UK TAX TREATMENT OF FOREIGN ENTITIES

James Kessler Q.C.[1]

1.1 Introduction

UK tax law categorises entities (in short) as companies, partnerships or trusts.[2] With more or less difficulty (depending on the similarity of the law of the country concerned) it is necessary to shoehorn foreign entities into these categories; or more accurately, it is necessary to decide whether references to companies, trusts, partnerships, persons, etc in any particular statutory provision include some particular foreign entity. Similarly, it is necessary to decide whether terms such as 'share capital' or 'interest in possession' are apt to include rights in or under foreign entities (or indeed whether individuals have any 'right' or 'interest' in a foreign entity at all).

Memec v IRC explains the general approach:

> 'When an English tribunal has to apply the provisions of an UK taxing statute to some transaction, arrangement or entity which is governed by a foreign system of law, the tribunal must take account of the rules of that foreign system (properly proved if not admitted) in order to determine the nature and characteristics of the transaction, arrangement or entity. But having informed itself in this way, the tribunal must then apply the taxing statute as part of English law.' [3]

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1 *James Kessler QC is a member of Tax Chambers at 15 Old Square Lincoln's Inn. This article draws on material in chapter 79 of the author's work* Taxation of Non-Residents and Foreign Domiciliaries *published by Key Haven Publications Ltd.*

2 And lastly, PRs but PRs are not discussed in this chapter.

3 71 TC 77 at p.92. Most OECD countries adopt the same approach

Thus in order to say whether a reference to (say) a trust or trustee in any particular statutory provision include some particular foreign entity or person, one must ask some fundamental questions:

(1) What are the determinative characteristics of a trust or trustee (within the meaning of the section), a question of UK law; and

(2) Does the foreign entity or person have those characteristics, a question of the foreign law.

So far as the topic raises issues of foreign law I necessarily rely on secondary material. I would be interested in comments from readers with foreign law expertise if views expressed in this article need correction or expansion, and in particular if they disagree with HMRC official views. .

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1.1.1 'Transparent and 'opaque'

UK tax law categorises entities as transparent or opaque[4] The International Manual explains this terminology at para 180020:

> … Entities are described [in the official list set out below] as either fiscally 'transparent' or 'opaque' solely for the purposes of deciding how a member is to be taxed on the income they derive from their interest in the entity. In the case of a 'transparent' entity the member is regarded as being entitled to a share in the underlying income of the entity as it arises and is charged to tax in the UK on their share of the profits on that basis. But, in the case of an 'opaque' entity the member generally is taxed only on the distributions made by the entity.

The terminology is also used for CGT (eg a partnership is transparent for CGT); and for IHT (eg a partnership is not transparent for IHT). Indeed, one should strictly not use the term 'transparent' without specifying a tax, because an entity may be transparent for one tax and not for another, but the term is used most often with income tax in mind.

1.1.2 Significance of foreign law classifications and terminology

If the foreign tax law is sufficiently similar to UK law, it is considered that a foreign law classification as transparent/opaque ought to be relevant, though not of course decisive; but in practice that condition is often not satisfied, or at least, in the event of a dispute, the question whether the foreign law is 'sufficiently similar' is likely to be contested.

4 Note on terminology. The term sometimes used is 'fiscally transparent' (or 'fiscally opaque') but that is synonymous with 'transparent' (or 'opaque').

1.2 Definition of 'IHT-settlement'

It was noted above that UK tax law categorises entities as companies, partnerships and trusts. 'Partnership' is in general undefined, and the definition of 'company' (discussed below) is fairly standard. However quite different definitions of trusts are used in different taxes.

> In summary:
>
> '**IHT-settlement**' means a settlement within the IHT definition
>
> **'Standard IT/CGT settlement'** is a settlement within the standard IT/CGT definition.
>
> **'Settlement-arrangement'** is a settlement within s.620 ITTOIA, which applies for the purposes of the IT settlement provisions and many other purposes of which the most important is s.87 TCGA**.**

The terms trust and settlement are used interchangeably.

