ICAEW REPRESENTATION 26/17
TAX REPRESENTATION

Reforms to the taxation of non-domiciliaries and offshore trusts

ICAEW welcomes the opportunity to comment on the revised draft Finance Bill 2017 legislation published by HMRC on 26 January 2017.

- draft Paragraph 1 and sch 1 (was 40 & sch 12): deemed domicile: income tax and capital gains tax
- draft Paragraph 2 (was 41): deemed domicile: inheritance tax

This response of 23 February 2017 has been prepared on behalf of ICAEW by the Tax Faculty. Internationally recognised as a source of expertise, the Faculty is a leading authority on taxation. It is responsible for making submissions to tax authorities on behalf of ICAEW and does this with support from over 130 volunteers, many of whom are well-known names in the tax world. Appendix 1 sets out the ICAEW Tax Faculty's Ten Tenets for a Better Tax System, by which we benchmark proposals for changes to the tax system.

We should be happy to discuss any aspect of our comments and to take part in all further consultations on this area.

On 20 February 2017 we attended a meeting with HM Treasury and HMRC jointly with other professional bodies in which we were able to put forward some key comments and concerns and discuss aspects of the draft legislation.

ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 147,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

For more information, please contact ICAEW Tax Faculty: taxfac@icaew.com

icaew.com

INTRODUCTION

1. We submitted our comments on the original draft of the legislation in ICAEW REP 13/17 and most of those comments still stand. Our substantive comments below are on the income tax provisions as these are the new provisions published on 26 January.

2. We are very concerned about the introduction date of 6 April 2017 given that the draft legislation is still work in progress; the draft legislation for the income tax amendments was issued on 26 January just 69 days before going live. To introduce such complex legislation with such haste is wrong in principle and in our experience could lead to problems further down the line.

COMMENTS ON THE DRAFT LEGISLATION

Schedule 1: Deemed Domicile: Income Tax & Capital Gains Tax Part 1

3. No further comments.

Schedule 1: Deemed Domicile: Income Tax & Capital Gains Tax Part 2

Paragraphs 18 & 19

4. Very few changes have been made to these provisions, so our previous representations/observations stand. We welcome the extension of rebasing to offshore funds (non-reporting). We also welcome the change to the cleansing provisions. However, we still have some significant concerns and we are submitting a separate representation on the cleansing provisions.

ITTOIA 2005

Paragraph 25: New s628A Exception for protected foreign source income

5. This new section seeks to limit the scope of s.624 ITTOIA 2005 by excluding from its remit 'protected foreign-source income' (PFSI) for the year. In doing so it relies upon the definition of relevant foreign income as being equivalent to foreign source income. In reality the ambit of relevant foreign income (RFI) is narrower than foreign source income. There are 24 categories of RFI altogether. Some types of foreign income are not included in this definition, with the most important category being chargeable event gains.

6. It may be that it was intentional to limit PFSI to categories of foreign income than can benefit from the remittance basis. However, holding investments through insurance wrappers is a relatively common way of managing investments. To include chargeable event gains within the PFSI definition will be attractive to settlors and may be important in decisions taken about whether to leave the UK prior to becoming deemed domiciled here. .

7. S628A(2)(d)(i) refers to 'the year' whereas it should say tax year. The term tax year is used in other drafting so the drafting used here should be consistent.

8. S628A(3) and S628A(4) – the wording used in the Capital Gains Tax legislation has been drawn on. As such, we have the same concerns with respect to issues such as loans etc. Also:

- S628A(4)(a) includes reference to a transaction entered into at arm's length; it is unclear whether tainting will occur irrespective of the commerciality of the transaction simply because the parties (the settlor for example) are connected to the trustees. For clarity, this provision should make it clear that it applies to transactions entered into on arm's length terms rather than actually at arm's length.
- S628A (4)(c) continues the issue identified in relation to the CGT provisions as regards expenses.

9. S628A(2) refers to income being PFSI for the tax year in which it arises if the conditions are met. However, it is not clear that PFSI remains PFSI in year 2 (say) if the conditions are not met in year 2 (e.g. the settlor becomes deemed domiciled in Year 2). S643A uses this definition of PFSI to construct a "pool" of income, therefore we believe it is important that it is put beyond doubt that once income is classified as PFSI because the conditions are met in the tax year in which it arises, that income remains PFSI irrespective of whether the conditions are met in later, subsequent tax years. Otherwise the pool in s643A will need to be recalculated every year from scratch and this would add a layer of complexity that would just not be possible in practice.

