neither the taxpayer nor the transferee makes a remittance [to the UK]."*[145]

This serves to support the foregoing analysis.

5.4.10 Rupert's Offshore Vehicle

In order to leave Rupert's overseas royalty income from endorsements and personality merchandising outside the charge to UK tax it is proposed that a Jersey-based limited partnership (JerseyLP) is be formed. The characteristics and effects of such a partnership were examined in Chapter 3, section 3.5.4. Rupert would be the limited partner, and a Jersey International Business Company,[146] the general partner. As the limited partner, Rupert would not be involved in the management of the partnership, nor would he own directly or indirectly the Jersey IBC serving as the general partner. Typically, in these type of arrangements, the IBC is supplied and owned by a Jersey trust company or professional firm, the income accruing to the IBC in its capacity as the general partner representing the fees for the professional and company secretarial services provided.

143 See Chapter 2, section 2.1.6.5.
144 *Congreve v IRC* [1947] 2 All ER 170, at 190, per Wrottesley J.
145 G. Clarke Offshore Tax Planning (Fifth Edition) London, Butterworths (1998) p. 57
146 See Chapter 3, section 3.3.4.2

Notwithstanding Rupert's UK residence, there is no possibility of JerseyLP being held to be resident in the UK provided the structure as set out above is followed. The residence of limited partnerships, as discussed in Chapter 3, section 3.5.2, is determined by where they are managed or controlled, irrespective of the fact that one or more of the partners may be resident in the UK.[147] On this basis, JerseyLP is non-UK resident by definition; that is, the sole UK partner, Rupert, is the limited partner, and under the laws pertaining to limited partnerships he can have no involvement in the management of the limited partnership at all. All management and control would be exercised by the general partner, the Jersey IBC (which in turn is neither owned nor controlled by Rupert).

The income earned by Rupert from JerseyLP will fall to be taxed under Schedule D(V),[148] as income from a foreign possession. An interest in a non-UK resident partnership is a foreign possession. This was established over one hundred years ago in the case of *Colquhoun v Brooks,*[149] and subsequently confirmed in *Newstead v Frost.*[150] (For a fuller analysis of this case see Chapter 3, section 3.5.3.)

The remittance basis applies to Schedule D(V) income where the taxpayer

(a) is UK resident but not domiciled in the UK; or

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[147] ICTA 1988 s.112(1)(a)

[148] As discussed in Chapter 3, section 3.5.3, income from a foreign partnership falls to be taxed under Schedule D Case V.

[149] (1883-1890) 2 TC 490

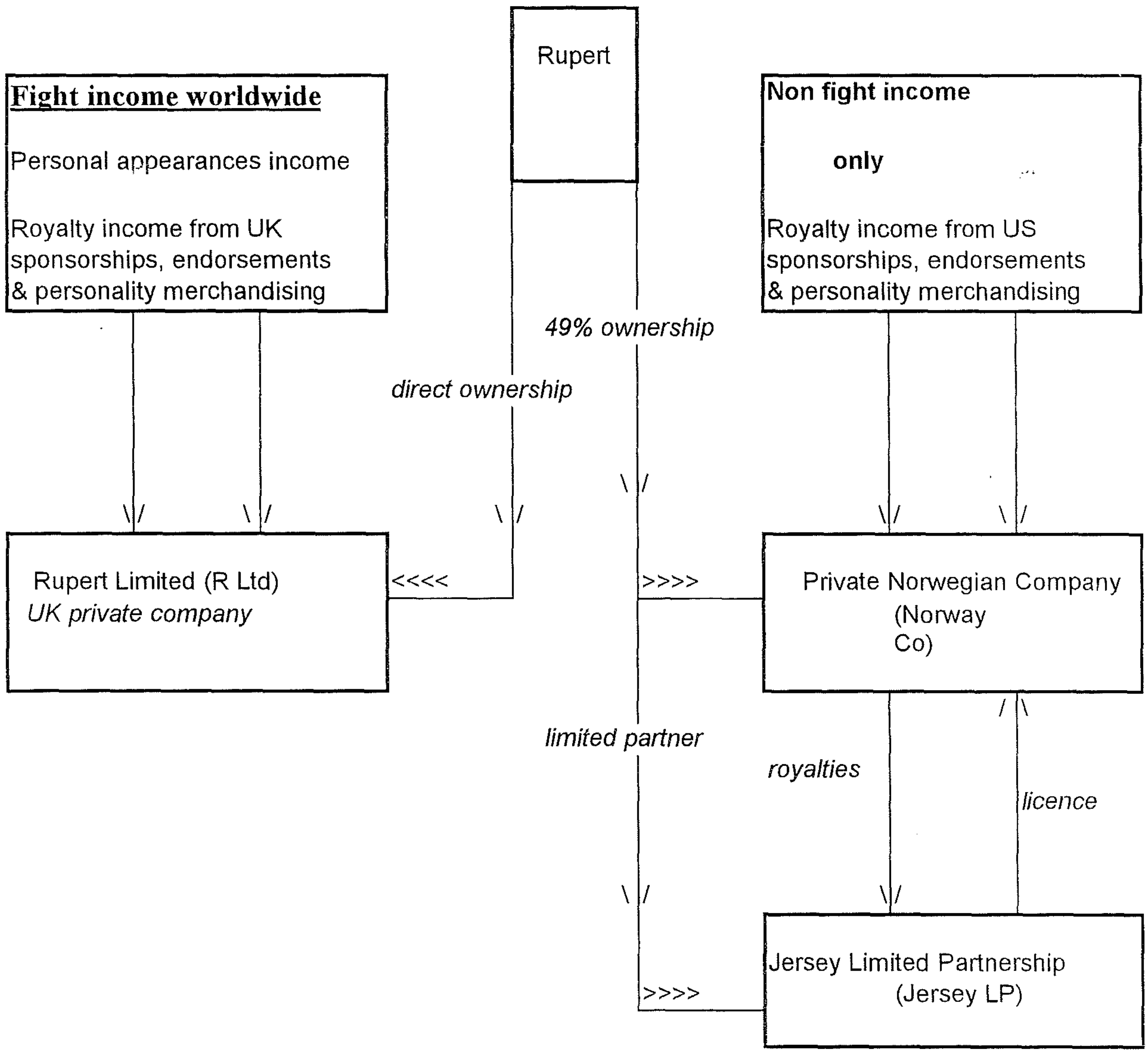
(b) is a Commonwealth citizen (including British) and is not ordinarily resident in the UK.[151]

As a non-UK domiciled individual Rupert falls into category (a). As such the income that accrues to Rupert in JerseyLP will escape UK taxation unless and until the income is remitted to the UK.

