# Sovereign report

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## Sovereign MasterCard®

Unhappily Axxess International has decided to withdraw from the MasterCard issuing business. Our apologies to all Sovereign clients who have been affected. We now have an alternative issuer and are in a position to replace the obsolete cards and start processing new applications. Please contact Julia Connolly in Hong Kong or Marie Pulman in Gibraltar if you would like to obtain a card linked to your offshore company account.

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## China and Hong Kong

China has initiated the CEPA ("Closer Economic Partnership Arrangement") between Hong Kong and the Chinese Mainland. Under this arrangement, the usual licensing and capitalisation requirements applicable to foreign companies wishing to establish themselves in China have been relaxed in relation to Hong Kong companies either registering in China or setting up wholly-owned subsidiaries. In terms of ease, cost and speed, routing an investment through Hong Kong is therefore an excellent way of creating a business entity in China. Our Hong Kong office has details.

Michael Foggo has now left the organisation to set up his own business but continues to work closely with Sovereign. He is replaced by Stuart Stobie who was previously Managing Director of the Hong Kong office but then moved to head up our office in Gibraltar. Welcome back to Stuart.

## Portuguese property held offshore

Time is running out for those holding a Portuguese property through an offshore company to avoid the punitive new taxes (*see page 9*). Some action must be taken by the end of the year. Whatever arrangements are to be made will take time to implement so we are fast reaching the cut-off point. Nigel Anteney-Hoare could justifiably claim to be a world's expert in this rather confusing area so do give him a call in our Portugal office soonest if you think you may be affected. Doing nothing is going to be very expensive!

## Malta

Malta is the preferred jurisdiction into which to redomicile offshore companies which own Portuguese property. Following an invitation from Professor Bannister, Chairman and President of the Malta Financial Services Authority, our annual conference took place in Malta during the first week in October. The Maltese government kindly hosted a reception for us in the beautiful walled city of Medina. Many thanks to them for their kind hospitality.

# chairman

Sovereign, and in particular Mark Miggiani who heads up our Malta office, was instrumental in getting new legislation on the statute books which allowed for the redomiciliation of offshore companies into Malta and we have a large number of applications underway.

## The Sovereign Art Foundation

Sovereign has established a charitable foundation whose aim is to promote art in Asia. The foundation has launched The Sovereign Annual Contemporary Art Competition which carries a first prize of US$10,000 and is open to any artists who reside in Asia. Entries must be received by the end of this year but, initially, it is only necessary to send us an image by e-mail or post. We have an expert panel of judges and there will be an exhibition in Hong Kong for the final 30 entries during the first quarter of next year. These will be sold at the end of the exhibition, with the artists receiving 50% of the proceeds and the remainder being used to further the charitable aims of the Foundation, such as sponsoring places at the world's leading art schools. If you are an artist living in Asia then please have a go. Or if you know of such an artist please encourage them to enter. Further details can be found on the website www.sovereignartfoundation.com.

## Christmas and New Year

We would like to use this opportunity to wish all our clients, colleagues and friends a very happy Christmas and a prosperous New Year. We will not be contributing to the destruction of rainforests by sending out Christmas cards but this doesn't mean we don't love you. Instead, we'll be donating an equivalent sum to charity.

**Howard Bilton** BA(Hons)
Barrister-at-Law (England, Wales & Gibraltar)
Chairman of The Sovereign Group

# Gibraltar gains EU "passporting" for investment services

Gibraltar finally received passporting rights into the EU and EEA single market for investment services in July, enabling Gibraltar-based investment services providers to operate in other member states on the basis of their Gibraltar authorisation.

The move is likely to spur further growth in the investment services sector, which has already seen the number of Gibraltar-licensed investment firms rise from 11 in 1998 to 27 in 2003. Similar passporting rights in respect of banking and insurance were granted in 1999 and 1997 respectively.

Recognition of passporting rights for investment services has also enabled the Gibraltar government to bring the Investor Compensation Scheme Ordinance, which was passed by the House in July 2002, into force.