10. Additionally, s628A(2) could be read as saying that PFSI only exists for the year in which the income arises and then disappears which we assume is not the intention: "…income arising…in a tax year is PFSI for the year if -…"

Paragraph 26: New s630A Exception for protected foreign source income

11. This provision seeks to introduce the same limitation in relation to s629 ITTOIA 2005 (income paid to relevant children of settlor). The wording used in the draft legislation is similar to Paragraph 25 and/or refers to new s 628A (enacted by Paragraph 25). As such, our comments for Paragraph 25 (above) are also relevant here.

Paragraphs 27-28: Changes to capital sums treated as income of settlor

12. The aim here is to introduce the same restriction to the definition of income capable of being assessed on a settlor by reference to capital payments made. Again the same observations apply here as they do in relation to Paragraphs 25-26.

13. In addition it seems possible that the various interactions resulting from provisions being switched off could mean that a benefit paid to a settlor would not be caught by the income tax provisions (though in such a case the capital gains tax provisions would be in point). The specific issue is that whilst the transfer of assets abroad legislation has priority in charging the settlor it will not always bite (the motive defence may be in point) and new s 643A does not apply a charge to a benefit received by the settlor.

Paragraph 29 new s643A Benefits for close family members

14. There are serious drafting issues with new ITTOIA 2005 s 643A and s 643B. As discussed s 643A does not catch its intended target. The intended target being the settlor where the transferor of assets abroad legislation does not apply and a benefit is provided to him or her. In the limited time available this is one of the key issues that needs to be focussed on.

15. We would suggest that the close family member rules are removed in their entirety as they only adds complexity for no benefit. Assuming they are retained the charge

relating to benefits provided to the settlor should be in one paragraph with the close family member rules in another paragraph.

16. There are various issues with the proposed ITTOIA 2005 s 643A pool. Whilst we appreciate why a pool is required within the settlements' regime we do not think that a pool that works on a totally different basis to the ITA 2007 s 731 pool is helpful. This can lead to various interaction issues. As such we feel that a simpler route should be followed i.e. where the motive defence prevented matching of the benefit to the s 731 pool there would be matching to the s 643A pool with this pool working in the same way as the s 731 pool only it would just take trust level income into account.

17. If the current s 643A pool is retained we have the following comments:

- S643A commences with the following: "the trustees of a settlement…". The settlements legislation is far wider than trusts. The meaning that the word "settlement" is intended to take in s643A should be clarified i.e. is it restricted to trusts which the use of the word trustee implies or is it in fact wider and we need to identify a "trustee" of the wider definition of settlement.

- Similar comments could be made for s628A which seems to use the word settlement to be both the wider settlement (under s 620) and to mean a trust (s628A(2)(e)).

- The legislation is strangely drafted for both CGT and Income Tax as a close family member taxable on the Remittance Basis can ensure that the provisions are not triggered by remitting just £1 of income.

- The relationship (spouse/partner/cohabitee) and definition of minor child needs to be clarified to make it clear at what point in the tax year (start, end or at any point during) the individual needs to meet the definition to be taken into account for the purposes of the legislation. In addition the close family member definitions are different from the definitions used in the other parts of the settlements' code. The definitions should be aligned.

- The Income Tax close family member rules only apply to foreign dom/deemed dom while the CGT rules apply to all settlors. Is this intentional?

- This new Paragraph replicates the equivalent provision in the new s87G TCGA 1992 (Cases where settlor liable for section 87 charge on closely related beneficiary). The difference between the CGT code and the new proposed code is that the former is based around capital payments (which includes the provision of benefits). It is suggested that the meaning of the term benefit should be expressly defined for the purposes of s643A, if only to ensure that it is consistent with the meaning applied for the purposes of s731 ITA 2007.

- S643A mimics the way that s731 ITA 2007 operates. The difference is that applying the income tax settlement regime should mean that the income concerned will carry with it its own distinct nature, including the availability of income tax credits. Since the s 643A mechanism is a pool available to match to benefits to close family members this could, however, be difficult. This is another reason why this provision is problematic.

- To try to make it work, there needs to be an ordering provision (given the lack of time to consider this the provisions at ITA 2007 s 735A could be taken as a model) that determines how income is to be applied to the various benefits conferred. This could be a set order of priority, by reference to the type of income concerned, or it could be on a pro rata basis. Where benefits are provided in different years of assessment there needs to be an ordering rule as there is for allocation of gains for the purposes of s87 TCGA 1992. The interactions between this and the transfer of assets abroad provisions (TOAA) need much greater thought.

- The scheme of s643A (1)-(3) seems slightly out of sync.
  (1) says that (2) applies if broadly the close family member is not taxed on the benefit.
  (2) then says treat the benefit as income (but it will not be taxed anyway because (2) is only triggered if it isn't taxed).
  (3) then says if it is not taxed on the recipient (which is broadly (1)), tax it on the settlor.