[150] *Newstead v Frost* [1980] 1 W.L.R. 135 (H.L.)

[151] Section 65(4) ICTA 1988.

5.4.11 Diagrammatic Representation of Tax Strategy



5.5 CASE STUDY IV

This case study concerns a four-piece rock band called WhiteApple. The band was formed in 1997 and has released one album, which reached number 20 in the album charts. The band's two single releases were moderately successful, reaching the top 40 in the singles charts but failing to reach the top ten. The album and the singles also enjoyed moderate success in the US. Nonetheless, having been featured on the television, radio and in several magazines, WhiteApple is considered to be a band with a future.

WhiteApple presently trades as a partnership, though they have incorporated a UK company, WA Ltd, for future trading purposes. The band has four members: Adam, Barry, Charlie and Dean; and one manager, Eddie. All are UK resident and ordinarily resident.[152] In addition, Adam and Barry are not domiciled in the UK;[153] Adam is Australian and Barry is a citizen of the United States. Charlie, who composes all of the band's songs, is preparing to write the material for the next album, due for release in the year 2000. To coincide with the release of the album, the band proposes to undertake a tour of the United States.

5.5.1 Royalty Income in the Record Industry

Before addressing the tax planning issues, it is valuable to set out a brief

[152] The issues of residence and ordinary residence were discussed in a case study context in Case Study I, section 5.2.2.

description of the royalty income in the record industry so that it is clear how and when the income arises and to whom it accrues.

When a songwriter has composed a song, the first step is usually publication. The publisher's role is to promote and monitor the use of the music through sheet-music sales and, more importantly, through recordings and live performances.[154] In normal circumstances, a composer surrenders 50% of his copyright interest in the composition to the publisher in return for an advance of royalties (the taxation of which was discussed in Chapter 1).[155] Consequently, the publisher and the composer share the ensuing royalty income on a 50:50 basis. The royalties derived from the publication of sheet-music and from the sale of recordings based on the sheet-music are known as mechanical royalties.[156] Such royalties have also been held to arise when music is downloaded from the internet.[157]

When the music is 'performed', whether by a band, an orchestra, a night club

[153] The issue of domicility was discussed in a case study context in Case Study III, section 6.3.2.
[154] H.L. Vogel Entertainment Industry Economics Cambridge, Cambridge University Press (1994) p.136
[155] See Chapter 1, section 1.1.3.3.
[156] Under US copyright law, there exists a statutory rate at which any record company can obtain a compulsory license for a song from the Copyright Office. The only restriction is that the writer/publisher may set any price for a 'first use' of the composition. Once a song has been recorded with the consent of the copyright owner, anyone may record the composition by obtaining a compulsory license. The UK, by contrast, does not have a compulsory license provision. Instead, the Mechanical Royalty Tribunal sets the rate when the publishers and record companies fail to reach an agreement in the free market. See S.J. Gabe 'Examining U.K./U.S. Copyright Law; Singing Different Songs' Entertainment Law & Finance, Vol. VII; No. 12, March, 1992, p.3
[157] In 1993, a class action suit was brought in the US against CompuServe, an internet on-line service provider, for permitting subscribers to download recorded performances without the permission of the copyright owners of the musical compositions (Music Corp. v. CompuServe Inc., No. 93 Civ. 8153 (JFK) (SDNY 1993)). The court approved a settlement under which CompuServe paid the copyright owners $568,000. The parties also entered into a licensing arrangement whereby CompuServe agreed to pay mechanical royalties in the future.

singer, or, most importantly, played on the radio, the composer becomes entitled to a performance royalty. Pop music tends to generate high performance royalties, whereas rock and rap music tends to fare better on mechanical royalties, especially through album sales.[158] Finally, the composer and his publisher can enjoy synchronization royalties when the copyrighted music is used in a film sequence.[159]

The royalties accruing to the performers of the music on records are known as talent royalties. Such royalties are usually fixed as a percentage of the retail price of the record,[160] the total income being dependent on the quantity of records sold. Major artistes can command over 15% of the retail price, lesser artistes tend to settle at a rate of 10% or less.[161]

In the case of WhiteApple, Charlie will already have a publishing deal from the first album. He will earn mechanical royalties from sheet-music sales and WhiteApple's recordings, and performance royalties from the band's live performances, radio play of the band's records and any cover versions of the band's tracks. The other members of the band, together with Charlie, will earn talent royalties from the sale of the WhiteApple's albums.

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[158] 'Worth Its Weight In Gold' Music Week, Miller Freeman, June 5, 1999, p. 24
[159] H.L. Vogel, op. cit., p. 138
[160] This is sometimes done on a step basis, as in 10% for the first 100,000 sales and 11% on all sales over 100,000.

5.5.2 Composing in an Offshore Jurisdiction

Charlie does not need to be in the UK in order to compose the tracks for the forthcoming album, which he anticipates taking just over twelve months to complete. He would happily relocate for a year and wonders whether there will be significant tax advantages in composing his songs in an offshore financial centre.

In most instances, if an individual were equally able to conduct his professional affairs from an offshore financial as from the UK, there would be a considerable fiscal advantage in doing so. This, however, will not necessarily be true for Charlie because of the duration and nature of his work. Working abroad for a year will not necessarily make him non-UK resident for that year. Even if the year abroad covers an entire fiscal year, in the absence of full-time employment it is possible that the Inland Revenue will continue to treat Charlie as both resident in and ordinarily resident in the UK. There would be sufficient judicial authority for this stance. The issues of UK residence and ordinary residence are discussed in detail in Chapter 1.[162]

The Inland Revenue guidance notes on residents and non-residents, IR20, state in that the Inland Revenue will treat a taxpayer as being not resident and not ordinarily resident in the UK from the date of his departure if he leaves the UK to

[161] H.L. Vogel, op. cit., p. 141

[162] See Chapter 1, sections 1.6.2 and 1.6.3.

work full-time abroad under a contract of employment,[163] provided the taxpayer meets fairly minimal rules regarding his return visits to the UK.[164] Charlie is going to work for himself overseas, but this would not prevent him from forming an offshore company (WriterCo) and contracting with it to perform his services as a songwriter on a full-time basis. Should this satisfy the Inland Revenue, Charlie will be treated, on the basis of IR20, as not resident and not ordinarily resident in the UK for the duration of his time abroad.