Deputy Chief Minister Keith Azopardi said: "The Gibraltar government has been negotiating this with the British government for nearly two years. It is an important development because it will allow Gibraltar's Finance Centre to grow in yet another area of activity, namely investment services, just as it is currently growing in insurance business."

The Gibraltar government also welcomed a House of Commons Foreign Affairs Committee report which recommended that the Foreign & Commonwealth Office withdraw its unacceptable joint sovereignty proposal, and instead establish normal relations between Spain and Gibraltar as should be the case between member states of the EU and their dependent territories.

The Committee questioned the current negotiating arrangements which give the UK and Spain the right to agree measures relating to Gibraltar without its consent, except in cases affecting sovereignty which require a referendum. It instead supported a reversion to the policy of not sanctioning any proposals concerning Gibraltar without its specific consent.

The Foreign Office said it does not accept the main conclusion in the report, that joint sovereignty was unacceptable.

### Sovereign comment

Gibraltar has long been touted as having a unique advantage due to its full membership of the European Union – it does not have to comply with the common agricultural policy, the imposition of VAT and the common tariffs and trades directive, but is otherwise a full member of the EU for all purposes. But the reality was that the EU membership was only of benefit if it gained Gibraltar companies these passporting rights. Gibraltar has quite diligently implemented EU directives which are not beneficial but, despite this, had struggled to gain full passporting rights. This latest development does give investment businesses the full advantage of EU membership.

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## Isle of Man will not apply retrospective KYC checks

The Financial Supervision Commission said it will not be introducing compulsory retrospective Know Your Customer (KYC) checks after the UK Financial Services Authority abandoned a similar proposal because of fears of disruption to financial institutions and service providers.

The UK's largest banks agreed instead to employ a simpler risk-based system which would minimise the disruption to their day-to-day business.

Under existing rules, financial service providers in the Isle of Man are expected to identify new customers by carrying out the KYC tests, but this does not apply to clients who pre-existed the introduction of the KYC rules.

The Financial Supervision Commission issued the 150th Corporate Service Provider (CSP) Licence in July. It has now considered all outstanding applications although a final decision has been deferred in a few cases.

**Sovereign comment.** Sovereign's Isle of Man office was long ago granted its CSP license. There are still many businesses operating in the Isle of Man which have neither been granted a licence nor been required to cease operating. We believe there is little point in having a regulated system if companies which require a licence are allowed to continue doing business without one.

# Sweden introduces new holding company regime

New changes to the Swedish holding company regime may open Sweden as a competitive alternative to the traditional holding regimes. The regime is expected to be fully effective as of 2004.

The company ("aktiebolag," is abbreviated to "AB") is the main entity for conducting business in Sweden. It may be acquired and held by foreign nationals without any special acquisition permits. All corporation shares must be of equal par value and must total at least SEK 100,000 (Euro11,000) – the minimum capitalisation.

As an onshore jurisdiction with a global network of tax treaties, a Swedish holding company may provide advantages including: no tax on dividends received (for listed shares, the exemption requires at least 10% share ownership and a holding period of 12 months); no withholding tax on dividends or interest paid and no capital gains taxation. Interest paid by the holding company is also tax deductible and no thin capitalisation rules apply.

Interest-free loans (and other shareholder benefits) are permitted without tax penalty and there is no tax on capital contributions and transfers, and no stamp duty. Current Swedish controlled foreign company (CFC) rules apply if the income of the participation is taxed at a rate below 15.4%. If the income is considered CFC income, the Swedish parent will be taxed in Sweden on its share.

### Sovereign comment

It is interesting to note that Sweden is introducing an attractive holding company regime at a time when other holding regimes are under attack from the OECD. It is inconceivable that Sweden has introduced this regime without consultation with the OECD or without taking account of their views, so what is happening? The level playing field certainly does not appear to be working.

