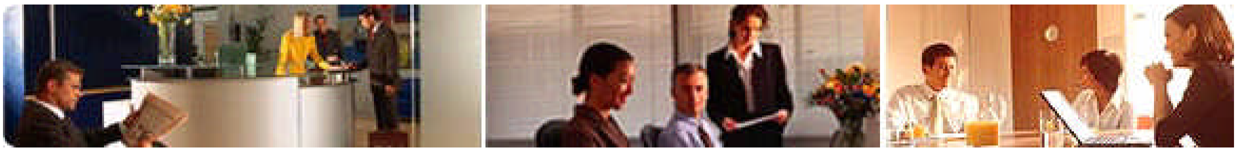

London Consulting&Trustee Limited

Network of international attorneys and tax counsel
www.london-consulting.net

Basic considerations within the framework of international taxation

Our clients reside in places all over the world. As a rule, with the formation of an offshore company, they pursue the following targets: minimization of taxes, limitation of liability and / or anonymity. In the following you will receive an overview over the basics of international tax arrangements. All of our clients are highly recommended to take their time to study such basics in order to understand the fundamental principles of international tax efficiency. A well-informed client is bound to make fewer errors in daily practice, is able to define himself suitable types of ownership to fit his targets and he also has less consultancy needs. In general we need the following information which enables us to offer you the necessary scope for formative action:

- *1. Brief description of your priorities: minimization of taxes on earnings, limitation of liability, restart after insolvency in your home country, others?*
- *2. Object of your company (e.g. services, manufacturing etc.)*
- *3. Does your company mainly or exclusively serve domestic (local) customers?*
- *4. Location (country) of your company?*
- *5. Your company's previous type of ownership?*
- *6. Fiscal residence of the company's management and / or co-partners?*
- *7. Do you employ salary-earning staff?*
- *8. As regards "retail stores" or manufacturing facilities (e.g. tanning salon, hairdresser, vehicle repair workshops etc.): Do you operate several locations?*
- *9. Would you be willing to move your fiscal centre of life to a low-tax country? Alternative: Would you be willing to delegate a "colleague" to a foreign country in order to act as a managing director there?*

Brief notes to the above queries:

2. According to the double taxation agreement (DTA) a manufacturing facility and / or a retail store in its sense will constitute a taxable entity at home. Consequently, profits earned at home will always be subject to domestic taxes on earnings. Tax effects can therefore only be gained, e.g., if an offshore company invoices the company at home and/or in the event of a holding structure through an offshore company. Alternative: The production process is fully transferred to a foreign country. On the other hand, advisory activities, pure auxiliary activities and / or a warehouse will not constitute a taxable entity at home.

3. Active business: Is your company engaged in the active conduct of a trade or a business abroad?

4. Which double taxation agreement will apply?

5. As a rule, corporations will enjoy a greater scope of action, e.g. within the framework of the EU Directive on parent companies and their subsidiaries in the European Union.

6. Place of company management according to DTA = place of taxable entity in its sense.

7. Exceptional budgetary position within the DTA: The domestic representative office of an offshore company can generate a taxable entity at home nevertheless, if dependent staff is employed in the home country.

8. According to DTA, retail stores will constitute a taxable entity in the home country. However, if the entrepreneur operates several places of business/manufacture in the home country the majority of profits can be earned abroad through a holding structure.

9. *Place of business management* as place of taxation according to DTA: If you or authorized people do not wish to transfer your centre of life, we are able to provide a nominee director in the country of the company's registered office.

Introduction

> Almost all EU member states, the USA and Switzerland have legal provisions which were enacted in order to prevent the improper use of the scope for action. Such legal provisions are aimed at enabling the relevant country or state to formulate its individual taxation power in order to collect as many taxes as possible on its own territory. Within the framework of tax efficiency strategies such provisions, the double taxation agreements (based on the <u>OECD's: Articles of the Model Convention with Respect to taxes on income and on capital)</u>

as well as the *EU Directive on parent companies and their subsidiaries in the European Union* therefore play a decisive part. If tax planning is not meant to end up in a tax trap, it is in general of great advantage if the client establishes a taxable entity in a country which maintains a *double taxation agreement* with his country of residency (country where our client lives), or, even better, if the *EU Directive on parent companies and their subsidiaries in the European Union* applies. If a taxable permanent establishment is installed in a country which does not maintain a double taxation agreement with the country of residence and which imposes a lower tax rate on earnings, we talk, in fiscal parlance, about an offshore state of facts.