Because the definitions are different, it is a mistake to ask if an entity is a trust 'for tax purposes'. One must ask if it is a trust for IT/CGT, or for IHT purposes or if it is a settlement-arrangement. An entity may be a trust within one, or two, or all three definitions.

> Section 43(2) IHTA provides the IHT definition:
>
> 'Settlement' means any disposition or dispositions of property, whether effected by instrument, by parol or by operation of law, or partly in one way and partly in another, whereby the property is for the time being—
>
> (a) held in trust for persons in succession or for any person subject to a contingency, or
>
> (b) held by trustees on trust to accumulate the whole or part of any income of the property or with power to make payments out of that income at the discretion of the trustees or some other person, with or without power to accumulate surplus income, or
>
> (c) charged or burdened (otherwise than for full consideration in money or money's worth paid for his own use or benefit to the person making the disposition) with the payment of any annuity or other periodical payment payable for a life or any other limited or terminable period,
>
> [d] or would be so held or charged or burdened if the disposition or dispositions were regulated by the law of any part of the UK;

[e] or whereby, under the law of any other country, the administration of the property is for the time being governed by provisions equivalent in effect to those which would apply if the property were so held, charged or burdened.

1.2.1 Limb [e]: provisions equivalent in effect to a trust

The standard IT/CGT definition has no equivalent of s.43(2)[e]. So while the IT/CGT definition requires that property is held 'in trust' it is (in short) sufficient for IHT that the property is governed by provisions which are equivalent in effect.

The statute refers to the *administration* of the property being governed by provisions equivalent in effect. Trust law draws a distinction between administrative and dispositive provisions, but the context here shows that this is referring to all the provisions which govern the use of the property, and not just administrative provisions in the strict sense.

Two difficulties lie in the short phrase 'equivalent in effect':

(1) Equivalent *in effect* presumably requires effective (or substantive) rather than exact equivalence, but where does one draw the line?

(2) Trusts can have the same effect as entails, usufructs, wills, corporations, charges by way of security over assets, and so on, though they are none of those things. A trust is a flexible, protean institution which can have markedly different effects.

In deciding whether a foreign institution is equivalent in effect to a trust, a court should have regard to the context - is it appropriate in the scheme of IHT that an entity should be subject to IHT in the same manner as a trust? This consideration supports the view taken below that a foundation (stiftung) is an IHT-settlement but a usufruct is not.

1.3 Meaning of 'company'

Section 1121(1) CTA 2010 provides the definition for the corporation tax acts:

> In the Corporation Tax Acts 'company' means any body corporate or unincorporated association, but does not include a partnership, a local authority or a local authority association.[5]

There are similar definitions for income tax and capital gains tax.

5 This is subject to some minor (unnecessarily complicated) exceptions but those need not be considered here.

The IHTA does not provide a definition of 'company' but the definition of close company in the close company rules incorporates the CTA definition. Section 102(1) IHTA provides:

> (1) In this Part of this Act 'close company' means a company within the meaning of the Corporation Tax Acts which is (or would be if resident in the UK) a close company for the purposes of those Acts;

For SDLT, s.100(1) FA 2003 provides a similar definition:

> In this Part 'company', except as otherwise expressly provided, means any body corporate or unincorporated association, but does not include a partnership.

1.4 Bare trusts/nomineeships

1.4.1 Definition(s) of bare trust and associated terminology

Section 466 ITA provides:

> (2) 'Settled property' means any property held in trust other than property excluded by subsection (3).
>
> (3) Property is excluded for the purposes of subsection (2)
>
> (a) it is held by a person as nominee for another person,
>
> (b) it is held by a person as trustee for another person who is absolutely entitled to the property as against the trustee, or
>
> (c) it is held by a person as trustee for another person who would be absolutely entitled to the property as against the trustee if that other person were not an infant or otherwise lacking legal capacity.

The phrase 'absolutely entitled to property as against a trustee' is defined in s.466(5) ITA:

> A person is absolutely entitled to property as against a trustee if the person has the exclusive right to direct how the property is to be dealt with (subject to the trustees' right to use the property for the payment of duty, taxes, costs or other outgoings).