5.5.2.1 Could The Inland Revenue Treat The WriterCo Arrangement As A Sham?

The issue of company recognition was addressed in Chapter 3, section 3.3.3. It will be recalled that under the doctrine of incorporation the UK recognises all companies incorporated abroad provided they have been properly incorporated in accordance with the laws of their country of incorporation. Provided WriterCo has fulfilled these requirements it will be recognised as a separate legal personality in the UK. It does not follow, however, that the Inland Revenue are equally bound to recognise the employment contract between WriterCo and Charlie. They could seek to dismiss it as a sham.

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[163] IR20 (1996), para. 2.2

[164] The taxpayer must not return to the UK for 183 days or more in the tax year; nor return to the UK for an average 91 days or more a tax year. The average is taken over a maximum period of four years.

In the 1999 case of *Stone v Executors of Hitch (dec'd) & Ors*,[165] the only issue considered was whether certain documents forming part of a tax avoidance scheme were a sham. Jonathan Parker J considered that the leading authority with regard to the nature of a sham was the dictum of Diplock LJ in *Snook v London and West Riding Investments Ltd*,[166] where he said:[167]

> *"As regards the contention of the plaintiff that the transactions between himself, Auto Finance and the defendants were a "sham", it is, I think, necessary to consider what, if any, legal concept is involved in the use of this popular and pejorative word. I apprehend that, if it has any meaning in law, it means acts done or documents executed by the parties to the 'sham' which are intended by them to give to third parties or to the court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intend to create. But one thing, I think, is clear in legal principle, morality and the authorities (see* Yorkshire Railway Wagon Co v Maclure[[168]] *and* Stoneleigh Finance Ltd v Phillips[[169]]*), that for acts or documents to be a 'sham', with whatever legal consequences follow from this, all the parties thereto must have a common intention that the acts or documents are not to create the legal rights and obligations which they give the appearance of creating."*

In this context it is also worth recalling the words of Lord Wilberforce in the seminal anti-avoidance case of *WT Ramsay Ltd v IRC*:[170] "[T]o say that a document or a transaction is a 'sham' means that while professing to be one thing, it is in fact something different."[171]

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165 [1999] BTC 103
166 1967] 2 QB 786
167 Ibid., at p. 802
168 (1882) 21 ChD 309
169 [1965] 2 QB 537
170 [1982] AC 300
171 Ibid., at p. 323

Applying these tests to the employment contract between Charlie and WriterCo, the contract would be a sham if no genuine legal obligations ensued from it. More specifically, in this instance, the contract would be a sham if the copyright interest in the songs written became vested in Charlie rather than WriterCo. It is thus submitted that provided WriterCo is properly incorporated under the laws of the OFC of incorporation, and provided there is a bona fide employment contract between Charlie and WriterCo, and provided that under that contract the copyright of the songs Charlie composes vests in WriterCo, there is no basis on which the Inland Revenue could attack the arrangement as a sham.

5.5.2.2 IR20 And Anti-Avoidance

IR20 contains the following sentence in the preface: "Some practices explained in this booklet are concessions made by the Revenue. A concession will not be given in any case where an attempt is made to use it for tax avoidance." In *R v HM Inspector of Taxes, ex parte Fulford-Dobson*,[172] the High Court, in an application for judicial review, upheld the Revenue's denial of an extrastatutory concession to a taxpayer on this basis. The taxpayer had taken up employment in Germany four days before selling a farm, which his wife had given him the previous month. It was admitted that the purpose of the gift was to enable the taxpayer to take advantage of ESC D2,[173] which the court considered a clear case

[172] [1987] BTC 158

[173] Under the legislation a person must be non-resident for the whole fiscal year in order for his disposals to fall outside the charge to UK capital gains tax. Extrastatutory concession D2 allows the splitting of fiscal years: "When a person leaves the United Kingdom and is treated on his

of tax avoidance, entitling the Revenue were right to deny the concession.

Paragraph 2.2 of IR20, which treats a taxpayer as being not resident and not ordinarily resident in the UK from the date of his departure if he leaves the UK to work full-time abroad under a contract of employment, is only partially an extrastatutory concession. Extra-Statutory Concession A11 provides that an individual who goes abroad for 'full-time' service under a contract of employment may be treated as not resident and not ordinarily resident on a 'split year' basis, where other conditions apply. That is, the concession applies to the splitting of the years, not to the residence treatment of taxpayers working abroad full-time under a contract of employment. This latter treatment is the Revenue's interpretation of the law. That said, it is certainly an extension of the statutory law which simply provides that:

> *"Where–*
> *(a) a person works full-time in one or more of the following, that is to say, a trade, profession, vocation, office or employment; and*
> *(b) no part of the trade, profession or vocation is carried on in the United Kingdom and all the duties of the office or employment are performed outside the United Kingdom;*
> *the question whether he is resident in the United Kingdom shall be decided without regard to any place of abode maintained in the United Kingdom for his use."*[174]

Case law is inconclusive, though paragraph 2.2 of IR20 appears to the author, based upon a review of the case law, to give insufficient weight to the adhering

departure as not resident and not ordinarily resident in the United Kingdom he is not charged to capital gains tax on gains accruing to him from disposals made after the date of his departure."

[174] ICTA, s. 335(1)

quality of ordinary residence, which, as stated in Chapter 1,[175] is a more enduring personal attribute than simple residence. In an Inland Revenue explanatory note relating to a proposed amendment to the Finance Bill 1974, it was stated that ordinary residence is "a more elusive concept than simple residence. It can also be more adhesive, in that a person can remain ordinarily resident even though physically absent from the country throughout the year (and, accordingly, not resident)."[176]

In summary, it may be said that Charlie will not enjoy the benefit of year splitting, but should the Revenue follow IR20, he should be treated as not resident and not ordinarily resident in the UK provided his absence spans a complete fiscal year, noting that his nonresidence will only apply from 6 April to the following 5 April of the year of his departure. Though it should be noted that the Revenue may depart from IR20, as discussed in Case Study I,[177] in which circumstance, for reasons stated above, the courts are likely to hold that Charlie is ordinarily resident, though not resident, in the UK during his year abroad.

5.5.2.3 Emigration

If this analysis is correct and Charlie is held to be ordinarily resident in the UK, s. 739 would serve to negate any tax benefit to be derived from the composing of

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[175] See Chapter 1, section 1.1.6.3.
[176] See D. Davies, op. cit., pp. 30-31.
[177] See section 5.2.2.

the tracks for the second album in an offshore financial centre.[178] Moreover, even if s. 739 did not apply virtually all royalties accruing to WriterCo would be subject to tax in the source countries, as WriterCo's country of residence, being an OFC, will not have a network of double taxation treaties exempting royalty income from withholding tax.