1. Double taxation agreement

> DTA = double taxation agreement. Correctly: *agreement on the prevention of double taxation*. Double taxation agreements regulate which country is entitled to the right of taxation under which circumstances. The definition of the permanent establishment as place of taxation is essential for entrepreneurs. Since DTAs are OECD standardised, the definitions in all double taxation agreements are the same.

Extract to the subject of permanent establishment:

(1) For the purpose 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 out.

(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

g) a building site or construction or installation project that lasts more than twelve months.

(3) THE TERM “PERMANENT ESTABLISHMENT” DOES NOT INCLUDE:

a) the use of facilities **solely for the purpose of storage**, display or delivery of goods or merchandise belonging to the enterprise;

b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;

c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

d) the maintenance of a **fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information for the enterprise;**

e) the maintenance of a **fixed place of business solely for the purpose of advertising for the enterprise, issuing information, doing scientific research or carrying out similar activities of a preparatory or auxiliary character.**

“***Place of business management***” is a DTA key term that is to say in order to acknowledge a taxable permanent establishment abroad a person with permanent residence in such country must act as the company’s director. Either you – or a person authorized by you – will transfer the centre of life to the country of the company’s registered office or you employ a person with permanent residence in the country of the company’s registered office to assume the function as managing director or one of our attorneys active in the country the company’s registered office will act as nominee director (to the outside). For this purpose a notarial deed of trust is concluded between the attorney abroad (trustee) and the client (trustor).

1.1. A commercially equipped business operation

International tax legislation defines a commercially equipped business operation as a fully equipped office with at least one staff member working there. Numerous countries interpret double taxation agreements and national laws on taxation as follows: In order to have a taxable entity abroad acknowledged the aforementioned commercially equipped business operation must be established. For this purpose, a tenancy agreement and the contract of employment entered with the staff member must be submitted.
In our opinion a virtual office e.g. at Regus Center: www.regus.com. is the absolute minimum requirement. Arrangements can be made that the nominee director (if installed) also acts as employee.

However**, as regards companies within the European Union,** establishment of the above described *commercially equipped business operation* is NOT required, since *EU freedom of establishment* shall be applicable as a superior valuable right. However, the company must not constitute a bogus company in its sense that is to say not a mere “mailbox firm”. A deliverable postal address also for registered letters as well as availability via telephone during the usual office hours is a must.

Note:
Within the framework of company formations our legal office will never establish a “mailbox firm” in the country of the company’s registered office but a regular and proper business address as described above. It is a matter of course that this constellation is complex and thus costly.

2. EU Directive on parent companies and their subsidiaries

According to the EU directive on parent companies and their subsidiaries in the European Union, profits between corporations within the European Union are not subject to taxation.

Example:
An English Limited company holds a 50% stake in a Cypriot Limited. The Cypriot Limited will be first subject to a profit tax of 10% in Cyprus. What remains is a profit after taxation (net profit) in Cyprus, the so-called distribution profit.
50% of this profit are now collected free of tax by the English Limited. Cyprus has no withholding tax legislation while England has no power to impose taxes on such 50%-profit influx.
Taxation will not take place until the English Limited distributes such 50% to the shareholders of the same English Limited, provided that such shareholders are natural persons.

Conclusion: The EU Directive on parent companies and their subsidiaries in the European Union is a tax handout and prevents taxation at source from occurring in the country of the company's registered office.

Supplementary note: Switzerland submitted itself to the EU Directive on parent companies and their subsidiaries, although Switzerland is not an EU member state.

3. EU freedom of establishment

Within the European Union company founders enjoy a so-called "freedom of choice" as regards a company's type of ownership. It is considered legal if the regulation on the establishment of companies in an EU member state is circumvented by establishing the company in the particular member state whose company-law provisions offer the greatest scope of freedom. Later on, such company can become active in any given member state of the European Union, also in its home country, by way of branch offices and representative offices. For this purpose it is expressly not required to perform any kind of business activity at the company's registered office. Therefore and/or/complementary: The law of the country where the company holds its registered office shall be applicable, e.g. England, Cyprus etc.