I use the following terms:

> **'A bare trust'** (or '**nomineeship**', the terms are for present purposes synonymous) is a trust of property:
>
> (1) within s.466(3) ITA and its CGT equivalent, s.60 TCGA (ie, not settled property for IT/CGT purposes) and
>
> (2) not within s.43 IHTA (ie, not settled property for IHT purposes).
>
> These two definitions are not quite identical, but in practice they usually amount to the same.
>
> **'A substantive trust'** is a trust that is not a bare trust.

1.4.2 *The trust law background*

In classifying an entity as a bare or a substantive trust, three rules of trust law (or succession law) are particularly relevant:

(1) A substantive trust must confer rights on more than one person. If a trust has only one beneficiary, it can only be a bare trust.

(2) A testamentary disposition has no effect during the life of the testator/settlor, so if a disposition is classified as testamentary, it can only be a bare trust during the lifetime of the testator/settlor.

(3) A trust which is a sham is generally a bare trust.

Of course a foreign law entity may be classified as a bare trust, just as an English law trust may constitute a bare trust.

1.4.3 *Substantive trust must confer rights on more than one beneficiary*

Whether a trust confers rights on more than one beneficiary is a question of construction.

There may be a substantive trust even if the interest of the second beneficiary is a future interest of no economic value. There is no *de minimis* requirement.

Thus in *Corlet v Isle of Man Bank Limited* [1937] 3 DLR 163, and *Anderson v Patton* [1948] 2 DLR 202 lifetime trusts conferred what one might regard as minimal future revocable interests on beneficiaries other than the settlor, but the trusts were valid. The latter case concerned a document reciting:

> received from A \$5,000 which I am to hold in trust for A and which I am to pay out as instructed to X and Y if anything should happen to A. The money will be returned if A should demand it.

The Court held by a majority that even this was a valid trust. (One can see the force of the minority view that this was actually intended to be testamentary.)

While a substantive trust must confer rights on more than one person, there is no rule that the rights of the second person must exceed some *de minimis* requirement. It is well established that a settlor ('S' may create a valid trust conferring a life interest on S, with power of revocation exercisable by S, and subject to that, for R. The reversionary interest of R is not so small it should be disregarded. But R's interest has a nil economic value and a lifetime settlement of this kind has in substance the same effect as a will. How does one distinguish between revocable reversionary interests, which are valid, and (even) less significant interests (which are not)? Unless one knows what is too small an interest (and different views on that would be possible) it will be impossible to say whether trusts are substantial trusts or bare trusts.

The authorities do not provide any support for a *de minimis* requirement of this kind. The relevant cases are not consistent with any *de minimis* requirement of this kind. The question of whether there is a substantive trust is not determined by asking whether a beneficiary's interest was 'squeletic'. The question is whether the 'beneficiary' (using that word in a non-technical way) has an interest at all.

1.5 American revocable trust (grantor trust)

Revocable trusts are commonly used in the USA for estate planning.[6] With an American settlor these are almost always grantor trusts (a USA income tax concept) and transparent for USA tax purposes as to income and capital gains, though with non-USA settlors they are only transparent in limited circumstances.

The classification of a USA revocable trust turns on the nature of the rights conferred by the trust, which depends on the drafting and proper law of the trust.[7] Only general comments are possible here.

Under a common form revocable trust, the settlor (the synonymous terms grantor, trustor, creator or donor are often used in American trust documentation) is sole trustee, the trust is revocable and the income and capital is paid to the settlor on

6 I am grateful to Ian Watson for his comments on this section. For other USA trusts, see Sanborn, 'US tax classification of trusts', (2005) TQR Vol 3 issue 2 p.16 accessible to STEP members on www.step.org.

7 Each USA state is a separate common law jurisdiction, with its own trust law, ultimately derived from English law but with statutory and case law variations.

demand. Section 603 of the America Uniform Trust Code[8] provides:

> While a trust is revocable [and the settlor has capacity to revoke the trust], rights of the beneficiaries are subject to the control of, and the duties of the trustee are owed exclusively to, the settlor.