A better and more realistic proposition would be for Charlie to emigrate to an OFC. This avoids discussions of UK residence and ordinary residence, and the need for the incorporation of WriterCo. The withholding tax situation would still arise, but this could be avoided by selling his copyright interest in the new songs, once his non-UK residence status had been confirmed, thereby enjoying a capital gain free of tax in the OFC. The sale could be to his UK publishers or, better still, to a US publisher for reasons set out in section 5.5.3.1 below.

5.5.3 Recording in the Bahamas

Once Charlie has finished writing the songs, WhiteApple will begin recording their second album. Having read that the Rolling Stones, Paul McCartney and Sting have recorded album tracks in a studio on the tiny Caribbean island of Montserrat,[179] they are interested in whether there is any tax advantages in recording the album in an offshore financial centre. They know, for example, that

[178] For an explanation of this anti-avoidance provision see Chapter 3, section 3.6.1.1; for its application see Case Study I, section 5.2.6.
[179] This studio was destroyed in the volcano eruptions in Montserrat in 1997. See C. Steifel, 'Fighting the volcano' Science World, Thomson Corporation, November 17, 1997

the Bahamas has a state-of-the-art recording studio suitable for their needs: the Compass Point Studios in Nassau, where the best selling producer and rapper,[180] Puff Daddy,[181] recently finished recording his 1999 album 'Forever'.

The answer to the query is complex. Were WhiteApple to record their next album in the UK the worldwide talent royalties generated would be free from withholding tax by virtue of the royalties Article in the UK's network of double taxation treaties. The royalty income, less allowable deductions, would fall to be taxed in the UK alone. These rules apply, in general terms, wherever the actual recording takes place, as the members of WhiteApple are resident in the UK.

Should the band members create a new offshore company (BahamaCo) for the purposes of recording their new album in the Bahamas, withholding tax will be applied to royalties received by BahamaCo as the Bahamas do not have a network of double taxation treaties. Moreover, the very incorporation of BahamaCo, and the transfer to it of the right to own the intellectual property rights that will be generated by the recording of the new album, would, prima facie, be a 'transfer of assets abroad' caught by the UK's s. 739 anti-avoidance provision.

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[180] Three of Puff Daddy's Bad Boy Record Company releases - Notorious B.I.G.'s Life After Death, Mase's Harlem World and his own debut, No Way Out - each sold more than 3 million albums. Puff Daddy's single 'I'll Be Missing You', an elegy to rapper Notorious B.I.G ., who died in a drive-by shooting, outsold every other single in 1997 except Elton John's tribute to the late

5.5.3.1 Using The Boulez Case To WhiteApple's Advantage

Leaving the issue of s. 739 to one side for the moment, it may be possible to successfully attack the first of the tax planning obstacles, namely the withholding tax on royalties on US royalties. For this purpose it is necessary to re-examine the definition of royalties from a US perspective. It will be recalled that in the case of *Boulez v Commissioner*,[182] discussed in Chapter 4, section 4.4.6, the conductor, Pierre Boulez, a non-US resident alien, entered into a contract with CBS Records to conduct an orchestra for a studio recording in New York. CBS paid the conductor a percentage of the proceeds received from the sale of the records, but he did not retain a copyright interest in the recording. Notwithstanding the fact that his income was based on a sales percentage, the conductor was held to have received, not royalty income, but income from personal services performed in New York.

Using this case as a model, should WhiteApple record their new album on the condition that they will earn income based on a percentage of record sales, but that they will retain no copyright interest in the recording, it would follow that when the records are sold in the US, none of the income so generated could be considered to have been derived from a US sources, because all payments made from the US would not be royalties. Rather they would be payments for personal

Princess Diana, 'Candle in the Wind'.
[181] Also known as Sean ("Puffy") Combs.
[182] 83 T.C. 584 (1984), aff'd, 810 F.2d 209 (D.C. Cir. 1986)

services performed in the place of the recording, namely, the Bahamas.[183] Because WhiteApple's members would have no US source income from the recording, there would be no basis for the US to apply withholding tax to the payments generated from the sale of the recording. It is for this reason that in the previous section (5.5.2.3) it was considered that should Charlie emigrate it was best that he sell his rights to mechanical and performance royalties to a US publisher.

5.5.3.2 Will Tour Invalidate 'Boulez' Tax Planning?

This, however, is not the end of analysis for WhiteApple. When the band tours the US in the year 2000 they will be actively engaged in a trade in the US. This is well established: see Chapter 2, section 2.3.1. Income from the tour will be subject to withholding tax under Article 17 of the UK:US Double Taxation Treaty, and in accordance with s. 1441 (individuals and partnerships) or 1442 (corporations) of the Internal Revenue Code. One of the principal purposes of the tour, in common with most band tours, will be to promote the new album. The question then arises as to whether the income from the increased records sales arising as a consequence of the tour, insofar as this can be quantified, will fall within these withholding tax provisions.

[183] A similar argument is put forward by US tax lawyer Gerald Damsky. See G. Damsky 'Tax Planning for Foreign Entertainers; Maximizing Income' Entertainment Law & Finance, The New York Law Publishing Company, Vol. X; No. 4; Page 3, July 1995

There is no judicial authority on this point, but the author expresses with some confidence that the answer is in the negative. The business of the tour is to play live venues in return for ticket sales (or booking fees) and related income. Should the concerts increase the sales of the album it is because they serve as an advertisement for the album. The concerts will not generate the item sold. The item sold will have been generated by the work undertaken in the recording studio, and insofar as this work was performed outside the US, and the income generated deemed to be from personal services, the tour cannot retrospectively subject the income generated therefrom to US withholding tax.

5.5.3.3 Section 739

As regards s. 739, the provision was fully examined and applied in Case Study I, section 5.2.6. It is a well-established anti-avoidance provision which is broad in its applicability. It would catch the trading income of BahamaCo, for the same reasons that it caught the trading income of Caymanco, subject only to the shares being held in a trust of which neither the band members nor their spouses were beneficiaries. This is also discussed in Case Study I.[184] The non-UK domiciliary members of the band, Adam and Barry, may be able to defeat the operation of s. 739 by virtue of s. 743(3). This explored in section 6.3.7 below.