- In addition, if the settlor in on the remittance basis, is the deemed receipt by the settlor taxed on the remittance basis?

- And how is double tax relieved if the actual recipient remits it after the tax year of receipt?

- Is the right to recover legally enforceable? How will it work when almost by definition the recipient or trust is in another jurisdiction? Will not reclaiming the tax from the recipient be a benefit? Will not reclaiming the tax from the trustee be seen as tainting (i.e. addition of property)?

- It is not clear how s643A(11) is designed to operate in relation to the transfer of assets abroad rules (ToAA).

- S643A(11) defines B as income paid to beneficiaries. Unlike the ToAA rules, this does not take account of capitalised income. If income is capitalised and then paid to a non-resident beneficiary (not a close family member), there is no reduction in the pool notwithstanding that the income is no longer available. Is this the intention?

- S643A(11) does not seem to take account of life interests and how they sometimes operate in practice. If foreign income is paid up to the trustees but is not paid out to the life tenant (let us say the settlor in this case), it is taxable on the life tenant but also appears to remain in the PFSI pool as it is not paid out (B requires it to be paid out).

- If the life tenant is a close family member then even if it is paid out it does not appear to leave the PFSI pool – no deduction under B, or TOAA, or X or TI.

- The legislation will affect UK resident foreign domiciliaries who are claiming the remittance basis. Unfortunately, the current draft does not interact effectively with the remittance basis legislation. It talks about “remitting a benefit” but there is nothing in the current remittance basis legislation that this ties into. We do want the issue to be whether the benefit has been remitted rather than the actual income but it is necessary to amend the legislation so that this works. In addition we feel that adjustments to d 648(5) ITTOIA 2005 will be required.

18. Another facet that we would like to test with you is the meaning of income arising for the purposes of PFSI as defined in s643A (11). There is a question mark as to whether this definition works in the way that it is apparently intended. This is because for foreign domiciliaries
19. RFI does not arise for the purpose of the income tax settlement rules under the current provisions until such time as it is remitted: s648 ITTOIA 2005. This implies that PFSI cannot include unremitted RFI which makes the reference to income arising in any earlier tax year puzzling. The accompanying explanatory notes do not shed any light on this aspect (indeed the explanatory notes do not shed any light on any of the issues that we have queries about).

20. In s643A(11) there is a reference to trust expenses in category X. It is unclear if this means both capital and income expenses or just income expenses. Nor is it clear how expenses could be said to be properly met out of PFSI. If there is UK source income in the trust as well, then how are the expenses apportioned between UK and PFSI.

21. Is it the intention that there will be a provision of property to the trust where a settlor has the right in the tax legislation to recover tax from the trustee(s) but does not do so? In our view since enforcing this right can be impossible in practical terms in an offshore trust situation we do not think that a failure to recover tax from the trustee(s) should be seen as providing property to the settlement (particularly since in actuality no property is being provided to the trust).

22. On a related point can HMRC confirm that the reimbursement of the tax by the trustees will not count as taxable under either the CGT or the Income Tax provisions?

23. The current legislation deals with a situation where the settlor pays the tax first then seeks reimbursement from the trustee(s) or beneficiary. There is nothing about where the settlor takes the funds from the trustee(s) or beneficiary in order to fund the trust payment. This may be necessary because the settlor does not have the funds to settle the tax or because he does not have the funds to do so without making a taxable remittance. We think that the legislation should take this situation into account and that there should be no tax consequences of a payment from the trustee(s) or a beneficiary to the settlor to make the tax payment.

24. New s 643B is the re-cycling rule for s 643A. It is very closely modelled on the wording for the s 87 TCGA 1992 recycling rule. Our concerns with this provision have been detailed in the representation we have already submitted.

25. In addition:

- It is not clear if this section is intended to apply to income distributions;

- Clarity is required on how the section will apply to gifts made on death;

- The draft legislation refers to gifts not gifts and loans as the response document does. Is this intentional?

26. In s643B (2)(b)(ii) there is a reference to the "tax-producing amount of any relevant payment". This is defined in s643B(5) as "the amount of income tax for which a person is liable …". This appears to deduct the income tax amount from the payment but we assume the intention is to deduct the amount of income which generates that income tax from the payment. Please confirm our understanding. Otherwise, this will lead to double taxation. It does not appear to be consistent with the analogous provision in the CGT provisions.