A USA revocable trust of this kind is not an IT/CGT settlement as the property is not held 'in trust'. This seems paradoxical, but the fact that American lawyers describe something as a trust does not mean that it is a trust within the meaning of the word as used in UK statutes. In English law, there is an irreducible core of obligations owed by the trustees to the beneficiaries and enforceable by them which is fundamental to the concept of a trust. If the beneficiaries have no rights enforceable against the trustees there are no trusts.[9] The USA revocable trust may appear at first sight to grant rights to beneficiaries, but during the lifetime of the settlor (or at least while the settlor is mentally competent) the rights are unenforceable and do not amount to 'rights' at all.

If the settlor is not the sole trustee, there is a trust; but if (in the words of the Uniform Trust Code) 'the duties of the trustee are owed exclusively to the settlor' it is considered that the USA revocable trust is a bare trust for UK tax purposes. For CGT, the settlor is absolutely entitled as against the trustee. A USA revocable trust of this kind is similarly not an IHT-settlement, since:

(1) if the settlor is sole trustee there is no trust;

(2) if the settlor is not sole trustee there is only a bare trust.

The property is not held in trust for persons in succession. The better view is that a USA revocable trust of this kind is also not equivalent in effect to a trust for persons in succession. The element of succession is that of a will. In other words, a USA revocable trust of this kind is in English law a bare trust and a testamentary disposition. This view was adopted in *BQ v DQ*.[10]

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8 Accessible *www.nccusl.org*. The uniform code project is an attempt to standardise USA law. Adoption of uniform codes is far from universal, however, and each state adopting them may do so with variations. Some state statutes (eg, California Probate Code section 15800) impose rules almost identical in effect to UPC section 603, though independently of the uniform code project

9 *Armitage v Nurse* [1998] Ch 241 at p.253. Likewise Hague Convention art.2 ('A trust has the following characteristics … (c) the trustee has the power and the duty, *in respect of which he is accountable,* to manage, employ or dispose of the assets in accordance with the terms of the trust …'. The rule goes back to *Morice v The Bishop of Durham* (1804) 9 Ves Jun 399 at p.405: 'There must be someone in whose favour the Court can decree performance'.

10 Supreme Court of Bermuda [2011] WTLR 373; [2011] TLI 23 accessible www.gov.bm.

Depending on the wording, a USA revocable trust of this kind may cease to be a bare trust, and become a settlement (for IHT and IT/CGT) if the settlor loses mental capacity. This could of course have significant UK tax consequences.

1.6 Foundation (*Stiftung*)

1.6.1 Terminology

This section is concerned with non-charitable foundations which are found in Liechtenstein, Jersey, the Bahamas and many civil law jurisdictions. I focus on Liechtenstein foundations (*Stiftungen*) though I refer at points to other foundations.

1.6.2 Is a foundation an IT/CGT settlement, or a company?

A Liechtenstein foundation normally has legal personality. Biedermann explains at [1993] PCB 283:

> Since, in most cases, the Liechtenstein foundation has legal personality, it is subject to the general provisions concerning legal persons and it has a corporate structure with a board of foundation. The *in rem* aspect of the beneficial rights under trusts, i.e. non-reachability of trust property by creditors of the trustee, is not necessary for foundations, since the foundation has its own personality. The beneficial rights under a foundation may be less strong, because there is no specific tracing possibility *vis-à-vis mala fide* purchasers and volunteers. However, this deficiency is overcome by the public faith principle, since anyone dealing with a foundation has to look at the objects and competence clause of a foundation in order to know whether a board of foundation is entitled to *e.g.* sell some specific foundation property.

On the evidence of this passage it is considered that property in a foundation is not held 'in trust'. An essential (or almost essential)[11] characteristic of a trust is that 'the assets constitute a separate fund and are not a part of the trustee's own estate'. A foundation does not have this characteristic: A foundation holds property, but there is only one fund, not a fund separate from the foundation's own assets (as would be the case for a trustee). So it is not an IT/CGT settlement.