5.5.4 Tie-In Contracts

It is increasingly common that in the financing of rock band tours, sponsors are sought to fund the tour in exchange for advertising 'tie-in' privileges. WhiteApple will make use of the practice in their tour of the US in the year 2000. The 'tie-in' contracts will give the contracting companies the rights to use the WhiteApple's name and the band members' likenesses in selling tour-related products in return for a licence fee. As an additional benefit, they would be identified as sponsors on billboards, in advertisements, in commemorative programs, in press releases and on tickets.

Sponsoring tours is a growing business, attracting the major commercial enterprises. The 1999 $30 million grossing 'Millennium' tour of the highly successful Backstreet Boys was sponsored by Sears, Roebuck.[185] The objective of the sponsoring companies is to target a specific audience. General Motors' Oldsmobile Alero division, together with the Hard Rock Café, served as lead sponsors of RockFest, a US multiband rock tour, with a view to attracting a younger customer base.[186] Levi Strauss sought to combat low 1998 sales[187] by an advertising campaign that included the sponsoring of hip-hop diva Lauryn Hill's concert tour.[188] In addition to supporting established acts, sponsoring companies

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[184] See Case Study I, section 5.2.6.
[185] R. Waddell 'Backstreet Boys Tour: A $ 30 Mil Sellout' Amusement Business, BPI Communications, August 23, 1999
[186] T. Irwin 'Olds rocking in search of youth' Adweek, ASM Communications, May 17, 1999
[187] Sales had dropped 13 percent to $ 6 billion.
[188] M. Socha 'So Far, So Good, Holloway Says' WWD, Thomson Corporation, April 15, 1999

are also keen to use the marketing power of endorse up and coming bands. Cube, a new four-piece from Leeds, recently secured sponsorship funding from Virgin Megastores as part of the retailer's new artist support initiative.[189] The funding helped pay for the marketing activity in respect of the release of their debut album in September 1999. In return, the Virgin Megastores logo will appear on Cube promotional material, including tour posters and tickets, in a manner similar to that posited in this WhiteApple case study.

In order to formulate an appropriate international tax planning strategy for WhiteApple in respect of these contracts, it is first necessary to ascertain how the monies generated from the 'tie-in' privileges will be classified under the double taxation treaties. There are four possible double taxation articles under which the income could fall: Article 7 (Business Profits), Article 12 (Royalties), Article 14 (Independent personal services) and Article 17 (Artistes and Athletes (or Sportsmen)).[190]

Should WhiteApple contract for the tour 'tie-in' income through their single service company, WA Ltd, the income arising therefrom could be deemed to be the business profits of WA Ltd under Article 7. Business profits earned by a company resident in a Contracting State from a source in a second Contracting State will only be taxable in the source State if the company has a permanent

[189] 'Polydor signing Cube' Music Week , Miller Freeman, May 15, 1999

[190] A case could be made for including Article 15 (Dependent personal services) in this analysis, where, say, the band members were employees of their US promoter, but the author considers that this would not add materially to the analysis within this case study.

establishment there.[191] Should WhiteApple contract for the tour 'tie-in' income through the partnership of the individual group members, the income arising therefrom could be deemed to be income from independent personal services, under Article 14. Income from independent personal services are taxable solely in the State of residence unless the taxpayer has a fixed base regularly available to him in the source Contracting State for the purpose of performing his activities, in which case the income may be taxed in the source State.[192]

This gives rise to two questions: (1) does the 'tie-in' income arise from personal services or are they royalties; and (2) if they arise from personal services, do the arise from the personal services of the members of WhiteApple in their capacity as musicians (Article 17) or in some other capacity (Article 7 or Article 14)?

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[191] Article 7(1) of the 1992 OECD Model Convention provides: *"The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment."* This is consistent with the US:UK Double Taxation Treaty.

[192] Article 14 of the 1992 OECD Model Convention provides: *"1. Income derived by a resident of a Contracting State in respect of professional services or other activities of an independent character shall be taxable only in that State unless he has a fixed base regularly available to him in the other Contracting State for the purpose of performing his activities. If he has such a fixed base, the income may be taxed in the other State but only so much of it as is attributable to that fixed base. 2. The term "professional services" includes especially independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of*

5.5.4.1 Does 'tie-in' income arise from personal services or are they royalties?

The first question was recently considered by the US IRS in a published 'IRS Field Service Advice'.[193] The Advice readily acknowledged the absence of a clear legal distinction between activities that generate royalty income and those that lead to the receipt of personal services income. It concluded, however, that:

> *"A tie-in right is essentially dependent on an actual performance taking place. Other rights, such as the right to sell T- shirts incorporating a [logo or a performer's] name, may be transferred without a performance of services. Similarly ... a transfer of a copyright, such as a broadcasting right, will separately create royalty income. The acquisition of a tie-in right, however, is a payment for association with a particular performance. In accordance with the OECD commentary, we believe that tie-in income should be considered income from the performance of personal services."*

There is difficulty with this analysis insofar as most tie-in rights, including those set out in this Case study, include the right to promote merchandise based on a logo or likeness, be it on a T-shirt or other product. As such products may be sold 'without a performance of services', it would appear to follow that at least part of the 'tie-in' rights would qualify as royalties. The problem would appear to rest with a single 'tie-in' rights contract. Where such a contract exists it is likely, on the foregoing analysis, that the whole of the income generated under the contract

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physicians, lawyers, engineers, architects, dentists and accountants." This, too, is consistent with the US:UK Double Taxation Treaty.

[193] IRS Field Service Advice: Performers' Tour Income Is Personal Services Income Under U.K. Treaty;
Countries: United States; United Kingdom; Electronic Citation: 1999 WTD 107-30; Document Number: Doc 1999-2589

would fall to be treated as personal services income. If, however, the 'tie-in' rights were included in two separate contracts: one for the use of the band's trademark, along the lines discussed in Case Study II, section 5.3.4, and the second for the advertising element of the 'tie-in', the former should generate royalties and only the latter personal services income.

5.5.4.2 Does the personal services 'tie-in' income accrue to WhiteApple in their capacity as musicians (Art. 17) or in some other capacity (Arts. 7 or 14)?