ITA 2007

Paragraph 33 new s721A Meaning of "protected foreign-source income" in section 721

27. S721A(3)(b) borrows the term 'originating' from the income tax settlement rules by way of s721A(5) in order to help with the process of identifying income which can be classified as being 'protected foreign-source income'. It is not clear that it meshes in fully with the meaning of income attributed under a power to enjoy for the purposes of s720 ITA 2007. In that context income is identified by virtue of transfers abroad and related associated operations. Also the transfer of assets abroad rules are much wider than the equivalent income tax settlement rules. For example under the transfer of assets abroad rules s722 (3) provides that in determining whether an individual has power to enjoy income for the purposes of section721, regard must be had to the substantial result and effect of all the relevant transaction. This mismatch in the definitions implies that there could still be some foreign source income that would fall to be assessable under s720 ITA 2007, once income identified by reference to the income tax settlement rules had been excluded.

28. The meaning of s721A(3)(e) is unclear. It is contained in a part of the legislation providing clarification as to the meaning of the term protected foreign source income. It provides that such income includes cases where income is retained by the person abroad but if not retained would be paid out in respect of the trustees direct or indirect participation in the person abroad. It is not clear what the position is where the trustees have provided an interest free loan to a foreign company in which they do not hold any shares, or where instead of making a loan they have zero rate preference shares. The uncertainty is because they would not have an entitlement to income were the company to make an income payment.

29. Our understanding was that:

- it was intended that unremitted s720 ITA 2007 income which has arisen before 6 April 2017 would fall within the pool of "protected foreign-source income" from 6 April 2017; and
- transitional provisions would be enacted so that any pre 6 April 2017 income settlements' code or transferor income remitted by the trustees after 5 April 2017 would not be taxable by virtue of the trustees being relevant persons in connection with the settlor.

30. The current draft legislation is unfinished but we understand that the necessary provisions will be within the Finance Bill 2017.

31. We would ask that consideration is given to preserving the position of settlors/transferors with respect to be UK resident income (that is they have never been taxed on such income). Given the concept of relevant income within s 731 this could be done by providing that such income is not relevant income with respect to them.

32. If the ITA 2007 s 735A matching rules are used it would also be possible to consider preserving entitlement to foreign tax credits and the FA 2008 transitional on reinvestment in investments.

Paragraph 34

PFSI source income in ITA s 728

33. We have concerns about how successfully the provisions will work in the transfer of assets abroad legislation (ToAA legislation) where the trustees invest in a structured investment product/bond set up by a foreign company where the trustees are not a participator in that company? We think that a just and reasonable provision is required.

Paragraph 35

729A Meaning of "protected foreign – source income" in section 728

34. It is not clear whether the ambit of protected foreign source income as set out in s729A (and s721A) is sufficiently wide enough to deal with all instances that relevant foreign income for the purposes of s720 et seq ITA 2007 might arise. S729A applies the fiction that the income would have been relevant foreign income were it the individuals and then has two sets of rules. S729A (2) says that the person abroad is the trustees, and in s729A (3) the person abroad is a company where the trustees are participators.

35. What happens if the trustees invest in (say) a structured investment product/bond set up by a foreign company where the trustees are not a participator in that company? Presumably the person abroad is the entity that looks after the investment (s718 ITA 2007)? In some cases you would expect to look through into the structured product and say that the income within it was income capable of being assessed under s720 ITA 2007. If that income isn't protected foreign source income, it would be assessed under s.720 ITA 2007 on an arising basis? Is this intended to be the case? Again a just and reasonable provision may be required.

36. Same issues with tainting as we have commented on already with respect to the CGT provisions.

Paragraph 36

Revisions to s731 ITA 2007 Individuals receiving a benefit as a result of relevant transactions

37. At the moment the proposed new pool in the settlements' regime legislation and the ToAA s 731 pool are computed and matched in accordance with different rules. We think that the provisions need to be aligned so there is one computational and matching system (taking the ITA s 731 pool as the model) and where income is matched to a benefit from one pool it is taken out of the other pool (to avoid double charging). Priority matching rules are required and we would suggest using the s 735A ITA 2007 rules across the board.

38. As currently drafted, the relevant income pool for transferors will also include income which has arisen before the transferor became UK resident. This is a departure from the current regime – is this intentional?

39. At present, all transferors are caught by the proposed changes even those who are UK domiciled and those who are deemed domiciled but where the trust has lost its protection. It appears that both ss720 and 731 will run in parallel for transferors

generating potentially a double charge. This should be amended and any potential double charge removed.

40. We would also like to see the meaning of “benefit” aligned for the two Income Tax anti-avoidance provisions.

41. It is not clear how the new rules will operate where payments are made from protected settlements to a settlor which are 'old' unremitted income and gains.