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11 It is hard to make any comment about trusts without qualification. A charitable trustee incorporated under s.50 Charities Act 1993 might not constitute a separate fund. But that is an anomalous and unusual case and perhaps itself not a 'trust' in the ordinary sense.

There are of course other significant differences between a Liechtenstein foundation and a trust, in particular the beneficiaries of a foundation have different and somewhat weaker rights. But the failure to meet what the Hague Convention on the law applicable to Trusts identifies as a defining characteristic is crucial.

A foundation is a body corporate.[12] It is therefore a company for UK tax purposes. A foundation is therefore subject to UK corporation tax on its income and gains if it is UK resident and subject to income tax on UK source income at the basic rate if non-resident. The test of residence is the company test of central management and control.
A foundation is usually a close company as:

(1) The members of the board are directors.

(2) The members of the board are participators.

(3) The foundation is under the control of directors who are participators.

However this depends on the constitution of the foundation.

A foundation is a settlement-arrangement[13] so it is a 'settlement' for the purposes of s.87 TCGA; see too 48.2 ('Settlement' and 'trustee').

Foreign law views on foundations

The view of the Canadian Federal Court of Appeal is that an Austrian Privatstiftung is classified as a company, not a trust for the purposes of Canadian tax law (see Canada v Sommerer 2012 FCA 207)

Similar reasoning applies in the UK.

1.6.3 Is a foundation an IHT-settlement?

Foundation property is normally held 'for persons in succession' or 'held with power to make payments out of the income'. The question is whether a foundation is 'governed by provisions equivalent in effect' to a trust. This raises a question of Liechtenstein law as to the effect of a foundation. It is considered that a foundation is 'equivalent in effect' to a trust and is therefore an IHT-settlement. (The contrary argument would focus on the word 'equivalent', and state that since

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12 See the OECD commentary on the Model Treaty 'article 3(3) agrees:... the term person includes any entity that, although not incorporated, is treated as a body corporate for tax purposes. Thus, e.g. a foundation (*fondation, Stiftung*) may fall within the meaning of the term person'

13 Assuming (as will generally be the case) that the bounty test is satisfied.

there are undoubtedly some differences, the two are not equivalent. The expression ‘equivalent in effect’ is looking at the broad substance rather than absolute equivalence but where to draw the line is hard to tell.)

It is sometimes argued that a foundation cannot be an IHT-settlement if beneficiaries of the foundation have no enforceable rights and no interest in foundation property. But beneficiaries of a charitable trust have no rights and no interests in the trust property, and a charitable trust is clearly an IHT-settlement. All that matters is that there is some legal mechanism which recognises their rights and prevents the board of a foundation treating the foundation property as their own.

1.6.4 Is a foundation an interest in possession settlement for IHT purposes?

Since a foundation is an IHT settlement, the question may arise whether a beneficiary’s interest under the settlement is an interest in possession. (This question does not often matter for IHT for foundations made after 2006.)

This raises two issues: what exactly is the test for an ‘interest in possession’, a question of UK law; and whether any particular interest meets those requirements (a matter of applying Liechtenstein law to the document in question).

It is arguable a beneficiary of a foundation cannot have an interest in possession. ‘Interest in possession’ is a term of English trust law, a foundation is not a trust, so the beneficiary’s interest cannot be an interest in possession. This view is supported by s.46 IHTA which expressly extends the definition of interest in possession to Scottish entities which confer rights somewhat less than those of a life tenant of an English law trust. However the better view is that where ‘settlement’ is given an extended meaning, the meaning of related terms such as interest in possession should be given a comparable extended meaning. Thus a beneficiary has an interest in possession if they have the right to the income of the foundation as it arises. It might follow from this view that s.46 IHTA is otiose, but that is not a very strong objection.

Whether that requirement is met depends on the drafting (construed in accordance with Liechtenstein law). At the borderline the distinction between IP and non-IP trusts is one of form rather than substance, and not appropriate to a foundation which is not even a trust, but merely equivalent in effect. In such cases one can only answer the question on the basis of ’doing the best one can’ and with the benefit of appropriate foreign law advice.