# UK makes tax law threat to Cayman Islands

UK Chancellor Gordon Brown threatened to legislate to force the Cayman Islands to comply with European Union savings tax directive. The Chancellor, who led the way in demanding a system of exchange of information between EU tax authorities, told fellow EU finance ministers in Italy on 14 September that the British overseas territory had not yet told the Treasury how it intended to apply the new rules.

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In response to German finance minister Hans Eichel, who asked for assurances that all the UK's territories had fallen into line, Brown said that Guernsey, Jersey and the Isle of Man would apply a withholding tax regime similar to that permitted in Austria, Belgium and Luxembourg.

The British Virgin Islands, Turks & Caicos Islands and Montserrat had also indicated they would comply with the new EU rules. But Brown admitted that the Cayman Islands had not come forward with proposals, and he would legislate if necessary. "It would probably be through a Treasury order – secondary legislation," said the Treasury.

In a letter to the European Commission, the Cayman government questioned the legitimacy of efforts to compel the Caribbean Overseas Territories to go along with the savings directive and reiterated its desire for formal discussions under the procedure available to associated and dependent territories of EU member states.

"The government," it said, "is very concerned that the displacement or 'outburdening' by the EU of tax enforcement burdens to the Cayman Islands and other colonies which receive no benefit from the EU distorts economic competition, particularly when the EU is offering much less onerous burdens tied to substantial economic benefits to other countries, such as Switzerland."

The European Commission reported that reciprocal deals with Monaco, San Marino and Andorra were within reach. But EU internal market commissioner Frits Bolkestein warned that Liechtenstein remained unwilling to co-operate. "The Commission has asked the EU to apply pressure on Liechtenstein," his spokesman said.

### Sovereign comment

We believe that the Cayman Islands will have no choice but to toe the EU line. This is further clarification of the determination of the UK government to make the Cayman Islands do what it says, irrespective of any other judgments the Cayman Islands may obtain in the European or other courts (*see Issue 15 for details*). Both Cayman and Bermuda have threatened to seek independence if they are forced to introduce legislation against their will, but this seems unlikely because their stability and good reputation rely partly on their strong British connection.

# IRS issues summons to identify tax evaders

The US Internal Revenue Service (IRS) has, for the first time, issued a summons to a law firm for the primary purpose of obtaining the identities of the investors in what the IRS has determined are potentially abusive tax shelters.

The IRS received approval from the US District Court for the Northern District of Illinois to serve a John Doe summons on Jenkens & Gilchrist, asking the law firm to identify taxpayers who may have invested in listed transactions or other potentially abusive transactions organised or sold by the firm's Chicago office.

This is the latest step in a comprehensive strategy by the Treasury Department, the IRS and the Department of Justice to combat abusive tax avoidance transactions by requiring prompt disclosure of potentially abusive transactions by taxpayers and promoters.

Since 2002, the IRS has issued 268 summonses to 35 promoters to examine their compliance with the registration and list maintenance requirements, by requesting information and investor lists. Of these, 78 involving seven promoters have been referred to the Department of Justice for enforcement.

The IRS has also established a new nationwide partnership agreement to share information about abusive tax avoidance schemes with the 40 participating state authorities.

### Sovereign comment

There is a general move around the world to make advisors liable for the actions of their clients and, in particular, to cite advisors as accessories to tax fraud if they can show that their clients have set up structures which have been used in an abusive manner. Again, the emphasis is on tax evasion which generally means lying on your tax form. Any person is still entitled to arrange their affairs in a tax effective manner but those arrangements should be made within the laws and this is rarely going to be easy or inexpensive.

# Swiss/US clarify treaty limitation on benefits

The Swiss and US authorities agreed to clarify the derivative benefits test in the limitation on benefits article of the 1996 Switzerland-US tax treaty and the accompanying memorandum of understanding (MOU).

The agreement provides that a US resident will qualify as a resident of a North American Free Trade Agreement (NAFTA) party if the US resident is: an individual resident in the US; a political subdivision of the US or the US itself or instrumentalities thereof; or a publicly traded company incorporated in the US.