The second question raised above concerned whether the personal services element of the 'tie-in' income of the members of WhiteApple arose in their capacity as musicians (Article 17) or in some other capacity (Article 7 or Article 14). This issue was discussed in the 1987 OECD Report on the taxation of entertainers, artistes and sportsmen.[194] In discussing the types of income that should be within the scope of Article 17, the OECD acknowledged that one possible interpretation, the narrowest, was that only income deriving from an exhibition of the artistes' or athletes' talents falls under the Article.[195] Under this argument, income from sponsorship, endorsements and personality merchandising, if in the form of personal services would fall would under Article 14, and if in the form of business income would fall under Article 7.[196]

[194] OECD Taxation of Entertainers, Artistes and Sportsmen Paris, OECD (1987)
[195] Ibid., para. 78

The OECD rejected this argument in favour of a wider interpretation under which Articles other than Article 17 would only apply to non-royalty income where there was no direct link between the income and a public exhibition of the performer, as discussed in Chapter 4, section 4.4.4. Specifically, the OECD held that advertising and sponsoring income paid especially in connection with a performance (whether before or after the event) or a series of performances, would fall under Article 17,[197] resulting in withholding tax being applied by the source Contracting State.

In the absence of a developed body of case law in this area, it is appropriate to place reliance on the OECD interpretation of its own model treaty. From a tax planning perspective, this only serves to emphasise the advantage of two separate 'tie-in' rights contracts, as suggested in section 5.5.4.1 above.

5.5.4.3 'Tie-in' income and Eddie, the manager

The foregoing analysis of the treatment of 'tie-in' income does not apply to Eddie, the manager of WhiteApple. This is because Eddie does not fall within the ambit of Article 17. In Chapter 4, section 4.4.3, the discussion as to who constitutes an athlete, sportsman or entertainer, for the purposes of Article 17, highlighted that there were no firm lines of demarcation. Band managers are certainly not specifically included in the definition of athlete, sportsman or entertainer in the

[196] Ibid., para. 79
[197] Ibid. para. 83

OECD and US Model Treaties or the supporting OECD Commentary and US Treasury's Technical Explanation. Moreover, the exclusion from the definition of all support staff, film producers and directors, and impressarios, lends considerable weight to the argument that band managers are also excluded. This is the conclusion of the author.[198]

It follows that Eddie's non-royalty 'tie-in' income from the US tour will fall under Article 7 (Business Profits) or Article 14 (Independent personal services) of the US:UK double taxation treaty. This income will therefore escape US withholding tax unless Eddie, trading through his service company, has a permanent establishment in the US or, trading independently, a fixed base there regularly available to him.

5.5.5 Touring the USA

Other than the major names in the world of entertainment, most touring bands do not make large profits on their tours. The tours are rather a vehicle for gaining larger exposure with a view to increasing record sales. Indeed, records companies often pay for up and coming bands to appear as a support act on the tour of an established artiste with a view to 'show-casing' their talent. With this is mind, it may at first appear inappropriate to structure a tax plan for the tour of WhiteApple, a band yet to break into the 'big time'. The reverse is true.

[198] This view finds support in R. Saunders 'The Taxation of Intellectual Property' in Finney M.J. and Dixon J.C. (Eds.) International Tax Planning Volume One Corporate Croydon, Tolley

The income earned by WhiteApple on their tour will be subject to withholding taxes under Article 17 of the UK's double taxation agreements. The withholding taxes, subject to separate arrangements, will be applied to the gross income. It is clear, thererfore, that Whitewater will suffer tax abroad that may not be available for double taxation relief in the UK should the tour only generate modest profits (or even a loss).

Notwithstanding the anticipated low profits of the tour, the *de minimus* provisions in the UK:US double taxation agreement provide no shelter. In Chapter 4, section 4.8.2, it was explained that Under the UK:US Treaty the income of a UK entertainers is only subject to tax in the US where the gross receipts derived by him exceed $15,000. Even allowing that each member of WhiteApple is entitled to his own $15,000 limit, the threshold is easily passed. As stated in Chapter 4, the $15,000 limit includes expenses reimbursed to the entertainer or borne on his behalf. Where the threshold is passed, say the entertainer's gross income, including expenses, totals $20,000, the full $20,000 is subject to tax in the US.

In Case Study II, it was seen how the use of the US system of central withholding agreements could minimise the exposure of US generated income from double taxation. However, in the Case Study II Rupert was assured of a profit on his boxing contests. WhiteApple have no such assurance and the central withholding

Publishing (1993).

agreements are conservative with regard to the amount of withholding tax that may be relieved.[199]

5.5.5.1 Incorporating A US Personal Service Corporation

One solution to this problem is for WhiteApple to incorporate a US corporation (WAUS Inc) for the US part of their tour. The US corporation, as a resident of the United States should not be subject to US withholding tax. WAUS Inc would have to file US corporation tax returns specifying its gross income and allowable deductions, all profits falling in charge to US taxation. Should the tour make a profit, WhiteApple will still have enjoyed a timing benefit on the payment of the resulting taxation, which would be based on actual, rather than anticipated, results. The profit would not be subject to double taxation, as the US corporation would be a separate personality in law and therefore fall outside of their worldwide profits subject to tax in the UK. Should the tour break even for tax purposes, there would be no charge to US tax and thus no tax loss due to double taxation. Should the tour incur more than a minimal loss, there would be an effective double taxation as the loss would not allowable for UK tax purposes to be offset against WhiteApple's worldwide income.

[199] As mentioned in Case Study II, the effect of the agreements is to reduce the US withholding tax so that is approximates to, *but is never below*, the US tax payable on the net profit of the engagement.

One word of caution: Eddie should have no interest in WAUS Inc. As stated in section 5.5.4.3 above, Eddie's personal tax planning requires that he have no permanent establishment or fixed base in the US. WAUS Inc should be the US trading vehicle of the members of WhiteApple alone.

5.5.5.2 Incorporating OFCs Into The Tour

An alternative tax planning idea for WhiteApple's US tour is for the contract to specify that one or more of the tour engagements be performed in an offshore financial centre in the American hemisphere, say the Bahamas or Bermuda. If there is a fixed payment for the period of the tour, an allocation may be made between US and non-US source income. Treasury regulations suggest that appropriate allocations may be made on a time basis or on the number of days that the services were performed. For example, if six concerts took place in the US and one in the Bahamas and one in Bermuda, then notwithstanding the fact that the six US concerts may be significantly bigger affairs that the two OFC concerts, one quarter of the fixed fee is paid could attributable to a non-US source. This time formula is consistent with not only US Treasury regulations, but also decided cases.