1.6.5 HMRC view

HMRC say:

> … foundations ('Stiftungen') [are] to be characterised, recognised and treated as *trusts* for UK tax purposes.[14]

HMRC do not refer to any statutory provisions but are clearly saying that in their view foundations are trusts for all tax purposes. It is true that HMRC recognise that there may be special circumstances but in the absence of special circumstances, if it suits the foundation to take the view that the foundation is a trust for all tax purposes, including the IT/CGT definition, it could properly do so. That might be relevant, for instance, to obtain the benefit of ESC B18, or if a taxpayer wished to argue that a foundation was an interest in possession trust and transparent for income tax purposes.

1.7 Liechtenstein *Anstalt* (Establishment)

Liechtenstein Companies House explains the nature of an anstalt.

TDSI guidance notes[15] para 2.3 provide:

> **Anstalts & Stiftungs**
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> Anstalts … are Liechtenstein business entities which are fiscally opaque. The current HMRC view is that Anstalts should all be dealt with as if they are companies. For TDSI, this means that Anstalts should receive gross interest.

Despite this statement, and classification in the official list as 'opaque', HMRC practice has not always been consistent. For example, the Liechtenstein disclosure facility takes a different approach.

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14 Joint Declaration by the Government of the Principality of Liechtenstein and HMRC Concerning the Memorandum of Understanding Relating to Cooperation in Tax Matters, 11 August 2009 *www.hmrc.gov.uk/international/joint-declaration-lich.pdf*. This is subject to a disclaimer and qualification:

15 Accessible *www.hmrc.gov.uk/tdsi/guidance-notes.pdf*.

1.7.1 Société civile immobilière

The Employment Income Manual provides:

> **11371 Homes outside the United Kingdom owned through a company: General background** [January 2009]
>
> …Meaning of company
>
> Company is defined in section 992 ITA 2007 as any body corporate or unincorporated association other than a partnership, a local authority or a local authority association. This wide definition is not restricted to companies registered in the UK and includes a number of entities formed under foreign law through which individuals may acquire homes outside the UK. Such entities will generally be classified as opaque for UK tax purposes. Examples include the ownership of a home in France through a 'Societe Civile Immobiliere' (SCI) or in the United States through a Limited Liability Company (LLC).

The view that a SCI is a company for UK tax purposes is controversial.[16] A société civile is classified as a partnership in the UK/France IHT DTA. The introduction of benefit in kind foreign homes relief and the subsequent France/UK DTA have made the issue somewhat less important but it still matters.

The issue arose in *Joseph Carter v Baird* 72 TC 303 where a company sold land and purchased a SCI. The company claimed roll-over relief which only applied on a purchase of land. The company failed since it acquired an interest in the SCI and not land. Unfortunately the question of whether an SCI was transparent for CGT was not argued and the necessary expert evidence was not put to the general commissioners. (The litigant appeared in person and was not represented by counsel). The case therefore has no authority at all, and on another occasion there is nothing to stop a taxpayer putting forward the argument for transparency, properly supported by evidence.

1.8 Foreign limited liability partnership

References to a LLP in UK legislation are references to UK incorporated LLP (unless the context otherwise requires.) It is considered that the statutory rules which (generally) make a UK LLP transparent for IT and CGT do not apply to a foreign LLP.

HMRC agree. See BIM 72145.

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16 See Frimston and Urquhart, 'La Vie en France' Taxation, 13 Jun 2002 (Vol 149, Issue 3861), p.296

HMRC classify a Jersey LLP as opaque in the official list. This is controversial.[17] However the issue is at present academic because (partly as a result of the HMRC view and partly due to burdensome Jersey law requirements) no Jersey LLP has yet been registered.

This discrimination would however be in breach of EU law so LLPs in Member States may be treated as transparent.