There was previously doubt about whether US residents could be taken into account in meeting the test's ownership rules, because "the US does not have a comprehensive income tax convention with itself."

**Sovereign comment.** Limitation of Benefits clauses simply state that if the recipient company is not owned by residents of the recipient territory then the treaty will not apply. This modification is an extension to the principle because, for example, it may be that a Swiss company is owned by residents of another state. In this case the US would either apply the tax treaty with that other state or, if the owners of the recipient company are residents of a non-treaty country, then no treaty relief would be available. Under certain circumstances these anti-avoidance rules can be very useful in a tax planning exercise because transparent structures owned by residents of treaty countries can be used to collect income tax free.

# South Africa issues draft regulations for tax amnesty

Draft regulations, finally released for comment on 18 August, have significantly extended the scope of the Exchange Control Amnesty & Amendment of Taxation Laws Act of 2003.

The Act provides amnesty in respect of voluntary disclosure by South African resident taxpayers, of contraventions of exchange control (excon) measures. It also covers failure to comply with domestic tax legislation to the extent that these contraventions relate to undisclosed foreign assets.

Applicants can be natural persons, close corporations, trusts or deceased estates. Offshore trusts are included if the applicant was the settlor or is a beneficiary. Local and offshore companies are excluded unless the applicant is a "related party" to the company, meaning a director or shareholder. Levies of 5% and 10% are applied to a successful applicant where assets are returned to South Africa or left overseas respectively. Assets are then also disclosed to the SA Revenue Service and will be taxed in future years.

Under the draft regulations, the amnesty will now include tax that would otherwise have arisen on direct or indirect donations by an SA tax resident to an offshore discretionary trust.

The Act stated that companies could apply for amnesty as facilitators only if they were wholly-owned by the applicant or their relatives. This has now been extended to cover companies where all the shares are held by an SA trust and all the beneficiaries of the trust are related.

Where unrelated people jointly hold the shares of an SA company that facilitated an exchange control or tax violation, this company may also apply as a facilitator, but only if the unrelated shareholders apply for the amnesty together. The draft regulations now allow, for purposes of calculating a levy, offshore loans to be deducted from the market value of offshore assets that serve as security for the repayment of the debt.

With regard to domestic tax, the draft regulations clarify that the 2% levy will be levied only once in relation to a particular amount. This means that for undisclosed income that was donated to an offshore trust, the 2% levy will not be payable on both the amount previously undisclosed and the amount donated.

The draft regulations have not affected the period of the amnesty, which is still planned to end on 30 November, after which no further amnesty applications will be accepted. The amnesty commenced on 1 June 2003.

### Sovereign comment

The tax amnesty unit said it had received 1,010 applications by the end of August, but would not disclose how much money was involved. The uncertainty surrounding the legislation, which was amended four times, and the subsequent delays in issuing regulations have made taxpayers reluctant to apply.

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## Jebel Ali introduces offshore companies

The Dubai government has introduced offshore companies by bringing the Jebel Ali Free Zone (JAFZ) Offshore Companies Regulations 2003 into effect on 15 January 2003. The regulations were made by the chairman of the Dubai Port, Customs & Free Zone Corporation under laws Numbers 1 and 4 of 2001.

Jebel Ali Offshore Companies must have a minimum of one shareholder, two directors who must be individuals, and a local registered agent who must be licensed by the Dubai authorities. The legislation is based on Jersey law but, for the time being, incorporation times can be slow.

The UAE Federal Cabinet approved a Federal Decree to allow the Dubai International Financial Centre (DIFC) a large degree of sovereignty. The decision must now be ratified by the Supreme Council. The DIFC must also be granted a specific decree to establish it as a Financial Free Zone.

**Sovereign comment.** Sovereign was one of the first organisations to be approved by the Dubai authorities as a registered agent. The fact that Dubai specifically, and the UAE generally, are not members of the OECD and not listed as harmful tax regimes should mean that the jurisdiction will not have to introduce exchange of information into its laws. Jebel Ali offshore companies may therefore be of interest to those who wish to retain a degree of confidentiality over and above that which will be found in the traditional OFCs.