4. Fictitious taxation of the shareholder, if such shareholder holds a dominating control that is say a stake of more than 50% in the offshore company

Various countries, e.g. Germany (§7-14 Foreign Transaction Tax Act/ AStG), have legal provisions which imply the following:

If a domestic resident (hence, in this case, our client / the founder of the company) holds a stake of more than 50% (the so-called "dominating control") in an offshore company and if this company has its registered office in a low-tax country and if this offshore company only yields passive earnings, the profit of the offshore company is taxed at the domestic resident even if such offshore company fails to distribute its profits.

Within the European Union the above fictitious taxation was declared illegal: Court decision of the European Court of Justice regarding the "Cadbury Schweppes" law case (C-196/04)

Example:

You have your permanent residence in England and you have just established a Cypriot Limited company with a taxable entity in Cyprus. You personally or your English Limited hold/holds an 80% stake in the Cypriot Limited.
For the moment, Cyprus is a low-tax country with a tax rate of 10% only; in England, on the other hand, the tax rate generally ranges between 19- 30%. The Cypriot Limited does only yield passive income; the company runs, for example, no manufacturing facilities on Cyprus. Nevertheless, fictitious taxation in England would be considered illegal since both companies have their permanent residence within the European Union.
However, what happens, if, e.g., the English resident decides to establish a company outside the EU, in a country which, from an English point of view, is considered a low-tax country, and the company only earns passive income and if such Englishman holds a stake of over 50% in such company?
Basically our Englishman runs the risk of facing similar regulations being applied such as the German addition taxation or being installed on a national level. In case of doubt our client should consult a national tax adviser in order to clarify the situation.

However, the above problem can be easily avoided by introducing the structure as described below. The founder / client or their company only hold a maximum of 50% (to the outside) and the other 50% will be held in trust by e.g. the tax office abroad.
With the above constellation the founder of the company / the client will still maintain the company's fate in his hand (for significant decisions 51% of votes are required) and fictitious taxation is prevented from being imposed in any case. Normally this is considered to be the best solution.

5. What about offshore state of facts?

As described above, international tax codes formulate offshore state of facts as follows:

- A country that is noted for its low taxation and fails to maintain double taxation agreements with other countries.

Of course, all countries will try to prevent such a taxation structure from existing and to establish the right to impose taxes on their own territory.
Since no "superior valuable right" (e.g. EU freedom of establishment or a double taxation agreement) does apply, such countries are very quick in formulating an improper use of the scope for action and decide to tax the offshore company at home (the client's country of permanent residence).

As a rule, this can only be avoided if the following applies:

- A commercially equipped business operation is established in the offshore country (e.g. Belize, Panama etc.) AND
- active business operations are developed AND
- the company can prove that its services and/or products are also offered in the country of the company's registered office, e.g. in Belize, and of course,
to make the list complete, that a person with permanent residence in the offshore country has assumed the company's business management.

Of course, there are several clients who make a point in saying that their national tax authorities may not even have the faintest idea of their offshore company's existence, since with the provision of a nominee director and a nominee shareholder and an improper use of the scope cannot be proved.
On the other hand clients arrange for their money to flow from the offshore company to their home country or they appear as an authorized person or within the framework of a representative office in their country. And sooner or later they will be trapped: The tax authorities will ask the client to demonstrate that he does not exert any executive influence on a given offshore company. As long as the client fails to provide such evidence the tax authorities of most countries will assume that they have the right to impose taxes (reversal of the onus of proof).

The foundation of an offshore company makes sense if the client / beneficiary transfers his centre of life to the offshore country (place of business management as place of a taxable entity) OR
if the client /beneficiary fails to maintain a noticeable relationship to the offshore company.

5. Holding companies abroad

Brief overview

Establishment of a foreign holding company is an excellent tool to direct the profits of domestic corporations to foreign countries free of tax. And all the better if the EU Directive on parent companies and their subsidiaries in the European Union is applicable, i.e. the foreign holding company is an EU company.

Legal consequences of an EU holding company: A commercially equipped business operation is not required (EU freedom of establishment), no withholding tax is imposed provided that the EU Directive on parent companies and their subsidiaries applies.

Cypriot Holdings are not subject to taxation. The same applies to *Swiss companies* with a holding privilege (Note: Switzerland has submitted itself to the EU Directive on parent companies and their subsidiaries in the European Union) and to a *Spanish S.L.* under the provisions of the holding privilege.