1.9 Dutch bewind

Kortmann and Verhagen say:

> The *bewind* cannot be characterised as a trust in the sense of Article 1 of the Principles. A trust in the sense of the Principles only exists in situations where the trustee legally owns the assets to be managed, which is not so in the case of *bewind*. In the case of *bewind* the beneficiary is legal owner of the assets to be managed. There are, however, restrictions on the beneficiary's right to dispose of the assets placed under *bewind*. Either the legal owner cannot dispose of these assets at all, or he can only do so subject to the *bewind*. The *bewindvoerder*, as the administrator is usually called, acts in the case of *bewind* only as agent for the owner of the assets (the beneficiary). Because the assets to be managed are not legally owned by the *bewindvoerder*, the assets remain unaffected by the bankruptcy of the *bewindvoerder*.[18]

On this basis it is considered that a bewind is a bare trust.

1.10 Dutch Stichting

The Australian Revenue have guidance on this subject which concludes that: 'all the necessary elements of Article 7(1) of the Netherlands/Australia double Tax Agreement are satisfied by the Stichting in order for the taxing rights of the Netherlands and Australia to be determined under Article 7(1) of the Netherlands Agreement.

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17 Walker, 'Limited Liability Partnerships: True Partnerships' [1998] JLR 1 argues that a Jersey limited liability partnership is a partnership in the ordinary sense of the word. In *R v IRC ex p. Bishopp* 72 TC 322 the Court was asked but refused to express a view on that.

18 Hayton, Kortmann and Verhagen, *Principles of European Trust Law, Law of Business and Finance* Vol 1,(1999) p.199. Similarly Gretton 'Trusts Without Equity' (2000) 49 Int'l & Comp. L.Q. 599: 'Though it functions as a trust, the *bewind* is not a trust, for a simple reason: the location of legal title is the reverse of the trust.'

The Stichting does not have a permanent establishment in Australia and Article 7(1) of the Netherlands Agreement provides a residence-only taxing right to the Netherlands over the business profits of the Stichting. Accordingly, Australia, as the country of source of the business profits, does not have a right to tax the business profits under the Netherlands Agreement.'

The Netherlands agreement is in OECD model form, so the same should apply in the UK.

1.11 US S-Corporations and LLCs

1.11.1 Transparency and treaty-residence

The DTR manual provides:

> **DT19853A United States of America: United States limited liability companies** [September 2011]
>
> Generally speaking, United States federal income tax is charged on the profits of LLCs on the basis that they are fiscally transparent, ie tax is imposed on the members of the LLC and not on the LLC itself.
>
> However, for the purposes of UK tax we have taken the view in relation to those LLCs that we have so far considered that they should be regarded as taxable entities and not as fiscally transparent. Accordingly we tax a UK member of a LLC by reference to distributions of profits made by the LLC and not by reference to the income of the LLC as it arises.

However, in *Swift v HMRC*[19] a Delaware LLC was held to be transparent. HMRC say:

> HMRC has appealed the decision and intends, for the time being, to continue with its current general practices in relation to US LLCs. If, however, any member of a US LLC feels that the UK treatment of a particular LLC should be reviewed in the light of the decision of the Tribunal, they should write to [HMRC contact] setting out fully why they believe that to be the case.

HMRC Tax Bulletin 29 also contained a concession but the problem is now dealt

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19 [2010] UKFTT 88. The Tribunal noted at [17] that its decision concerned only this particular Delaware LLC, and since there is wide freedom to contract the terms of a Delaware LLC, it may not be of general application. However I understand that the LLC did not in fact have any particularly unusual features

with in the 2001 treaty, see 55.14 (US/UK DTA). Also see 79.27.3 (Ordinary share capital: Delaware LLC).