## India bans investing through Overseas Corporate Bodies

The Reserve Bank of India (RBI) has imposed a ban on overseas corporate bodies (OCBs), prohibiting them from investing in India in any privileged form, and 'derecognising' them as investment vehicles.

OCBs are companies or partnerships in which more than 60% of the shares are held by non-resident Indians (NRIs). In November 2001, the RBI prohibited OCBs from investing in the Indian stock market under the portfolio investment scheme. But they were still permitted to open non-resident accounts, and to make direct investments.

In a statement issued on 16 September, the regulator said: "It has been decided, in consultation with the government, that henceforth, OCBs shall not be permitted to make fresh investments under the FDI scheme and in other investments, deposits or loans under the various routes/schemes available to non-residents under exchange control regulations."

The decision to ban OCBs outright follows the recommendations of a joint parliamentary committee tasked to investigate Mauritius-based OCBs. Tax disputes with the governments of regional powers such as South Africa and India were highlighted as a potential problem in a recent Financial Sector Assessment on Mauritius published by the IMF and World Bank.

### Sovereign comment

It is clear that many resident Indians were setting up OCBs to re-invest money back into India, often using overseas relatives as owners. In short, the privileges granted to these OCBs have been abused so it is not unsurprising that action has been taken. But this does not mean that Mauritius is no longer useful for genuine foreign investors. The Mauritius/India treaty continues to be the recommended and preferred route for genuine non-Indian nationals to invest into India. Cyprus would be another alternative and Sovereign has offices in both jurisdictions.

# Jersey Court rules on sham trusts

The Jersey Royal Court ruled that a trust deed will not be held to be a sham unless both the settlor and the trustee have the necessary intention to make it so.

In *Abacus (CI) Ltd v Sheikh Fahad Mohammad al Sabah*, handed down on 13 June, the Court dismissed a claim by Grupo Torres (GT), a Spanish-based subsidiary of the Kuwaiti Investment Office, against the assets of the trust, to enforce a judgment against the company's former chairman, Sheikh Fahad Al-Sabah, for having defrauded it of US$430m between May 1988 and October 1990.

The Esteem Settlement was one of a number of trusts established in several jurisdictions by Sheikh Fahad between 1981 and 1994. In 1999 the UK High Court found Sheikh Fahad, his wife and son liable for having conspired to defraud GT and ordered them to pay a total of US$800m.

GT lodged a claim on the assets in the Jersey trusts. In a first hearing, the Royal Court held it could not order the trustee to pay out assets to Sheikh Fahad's creditor because it would not be for his benefit. But GT was successful in a second action for restitution of 'tainted' assets within the trust that were traced directly to the fraud.

In a further action to secure "untainted" assets, GT and Sheikh Fahad's trustee in bankruptcy asked for the Esteem Settlement to be declared a sham. They argued that as settlor, Sheikh Fahad had exercised "substantial and effective control" over the trust.

The Royal Court held that a trust deed would not be held to be a sham unless both the settlor and the trustee had the necessary 'shamming' intention. It found, on the facts, that they had both intended there to be a genuine discretionary trust on the terms of the trust deed. The plaintiffs' case, said the Court, would have failed even if it was sufficient that the settlor alone had a shamming intention, because it was satisfied that Sheikh Fahad had no such intention.

### Sovereign comment

Banks and other financial institutions frequently use trusts as a way of capturing investment clients with the promise that they can remain in control of their money during their lifetime. Indeed this phraseology is often used in the marketing literature. It isn't possible!

You cannot have the advantages without some of the disadvantages, and settlors should be used to the idea that their suggestions to the trustees may be rebuffed. If their ideas are accepted without any discussion they should question whether the trustees are doing their job properly and protecting their long term interests.