In *Stemkowski v. Commissioner*,[200] the US Court of Appeals allowed Canadian resident professional hockey players to compute their US source income by allocating their salary on a days spent in the US basis. The allocation included the assumption that their contracts compensated them for time spent in training camp, the playoffs, and the offseason, as well as the regular season. Clearly this resulted in a reduced amount of income allocated to US sources, compared to that allocable on a more qualitative analysis of where the income was earned. It is this acceptance by the US authorities of a pro rata approach to allocating US source income that creates the tax planning opportunities non-resident aliens on fixed payment tours.

5.5.6 The Non-UK Domiciliaries

As stated in section 5.5.1, Adam and Barry are not domiciled in the UK. Adam is Australian and Barry is a US citizen. Adam will be able to take advantage of an offshore limited partnership as part of his tax planning for his talent royalties. This type of structure was discussed in detail in Case Study III, section 5.4.10, in the context of Rupert, the boxing champion. As a non-UK domiciliary Adam's overseas royalties are subject to UK tax on a remittance basis. Section 743(3) ICTA 1988 provides an exemption from the provisions of s. 739 whereby Adam will not be chargeable to tax in respect of any income deemed to be his by virtue of section 739 if he would not, by reason of his being so non-UK domiciled, have been chargeable to tax in respect of it if it had in fact been his income. To avoid withholding taxes, Adam, like Rupert, would need to establish a conduit licensing company in a jurisdiction which does not withhold tax on royalty payments made therefrom, and which has a network of double taxation treaties eliminating the

[200] 690 F. 2d 40 (2nd Cir. 1982))

withholding tax on royalties paid thereto. This is fully explained in Case Study II. Rupert took advantage of a Jersey limited partnership. There are other offshore limited partnership structures. The Cayman Islands limited partnership is discussed in Chapter 3, section 3.5.3.2.

From a UK perspective, Barry is in the same position as Adam, both being non-UK domiciliaries. However, where Adam is not subject to tax in Australia (other than on income and gains with an Australian source) because he is not resident there,[201] Barry remains taxable in the US on his worldwide income and gains because, though he does not reside in the US, he remains a US citizen. The US taxes on the basis of citizenship,[202] though non-residents can be exempt on up to $70,000 of foreign earned income. The royalties, however, will be US source income and, as such, will fall in charge to US tax, rendering the offshore limited partnership structure ineffectual as a tax planning vehicle for US source royalties.

5.5.7 Offshore Trusts

Adam may want an offshore trust as the vehicle for his non-UK royalty income, instead of the limited partnership recommended in 6.4.7 above. After all, s. 743(3) would still be applicable, thereby defeating the operation of the s. 739 anti-avoidance provision, and a trust has the advantage of potentially benefitting Adam's family members in a tax efficient manner. Rather than the royalties being

[201] CCH 'International Tax Expatriates' Sydney, CCH Australia Limited (1999) [CD Rom 6/1999]

paid by the partnership to Adam, taxed, and then gifted to a family member, the trust could make payments directly to that family members. This could prove very tax efficient if the recipient had unused personal allowance or a lower marginal rate of tax.[203]

Were Adam UK domiciled, in order for such a structure to work, he and his wife would have to be excluded from the settlement, which would defeat the purpose. A settlement including the settlor or the settlor's spouse as beneficiaries falls within the ICTA, Part XV anti-avoidance provision, under which the income of the trust may be attributable to the settlor. However, s. 660G(4):

> *"Where the settlor is not domiciled, or not resident, or not ordinarily resident, in the United Kingdom in a year of assessment... [income attributable to the settlor does] not include income arising under the settlement in that year in respect of which the settlor, if he were actually entitled thereto, would not be chargeable to income tax by deduction or otherwise by reason of his not being so domiciled, resident or ordinarily resident."*

The provision continues:

> *"But where such income is remitted to the United Kingdom in circumstances such that, if the settlor were actually entitled to that income when remitted, he would be chargeable to income tax by reason of his residence in the United Kingdom, it shall be treated for the purposes of this Chapter as arising under the settlement in the year in which it is remitted."*

The similarities between s. 743(3) and s. 660G(4) are immediately apparent. The result is that Adam and his spouse can be beneficiaries of the offshore trust free of

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[202] See Chapter 2, section 2.2.

UK taxation so long as their entitlement to trust income is not remitted to the UK. Should the trustees choose to make payments to Adam whilst he is out of the UK on tour, this income, not having been remitted to the UK, will also not fall in charge to UK taxation.

5.6 CONCLUSIONS

These case studies serve to emphasise the different tax consequences that flow from the individual circumstances of each sportsman, sportswoman and entertainer, each consequence giving rise, to a greater or lesser extent to tax planning opportunities. There is no 'off-the-peg' offshore tax avoidance plan that would be effective for all performers. From a UK perspective, those performers with the most opportunity to benefit from the use of offshore financial centres in international tax planning are non-UK domiciliaries. The effective use of offshore vehicles within the context of the US, a nation which taxes individuals on the basis of nationality, is very difficult. Indeed, UK resident performers working in the US can only make effective use of offshore vehicles for tax planning purposes by treaty shopping, a practice itself becoming increasing difficult because of the detailed limitation on benefits provisions being written into all new US bilateral tax treaties.

[203] Care should be taken over not triggering the ICTA, Part XV anti-avoidance provision by making payments to the settlor's unmarried minor child.

CONCLUSIONS

The objective of this thesis is to provide a critical examination from a UK perspective, with comparative analysis from a US perspective, of the degree to which offshore financial centres can provide effective tools for international tax planning for sportspeople and entertainers. It is clear from a UK perspective that offshore financial centres can be an effective tool for international tax planning for those performers who are not domiciled in the UK. For the resident, ordinarily resident and domiciled individual the anti-avoidance legislation in the UK has rendered effective offshore tax planning more limited. For UK resident sportspeople and entertainers performing in the US, the withholding tax provisions make the interposing of an offshore vehicle fiscally expensive; subject only to the relief provided by treaty shopping. From the perspective of the US itself, a country which taxes individuals on the basis of nationality, offshore financial centres tax minimisation vehicles tend to have their tax effectiveness nullified by detailed anti-avoidance provisions. As long as ten years ago US tax specialists were recognising that "[i]n most instances, foreign corporations are no longer useful as a tool for American artists to defer tax on their foreign earnings."[1] Moreover, in both the UK and the US the Revenue authorities maintain a close interest in the tax affairs of performers by virtue of their high visibility and potentially high income.

[1] B.M. Stiglitz 'International Tax Planning for Artists in the Entertainment Industry (Part 2)', Vol.