1.11.2 Capital contribution: company law background

Capital contributions are a common method for Delaware companies to raise additional capital. The CG Manual explains the company law background at para 43500 and the International manual has comments at para 503050:

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1.11.3 Capital contribution: tax analysis

The CG Manual then turns to the tax analysis at para 43501:

> 'A shareholder may make a capital contribution to a company at the same time as the shareholder acquires shares in the company. If the capital contribution is made as part of the terms of issue of the shares, then the capital contribution should be accepted as consideration given wholly and exclusively for the acquisition of the shares within TCGA 1992, Section 38(1)(a). If a capital contribution is made as part of the terms of a share issue which is treated as a reorganisation for capital gains purposes, then the capital contribution should be accepted as consideration given for the new holding for the purposes of TCGA 1992, Section 128(1). The amount of the capital gains deduction will remain subject to the other general rules, such as TCGA 1992, Section 17 and TCGA 1992, Section 128(2), see CG14530+ and CG51840+'-

So far the law is fair. However the Manual continues:

> **43502. Other contributions not allowable** [January 2008]
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> Where shares are disposed of in a company to which a capital contribution has been paid a claim may be made for a deduction in respect of that contribution in the capital gain computation. The claim will normally be for the contribution to be allowable as enhancement expenditure under Section 38(1)(b)TCGA 1992.
>
> Although a capital contribution will typically affect the value of the shares in the company to which the contribution is made, it does not represent either
>
> [1] expenditure on the shares,[20]or
>
> [2] expenditure reflected in the state or nature of the shares at the time of their disposal.

20 Point [1] is wrong and directly contradicted by the decision in *Fenston* but it would be sufficient if HMRC are right on point [2].

Section 38(1)(b) TCGA allows a deduction for:

> the amount of any expenditure wholly and exclusively incurred on the asset by him or on his behalf for the purpose of enhancing the value of the asset, being expenditure reflected in the state or nature of the asset at the time of the disposal …

In *Fenston v HMRC* [2007] STC (SCD) 316, the Special Commissioners correctly held that the capital contribution was expenditure 'on the asset for the purpose of enhancing the value of the sset.' Unfortunately they held that the expenditure was not reflected in the state or nature of the asset at the time of the disposal:

> 23 … [1] Further, 'state and nature' for these purposes must be something other than merely the value of the asset—otherwise this phrase would add nothing to the immediately preceding words.
>
> [2] In this case the capital contributions did not result in any increase in the number of shares in issue, or result in any change in the rights or restrictions attaching to the shares. The only effect of the capital contributions was to increase the surplus of the company—which would increase the amount available for distribution to shareholders, and therefore presumably the value of the shares. We do not consider this sufficient for the expenditure on the capital contributions to be reflected in the state and nature of the shares, either at the time the expenditure was incurred or at any time subsequently.

Point [1] is wrong[21] and point [2] is not in the least convincing. It is considered that the decision ought not to be followed, though a taxpayer who challenges it risks litigating to the Court of Appeal.

The CG manual discusses the possibility of relief under the last part of s.38(1)(b) TCGA which allows a deduction for 'expenditure wholly and exclusively incurred by them in establishing, preserving or defending his title to, or to a right over, the asset.'

> There may also be cases where companies call on their shareholders to provide further capital to meet a specified purpose, in circumstances where a shareholder who fails to provide the additional funds may lose the entitlement to the shares held. In this situation, depending on the particular facts, the shareholder may be able to establish that the

21 The words 'reflected in the state or nature of the asset' are needed to cover this situation: suppose T spends £x on a kitchen in T's home. 15 years later the kitchen is replaced by a new kitchen. The x was 'incurred on the asset for the purpose of enhancing the value of the asset' but was not 'reflected in the state or nature of the asset' at the time of disposal. In this case it is sensible to disallow the capital expenditure in a CGT computation.

additional payment represents expenditure on preserving or defending the title to the shares within the terms of Section 38(1)(b)TCGA 1992.

1.11.4 Planning implications

The tax planning advice is that companies should if possible be funded by subscriptions for shares or loans, and not by capital contributions, because the expense of the capital contributions will in most cases be disallowed for CGT purposes (or else the taxpayer will have to litigate to a high level to obtain them).
The HMRC view that 'If there is a possibility that the money can be repaid, it is likely to be a debt' mitigates some of the unfairness of the treatment of capital contributions by reducing the number of occasions where a transaction is categorised as a capital contribution.