# FATF revises anti-money laundering standards

The Financial Action Task Force (FATF) issued a revised set of Forty Recommendations to combat money laundering at the conclusion of its plenary meeting in Berlin in June. The revision makes significant changes, which when combined with the Eight Special Recommendations to combat terrorist financing, create a substantially strengthened international framework.

The major changes include: specifying a list of crimes that must underpin a money laundering offence; expanding the customer due diligence process for financial institutions; enhancing measures for higher risk customers and transactions, including correspondent banking and politically exposed persons; strengthening transparency requirements through information on the beneficial ownership of companies or trusts; and prohibiting shell banks.

Anti-money laundering measures will also be extended to designated non-financial businesses and professions including casinos, real estate agents, dealers of precious metals or stones, accountants, lawyers, notaries and independent legal professions, and trust and company service providers.

South Africa and the Russian Federation have been admitted as full members of the FATF following an assessment of their systems for combating money laundering and terrorist financing.

The FATF has removed St Vincent & the Grenadines from the list of Non-Cooperative Countries & Territories (NCCTs). The current list of NCCTs is: Cook Islands, Egypt, Guatemala, Indonesia, Myanmar, Nauru, Nigeria, Philippines and Ukraine.

### Sovereign comment

Although the FATF is a sub-division of the OECD, it concerns itself solely with money laundering whereas the OECD has a much broader, and sometimes unwelcome, agenda. Many of the countries on the list of NCCTs are perceived as international pariahs and businessmen should be wary of doing business with them.

# Caricom to establish Caribbean Court of Justice

The regional governments of the Caribbean Community (Caricom) signed legal instruments for the establishment of the Caribbean Court of Justice (CCJ) on 4 July. This will replace the British Privy Council as the final appellate court for members.

An inauguration date had not yet been finalised, but heads of government have agreed a start-up date in the second half of 2003 and steps to bring a regional Judicial & Services Commission into operation are underway.

Caricom members are: Antigua & Barbuda; Bahamas; Barbados; Belize; Dominica; Grenada, Guyana; Haiti; Jamaica; Montserrat; St kitts & Nevis; St Lucia; St Vincent & the Grenadines; Suriname; and Trinidad & Tobago.

**Sovereign comment.** International business interests will not necessarily be best served by a locally-empowered final court of appeal and it may be that they will prefer to use other jurisdictions which will continue to be part of the British legal system for settlement of commercial disputes. We believe that this may be an argument for preferring British overseas territories rather than those independent territories who are moving away from the British legal system.

# OECD reports on access to bank information for tax purposes

The OECD Council considered issues relating to access to bank information for tax purposes. It failed to secure agreement on a draft recommendation for improving access to bank information for tax purposes, but 28 members accepted a common understanding of tax fraud and 26 agreed to take appropriate initiatives to achieve, by 31 December 2005, access to bank information for the verification of tax liabilities and other tax administration purposes.

In April 2000, the Committee on Fiscal Affairs published a report, "Improving Access to Bank Information for Tax Purposes", which set out a standard of access to bank information, that “all Member countries should permit access to bank information, directly or indirectly, for all tax purposes so that tax authorities can fully discharge their revenue raising responsibilities and engage in effective exchange of information with their treaty partners.”

In 2003 the Committee undertook a formal review of the steps taken by member countries. It found there had been positive developments in implementing several measures: anonymous accounts could no longer be opened in any OECD country, customer identification requirements had been established in all OECD countries, and no OECD country still required a domestic tax interest to obtain information for a treaty partner.

But there were also key areas where little progress had occurred. A common understanding of tax fraud had not yet been agreed by all 30 member countries and few developments in the area of access to bank information for civil tax purposes had been reported.

It noted that in response to the OECD’s Harmful Tax Practices initiative, 32 jurisdictions had made political commitments to engage in effective exchange of information for criminal tax matters for tax periods starting from 1 January 2004 and for civil tax matters for tax periods starting from 2006.