The term **Holding** does not paraphrase an independent type of business ownership; a holding acts as an umbrella company of a group of companies - an organisational form which has established itself in practice - and lacks any legal definition.

The **holding organisation** consists of two levels: the **Group headquarters** or the umbrella company and several legally and organisationally independent **subsidiaries**, with the holding company holding a capital stake in such subsidiaries (derived from the English term “to hold“).

In contrast to the organisation of functional areas and the organisation of areas of responsibilities, a holding’s organisational form defines itself less through the internal allocation of responsibilities rather than through the distribution of rights of ownership and thus through decision-making powers and managerial authorities.

Creation of goods and services takes place at the subsidiaries, the basic units of a group of companies. Whether these vertical fractional steps operate within the same value added process and thus a functional structure is present or whether they are active in different value added processes and thus a task-area based structure is given, is not relevant. Numerous holding companies try to use synergy effects between the various subsidiaries. Out of this intention central areas are created with the relevant functional directive authority against subsidiaries whose creation is based on regional or product-oriented aspects.

The holding organisation is a tool which is used to exploit tax breaks, to avoid capital investment limits and to realize the advantages of economies of scale and specialization within the framework of capital investment. Furthermore, this organisational form allows effortless integration of acquired companies. Tax breaks can be used by arranging the holding company to transfer its registered office to a country where more attractive general tax rules prevail.

The profits transferred from the subsidiaries to the holding companies are thus subject to a more favourable tax legislation. For antitrust reasons companies are frequently forbidden to hold larger capital stakes in other companies. In many cases, exceeding the minimum investment sum also ensues legal obligations. In order to prevent this from occurring, this leads frequently to the foundation of holding companies.

5.1 Cyprus Limited as Holding: no taxation!

Cyprus Holding (legal form of a Limited company) is not subject to taxation. In addition to the characteristics of a permanent establishment according to tax laws, it requires pure holding tasks and that the shareholders/co-partners perform active operations in their respective countries and are taxed or that the right of taxation is utilised, respectively. Example: an entrepreneur has independent enterprises in the form of limited liability companies in several countries, i.e. for example, an English Limited, a German GmbH and a Spanish S.I. All companies carry out active business in their countries and are subject to tax or the right of taxation is used, respectively. Now a Cyprus Limited is established, which becomes shareholder in the foreign companies. The foreign companies' profits flow tax-free into the Cyprus Limited. Provided that they are European companies (directive on parent companies and their subsidiaries in the European Union), no withholding tax is imposed in the countries of the co-companies. That means that any profits may be received completely tax-free! It is again important that the Cyprus Limited (Holding) company meets all requirements of a permanent establishment according to tax laws:

- Place of business management: A Cypriot must hold the business management, at least to the outside (nominee solution)

- No bogus company in its sense, but a regular registered office (deliverable postal address, availability by telephone and fax during normal business hours, company sign). Any office or employees (commercially equipped business operation) are not required, since the freedom of establishment in the European Union is applicable

- Bank account in Cyprus

If the member companies are non-EU companies, withholding tax is usually imposed in case of a flow of profits into the Cyprus Limited. This withholding tax varies greatly within the individual countries.

5.2 Holding companies in Switzerland

AGs (stock corporations), GmbHs (Limited Liability Companies) and cooperative associations are entitled to the holding privilege

- if their statutory purpose mainly lies in the permanent administration of essential equity holdings in other corporations and cooperative associations,
- if at least 2/3 of the shares constitute long-term financial investments and scattered stock holdings. The rating of financial investments may be effected by way of corporate profit tax values (fiscally prevailing book values) or at market value appraisal.
- As an alternative to shares the requirements can also be met with profits, that is to say if at least 2/3 of profits constitute capital investment earnings and dividend earnings from scattered stock holdings.

Capital investments of 20% in the capital stock or nominal capital of a different company or a market value of 2 million Swiss francs are considered essential. To gain the holding status it is necessary that the company holds at least one substantial stake. Scattered stock holdings can also be added for quota determination.

In order to qualify for taxation as a holding company, such a company is also not allowed to carry out business activities in Switzerland. Permitted business activities and activities not harmful to the holding privilege include the administration of capital investments including all related activities, the executive management of the group of companies, management of its own accounting system, group management, group strategy development but not the executive management of the individual subsidiaries.