42. In Paragraph 36(2) the draft changes “non-transferors” to “individuals”. While this may appear to be insignificant it illustrates succinctly the point that non-domiciliaries are going to struggle to arrange their affairs before April 2017. Many non-domiciliaries on the remittance basis will assume that, as they are not becoming deemed domiciled in April, the changes will not impact them and will not have taken any action at all. This small change will mean that non-domiciliaries who were outside of s731 because they were taxed on the remittance basis under s720 will also need to review their relationship with the trust and amend it accordingly pre April 2017 to avoid tax charges. This is a much wider population of people than originally anticipated. This is why the detail is so important in this area and why non-domiciliaries cannot arrange their affairs until the detail is provided – these are highly technical provisions and much turns on small changes.

Paragraph 38

S733A settlor liable for section 731 charge on closely related beneficiary &

s733B Attribution of deemed income to recipient of onward gift.

43. These provisions are very similar to those within ITTOIA 2005 and as we mentioned above in that context are these provisions really required? They include an element of complication which is disproportionate to the mischief they seek to address, as well as carrying with them the inherent defects in the equivalent capital gains tax changes already announced. We confirm that we think that the equivalent CGT provisions are similarly not required.

44. As a general comment: the complication involved in constructing the s731 pools is such that, under the existing rules, it is incredibly difficult in practice for anything other than straight forward scenarios. Adding yet more complication on top will make it virtually impossible for beneficiaries to remain compliant.

45. In addition, while s643A allows a deduction from that pool for benefits matched under ToAA, the opposite is not true – there is no deduction from the s731 pool for benefits matched under the s643A pool. While we appreciate that the wording of the s643A pool gives precedence to ToAA we cannot foresee many circumstances in which the s643A pool will be required. However, for the avoidance of any doubt we believe that benefits matched under the s643A pool should reduce the relevant income in the s731 pool. Otherwise there is the potential for double taxation as the s643A pool and the s731 pool basically run in parallel and contain much of the same income. Therefore if the income is used in one pool it should not be used again in the other parallel pool. As mentioned above we feel that the best way to deal with these issues would be for the s 643A pool to broadly follow the s 731 rules with the differences being no motive defence and the s 643A pool would only take trust income into account.

46. Incidentally, the priority given to ToAA in the s643A pool is in direct opposition to the hierarchy between s624 and ToAA. So as it stands, there will be alternative priorities depending on which part of the extended settlements legislation is in point. Is this the intention?

47. New s 733B is the re-cycling rule for s 731. Similar to the ITTOIA 2005 recycling provisions it is very closely modelled on the wording for the s 87 TCGA 1992 recycling rule. Our concerns with this provision have been detailed in the representation we have already submitted. We think that it needs to be completely re-written and that amending this should be one of the top priorities in the limited time available.

Other issues (1)

48. The pre-owned asset tax (POAT) legislation on intangible assets held by a settlement, which is found in paragraph 8 of Schedule 15 FA2004, uses the settlements provisions in s624 ITTOIA 2005 as a reference point to define which assets are caught (ie only property the income from which would be taxable on the settlor under s624 ITTOIA 2005 is within the ambit of the POAT charge).

49. The effect of new s628A ITTOIA 2005 and the exception from s624 ITTOIA 2005 that it provides, is apparently to take assets producing income that would be "protected foreign-source income" out of the scope of the POAT charge on intangibles. Was this intentional?

Other Issues (2)

50. The December 2016 document “Reforms to the taxation of non-domiciles: response to further consultation” states on page 15 that “The government proposes to provide for any gains representing carried interest in section 103KA (Part III, TCGA 1992) to be excluded from the provisions that will charge tax on benefits taken from a protected trust. This will ensure that no double tax charges arise.”

51. Our question is whether this exclusion, when introduced, will apply retrospectively to 8 July 2015, since the carried interest rules in s103KA TCGA 1992 have been in force since 8 July 2015 and therefore the double tax charge which the government are seeking to avoid would be a problem for carried interest gains arising between 8 July 2015 and the effective date of the above mentioned change if it is not retrospective.

52. In addition there will be situations where the carried interest profits are income rather than capital. This situation also needs to be addressed.

APPENDIX 1

ICAEW TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.

2. Certain: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.

3. Simple: the tax rules should aim to be simple, understandable and clear in their objectives.

4. Easy to collect and to calculate: a person's tax liability should be easy to calculate and straightforward and cheap to collect.

5. Properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.

6. Constant: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.

7. Subject to proper consultation: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.

8. Regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.

9. Fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.

10. Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see http://www.icaew.com/-/media/corporate/files/technical/tax/tax-news/taxguides/taxguide-0499.ashx).