A number of these jurisdictions had already negotiated or were in the process of negotiating Tax Information Exchange Agreements (TIEAS), which required access to bank information for both civil and criminal tax purposes.

Since 2000, the US had signed TIEAS with Antigua & Barbuda, the Bahamas, the British Virgin Islands, the Cayman Islands, Guernsey, Isle of Man, Jersey and the Netherlands Antilles. Other OECD members such as Germany, Ireland, the Netherlands and Spain were in the process of negotiating similar agreements with the committed jurisdictions.

### Sovereign comment

Confidentiality is dead! By the end of next year the US will have TIEAs with all the offshore jurisdictions. Under these agreements the US can get whatever information it requires about the tax affairs – and ownership of offshore companies and trusts – in order to tax its citizens correctly. Other nations are also now committed to implementing TIEAs with the relevant OFCs and the OECD and EU are also requiring exchange of information. In short, any tax planning must be well thought out and capable of withstanding scrutiny from the home tax authority of the client. Reliance on confidentiality has never been good tax planning but now it is even more likely to end in tears.

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# EU proposes to extend Parent-Subsidiary Directive

The European Commission has issued a proposal to extend the scope of the parent-subsidiary directive. The minimum shareholding requirement for a parent company to own a qualifying shareholding in its subsidiary would be reduced from 25% to 10% and, where the parent company tax regime eliminates double tax for underlying taxes on the dividend from the subsidiary through a foreign tax credit rather than by exemption, the requirement for full foreign tax credits would be extended to lower-tier subsidiaries in a chain of ownership as well as the directly-held subsidiary.

Where the member state in which the entity is established treats the company as a corporation for tax purposes, but another member state, whose resident has an interest in the entity treats it as transparent, that member state would also be obliged to extend the benefits of the parent-subsidiary directive to the resident with an interest in the entity.

**Sovereign comment.** One of the major barriers to using this directive for tax planning purposes is the condition that the recipient company must not be exempt from tax in its country of tax residence. This still leaves considerable scope for tax planning. Locating a holding company in the Netherlands, Luxembourg, Denmark, Spain, UK or other EU member states can be extremely advantageous and reduce both withholding and corporation taxes. Other jurisdictions such as Malta and Cyprus may also be useful when they become full EU members.

# OECD threatens Switzerland with tax blacklisting

The OECD has threatened to place Switzerland on its “harmful tax” blacklist according to a leaked internal report. The Swiss finance ministry is engaged in talks with the OECD's Forum on Harmful Tax Competition to resolve the issue.

Although there is no special holding company status under federal Swiss law, holding companies qualify for total exemption from income tax while paying a low corporate tax rate in most cantons. Dividends from a qualified subsidiary also benefit from the participation exemption rule.

Switzerland, which abstained from joining the Forum when it was established in 1998, is the only OECD member to be named by the body. In June 2000, the Forum listed Switzerland as among dozens of developed countries having 'potentially' harmful tax practices. An OECD spokesman said that since then, Switzerland had not changed its tax practices.

### Sovereign comment

There is no level playing field here. Nearly every other EU/OECD member state has regimes for holding companies or other “ring-fenced” tax regimes which have been identified by the OECD as harmful. But none of these countries are doing anything about repealing their legislation and, indeed, Sweden has only just introduced a new and very attractive holding company without causing comment. For now, our advice would be to refrain from using Swiss holding structures until the matter is clarified. There are plenty of other holding structures which give equal or better advantage and none of these appear to be under current attack from the OECD.

# DEADLINE LOOMS FOR PORTUGUESE PROPERTY OWNERS

If you own property in Portugal through an offshore company structure, new Portuguese legislation intended to reform the property tax system may have a significant – and costly – impact.

For many years purchasing Portuguese property through an offshore company has been favoured as the most effective way to own high-value property. But the Reforma do Patrimonio, which was passed on 30 July and comes into force on 1 January 2004, introduces a large tax increase for property owned by companies incorporated or domiciled in offshore jurisdictions which appear on a Portuguese government blacklist.