If the requirements to qualify for the holding privilege are temporarily no longer met a canton's tax authority may grant a reasonable period to restore the legally required situation. The holding privilege will remain existent during this period of time.

Holding companies are exempt from the tax on earnings. Earnings obtained from Schaffhausen properties are subject to proper taxation.

The capital stock tax imposed on capital stock, open reserves and the surplus brought forward is 0.05 per thousand, or a minimum of CHF 100 annually. This basic tax is multiplied by a factor determined by the canton and the local authority.

b) Associated companies: Companies which do not qualify as a pure holding company but hold significant stakes in other companies nevertheless can be taxed in their function as associated companies by claiming the investment allowance.

A capital stake of 20% in a different company or a market value of CHF 2 million and exceeding is considered essential.

Associated companies have to pay a reduced tax on earnings which is calculated from the overall profit and reduced by the investment allowance. Calculation of the investment allowance is based on the net-of-tax return method that is to say it is based on the ratio between net investment earnings and the overall net earnings. Net investment earnings are equal to the overall investment profit, reduced by the financing charges falling upon investment profits and a management expense share of 5%. The tax rate ranges between 1% and 10% and is multiplied by the tax rate determined by the canton and local authority. With effect of January 1st, 2001 the investment allowance can also be claimed for capital gains (requirements: investment stake of at least 20%, holding period at least 1 year).

Associated companies are subject to a reduced capital-stock tax owed for the paid-up capital and open and latent reserves. The share of capital falling upon investments is subject to a tax of 0.05%. The remaining part of the capital is subject to the full tax rate of 0.15%. The amount determined by the above method is multiplied by the cantonal and local tax base.

c) Domicile companies

AGs, GmbHs and cooperative associations are entitled to the domicile privilege if

- they only have their permanent registered office in the canton
- they only pursue an administrative function but no business activity in Switzerland
- they do not employ their own staff and maintain no office premises in Switzerland.

Pure administrative functions include in particular the management of one's own assets. Auxiliary work such as the utilization of immaterial rights, the provision of know how, invoicing and collection are also considered as administrative work, provided that such work does not require regular office operation and staff employment in Switzerland.

Foreign earnings are exempt from tax on earnings. Domestic income is subject to full taxation as well as property income earned in Switzerland. The total profit is decisive for the determination of the rate to tax the taxable earnings in a given canton.

Domicile companies are subject to a capital-stock tax of only 0.05 per thousand imposed on the capital stock, open reserves and profits brought forward, however at least a minimum of CHF 100 annually. This basic tax is multiplied by a factor determined by the canton or the municipality.

5. Overview over the countries

5.1 Which countries within the EU enjoy the lowest tax rates?

1. Cyprus: 10% income tax rate, holding companies are not subject to taxation
2. Ireland: 12% income tax rate
3. England: 19% tax rate for small- and medium-sized firms, after that progressively increasing up to 30%

5.2 With countries holding double taxation agreements with other countries enjoy the lowest tax rates?

1. UAE /Dubai: No taxation, except for oil companies and the petrochemical industry
2. Switzerland: 15.5% tax rate in the canton of Zug, 13% tax rate in the canton of Obwalden, domicile companies 8.5%, holding companies are not subject to taxation
3. Isle of Man (maintains only a double taxation agreement with England!): flat-rate tax of 450 GBP on foreign profits

5.3 Which countries not maintaining double taxation agreements with the majority of other countries enjoy the lowest tax rates?

- No taxation: Belize, BVI
- Isle of Man: flat-rate tax of 450 GBP on foreign profits

6. Overview over fees

To what amount will fees sum up, provided that London Consulting is commissioned with the formation of an offshore company including proper registered office (no bogus firm in its sense, no mailbox), including nominee director and nominee shareholder (no formation director or formation shareholder who will resign immediately after entry into the commercial register, but an attorney or a law office in the country of the company's registered office, with the company being available and registered during the entire term of contract), including opening of an account (online banking, credit card), incl. apostille, incl. translation of the foundation documents into the client's local language, with translation certified by a notary:

-English Limited: approx. 5,900 euros
-Cypriot Limited: approx. 10,000 euros

-Swiss AG: approx. 12,000 euros
-UAE/Dubai: approx. 15,000 euros
-Isle of Man: approx. 10,000 euros
-Offshore: approx. 6,000 euros