The UK presently has a tax reforming Government with a keen eye on closing offshore 'loopholes', as evidenced by the 1998 Finance Act. Though Government has stopped short of writing into statute a general anti-avoidance rule (GAAR), the Treasury has made it clear that GAAR remains an option if future action to close tax 'loopholes' is seen to be ineffective.[2]

The US is taking the lead in anti-treaty shopping provisions, rendering it difficult for any treaty provision to be enjoyed by a resident, corporate or personal, of a non-treaty country, which includes virtually all offshore financial centres. Added to the domestic and international provisions is the attack on offshore financial centres themselves. It is with a review of this current situation that this thesis ends.

On September 25, 1999, the finance ministers of the G7 countries met with the managing director of the International Monetary Fund in Washington, DC to affirm and plan cooperation on harmful tax competition in the context of developments in the world economy. The ministers issued a written statement after the meeting, reaffirming their support for the work of the OECD's Forum on Harmful Tax Practices in implementing guidelines and recommendations on the subject.[3] The ministers also endorsed the OECD's work in identifying tax haven

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11, No. 7, December, 1989

[2] D. Fairbairn 'Attacking with subtlety and taxing by stealth' Sunday Times, March 14, 1999

[3] The OECD announced that it would not publish the results of the initial review into harmful tax competition by the Forum on Harmful Tax Practices until June 2000. Jeffrey Owens, head of the

jurisdictions, which in this context includes all offshore financial centres, and engaging in meaningful dialogue with them directed at reforming 'harmful' practices.[4]

The ongoing developments following the publication of the OECD Report and the EU Code could lead one to conclude that we are presently witnessing the twilight years of the tax effectiveness of offshore financial centres. In the UK Labour MP Austin Mitchell recently called on the Government to respond to European pressure and end the tax haven status of the Channel Islands.[5] He said comments by the German Minister for Europe, Gunther Verheugen, that offshore banking 'loopholes', used by the wealthy to avoid paying tax should be closed by the European Union, must prompt the UK Government into action.[6] Some UK tax practitioners are already taking precautionary action. Offshore tax specialist Armstrong Neal, is recently quoted as saying:

> *"We don't advise clients to set up in the islands now. The major threat to them is from the EU. They say they are not part of the EU and are not bound by its regulations but the march of the EU is unstoppable and a lot of Jersey and Guernsey-based trusts are changing their domicile and looking further afield to the Cayman and the British Virgin Islands."*[7]

Yet in Jersey bank deposits went up to £109bn in the quarter to June, from

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Committee on Fiscal Affairs, said the OECD plans to achieve gradual progress and not to implement measures for the next couple of years. Owens explained that, when it transmits its report to the ministers in June 2000, the OECD will outline its proposals and views on countering harmful tax competition, including countering harmful tax practices in OECD member states. At that point, it will identify the list of offshore centers that meet the OECD criteria as tax havens.

[4] 'OECD Delays and Strengthens Implementation of Tax Initiatives While Target Countries React' International Enforcement Law Reporter, Vol. 15, No. 11, November, 1999

[5] 'Call to end tax haven' The Observer, January 3, 1999, p. 3

[6] Ibid.

£104.7bn in the quarter to March. Collective investment funds rose from £52bn to £57bn over the same period.[8] Moreover, 'looking further afield to the Cayman Island' is hardly a risk free course of action in light of the OECD Report. Pressure on the Cayman Islands can come from two powerful sources as Robert M Morgenthau, the District Attorney of the County of New York, pointed out in an opinion piece in the New York Times in November 1998:

> *"The Cayman Islands are a British dependency, and both the governor and the attorney general are appointed by the British Government. This means Britain can end the laissez-faire practices of the islands. And since, from a financial perspective, the islands are an American dependency, Washington can also stop the offshore shenanigans - for instance, by imposing more prudent oversight of lenders doing business with Cayman entities."*[9]

The truth is that the UK, the US and other developed countries have always had the power, be it political or economic, to effectively shut down most, if not all, of the offshore financial centres in the world. So why do they allow OFCs to exist? It has been argued that their continued existence, from a tax perspective, is owed to the fact that OFCs encourage international tax avoidance, which can always be countered by the legislature and the courts of developed nations. [10] Without OFCs, this argument concludes, international tax evasion would become far more widespread with consequent severe damage to the fiscal administration and economic regulation of the West. In this sense offshore financial centres are a fiscal and economic safety valve. If this analysis is sound the call for action on

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[7] G. Langdon-Down 'Safe havens or all at sea?', The Lawyer, September 20, 1999 p. 28
[8] Ibid., p. 26
[9] R.M. Morgenthau 'On the Trail of Global Capital' The New York Times, November 9, 1998, Section A, p. 25

the harmful tax competition of offshore financial centres is no more than "a tale Told by an idiot, full of sound and fury, Signifying nothing."[11]

There is a more powerful reason why developed countries tolerate offshore financial centres. The bank deposits taken by OFCs tend to be funnelled into the financial system of their host economy strengthening its balance of payments. The States of Jersey argue that the Channel Islands contribute circa £100 million per annum this way to the UK balance of payments.[12] The Cayman Islands have the same relationship with the US. In short, as much as the developed countries may talk of eliminating 'harmful' tax competition, they cannot do so without damaging their own economies.

There is one final paradox. For nonresident bank depositors, the US is itself as fiscally attractive as the Cayman Islands. In short, the US does not impose income tax on the interest paid to foreign depositors of US banks. As Ginsberg has observed:

> *"This encourages foreign depositors to leave their money in the United States. If this exemption was eliminated, billions of dollars would leave the banks, and the sudden loss of these funds might effectively destroy New York as a major capital market."*[13]

For all the discussion on harmful tax competition, the principal challenge to sportspeople and entertainers using offshore financial centres in their international

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[10] See Rice E.M. Essays on Corporate Tax Evasion and Avoidance Unpublished PhD thesis, Harvard University (1990)
[11] W. Shakespeare 'Macbeth' Act V, scene v, lines 27-28
[12] M.P. Hampton, op. cit. p. 158
[13] A.S. Ginsberg, op. cit., p. 11

tax planning is unlikely come from the pressure on the centres exerted by the developed world. The principal challenge to performers will be increasingly stringent anti-avoidance provisions, both domestically, through legislation and judicial decisions, and internationally, through individual bilateral tax treaties.

APPENDIX

A map of the distribution of the world's offshore financial centres

(Source: A.C. Hudson Globalization, Regulation and Geography: The Development of the Bahamas and the Cayman Islands Offshore Financial Centres Unpublished PhD thesis, University of Cambridge (1996) p. 2)

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