This blacklist covers most of the traditional Offshore Financial Centres (OFCs), including Gibraltar, Isle of Man and British Virgin Islands – all favoured jurisdictions for Portuguese property holding.

The new proposals introduce a municipal tax equal to 5% of the tax department or rateable value of any property held by a company in a blacklisted jurisdiction. Further, under legislation introduced in 2002, such companies will be assumed to be receiving a notional rent equal to 1/15th of the tax department value of the property, irrespective of whether they are actually in receipt of rent or not. This assumed rent will be taxed in Portugal at the standard rate of 25%.

**Clearly, these new taxes make offshore ownership of Portuguese property very unattractive.**

## SOLUTIONS TO THE PROBLEM

Existing offshore property owners have two possible options: pay capital gains tax and purchase tax to bring the property onshore, or transfer the domicile of the offshore company to an acceptable – non-blacklisted – location. A number of factors – not least the current value of the property and the price registered in the purchase deed – will influence the best course of action.

Many owners are considering winding up their offshore company and transferring the property into their individual ownership, but this will be treated as a sale and therefore the usual taxes payable on resale will apply. The transfer taxes and associated expenses can be considerable but the bigger bill may well be capital gains tax. Capital gains tax will be payable at a rate of 25% on the difference between the price registered in the property purchase deed and the current assessed value of the property. If the property has been owned for a long time, or the declared price was very low, then the resulting tax may be extremely high and may make this option very painful. As a result, unless the property was purchased recently and the full price was declared on the purchase deed, a transfer back to individual ownership may be prohibitively expensive.

> "Many property owners are failing to react to warnings and are doing nothing. This could be a big mistake."

The alternative would be to re-domicile the company into a jurisdiction that is not on the blacklist. It is not possible to re-domicile a company unless the legislation of the place of incorporation allows a company to be re-domiciled out and the legislation of the jurisdiction into which you are attempting to re-domicile the company allows for re-domiciling in. Although there are many countries that are not on the Portuguese blacklist, this limitation means that in practice the only suitable jurisdictions into which a company can be redomiciled are Malta, Delaware and New Zealand.

We believe that Malta is the best of these. Delaware is cheaper and may seem attractive but we doubt the wisdom of re-domiciling a company into the USA – one of the harshest tax environments in the world. For many clients, New Zealand will seem too remote. Malta has the advantage of having recently been removed from the Portuguese blacklist as a result of recent changes to its tax system. It also has a tax treaty with Portugal and is due to become a full member of the European Union as of 1 May 2004.

In our opinion, this makes it extremely unlikely that Malta will be blacklisted again by Portugal. Significantly, the Maltese government also believes this possibility to be very remote. In recent discussions with the relevant Malta authorities they indicated to us that they would strenuously challenge any move to discriminate against Maltese companies in this way.

## PROCEDURE TO REDOMICILE

Re-domiciling a company will involve paying a one-off fee to prepare the documentation required by both the outgoing and incoming jurisdiction. This fee would normally be in the region of £2,000 to £3,500. Higher charges will be incurred in the case of Channel Island companies where documentation and legal fees are more expensive. Increased annual running costs for the redomiciled company are also likely to be incurred but the total costs involved may well be insignificant when compared to the taxes payable for transfer of the property to the individual owner or the costs of doing nothing and becoming liable to pay the 5% annual tax.

## DON'T DELAY

Many property owners are failing to react to warnings and are doing nothing. This could be a big mistake. Any property which is still owned by a company incorporated in a blacklisted jurisdiction on 31 December 2004 will be subject to the first 5% annual tax. Failure to pay may result in the Portuguese government placing a charge against the Portuguese property with the possibility of an eventual forced sale of the property to recover the taxes due. *Doing nothing is not really an option.*

Sovereign's Portuguese office has considerable expertise in this area and is currently being deluged with enquiries from both professional firms, our own clients and clients of other organisations. **We strongly advise all offshore Portuguese property owners to take urgent action and seek expert advice.**

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