TAXREP 3/12

ICAEW TAX REPRESENTATION

REFORM OF THE TAXATION OF NON-DOMICILED INDIVIDUALS

Comments submitted on 9 February 2012 by ICAEW Tax Faculty in response to HM Treasury consultation on Finance Bill 2012 – draft clauses published on 6 December 2011

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the draft legislation on the *Reform of the taxation of non-domiciled individuals* published by HM Treasury on 6 December 2011 at http://www.hm-treasury.gov.uk/d/non_domicile_tax_reform.pdf.

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

3. On 23 January we attended a meeting with HM Treasury and HMRC in which we were able to put forward some key comments and concerns and discuss aspects of the draft legislation.

4. Information about the Tax Faculty and ICAEW is given below. We have also set out, in Appendix 1, the Tax Faculty's Ten Tenets for a Better Tax System by which we benchmark proposals to change the tax system.

WHO WE ARE

5. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter which obliges us to work 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 136,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

6. 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.

7. The Tax Faculty is the voice of tax within ICAEW and is a leading authority on taxation. Internationally recognised as a source of expertise, the faculty is responsible for submissions to tax authorities on behalf of ICAEW as a whole. It also provides a range of tax services, including TAXline, a monthly journal sent to more than 8,000 members, a weekly newswire and a referral scheme.

KEY POINT SUMMARY

8. We welcome the opportunity to comment on the draft legislation. We are disappointed, however, that the additional draft legislation that was promised for early 2012 remains unavailable and is unlikely to be available before the publication of Finance Bill 2012.

9. In connection with the draft legislation our key points are:

- a qualifying investment should include investment in a partnership, including an LLP;
- a taxable remittance will arise if the investment is in a close company which is a relevant person in connection with the investor when the company makes use of the funds;
- a qualifying investment should include the purchase of share/securities from a third party;
- clarity is required on the definition of an 'eligible trading company' as regards those holding residential property;
- the definition of 'substantial' for the purposes of determining whether a company is an eligible trading company should be in the legislation not in guidance;

- minority shareholders will have particular problems in determining whether a company has breached the 'substantial' test when looking at the whole of its trading activities; this test should be replaced by a 'wholly or mainly' test;
- consideration needs to be given to the interaction of these provisions with s 127, TCGA 1992 when a qualifying investment is acquired in a share for share exchange with a foreign company;
- the definitions of 'eligible trading company' and 'eligible stakeholder company' are too simplistic and do not cater adequately for more complicated group structures;
- there needs to be a grace period to permit the export of money when a prospective investment falls through;
- the 45 day grace period for removing sale proceeds from the UK needs to be extended where the potentially chargeable event is a listing of the target company;
- ceasing to be a relevant person should not be a potentially chargeable event;
- an individual should be allowed to take property equivalent to the value of the proceeds offshore to satisfy the appropriate mitigation steps;
- provision needs to be made where sale proceeds need to be brought back to the UK to satisfy warranties under the sale contract;
- in connection with the sale of exempt property, the 95 day time limit is too short and this condition should be removed. The grace period should start with the day that the sales proceeds are freely available to the seller; and
- the proposed simplification of the nominated income rules should allow an election, with a four year time limit, to amend previous elections.

GENERAL COMMENTS

10. We welcome the majority of the measures that are included in the draft legislation and are pleased to see that a number of the comments that we made in TAXREP 49/11 on the document *Reform of the taxation of non-domiciled individuals: a consultation* have been taken into account. Our detailed comments on the draft legislation are set out below.

11. We have one overriding general concern on the availability of the relief. It appears to us that, as the draft legislation stands, the benefit the relief provides is undermined where the investment is in a close company and the taxpayer, or any other relevant person, is (or as a result of the investment becomes) a participant in the company. The problem is that the company will then be a relevant person in connection with the taxpayer (s 809M, ITA 2007). The relief can be claimed on the initial investment but there is nothing to disapply s 809L, ITA 2007 when the company uses the funds in the UK and this will be a taxable remittance. We assume that this is not the intention and suggest the legislation is amended so that s 809L, ITA 2007 cannot apply in the circumstances outlined. This could be achieved by adding a sub-section to the new s 809VA. The new sub-section would state that where a qualifying investment is made the target company will not be treated as a relevant person in connection with the taxpayer when considering the application of s 809L, ITA 2007 in connection with transactions directly or indirectly related to the funds used to make the qualifying investment.

12. In connection with the remittance for investment purposes, we remain of the view that investment in a partnership, and particularly LLPs, should be a qualifying investment. We believe that including partnerships would lead to significant additional investment into the UK. We understand that consideration is now being given to including investment in such structures. We are happy to work with the Government to develop legislation in this regard with a view to including it in Finance Bill 2013.

13. We believe that there is still some uncertainty over the question of whether an investment in a company holding residential property, or property with a mixed use, will qualify. We refer you to our comments at paras 20 and 21 below.

14. We set out in TAXREP 49/11, at paras 23-25, our concerns that the proposals may not be compliant with European law and in particular the provisions on State Aid. We are aware that the Government has taken advice on this matter and would again ask that this advice be published to allay any uncertainty.

15. We await the draft legislation to treat the capital gain on the sale of an exempt asset as a foreign chargeable gain which will be subject to the remittance basis of taxation. We are concerned, however, that linking the relief to the exempt asset provisions could disadvantage those individuals who bring assets purchased out of 'clean' capital to the UK for sale, where any capital gain would remain chargeable. This could be a particular problem where the assets are part of a set. We suggest that for these purposes the assets which can qualify should include assets which would fall into the category of exempt assets if they had been acquired remittance basis income and gains.

16. In connection with the simplification measures we are disappointed that our proposal to increase the £2,000 de minimis limit for unremitted foreign income or gains to the level of the personal allowance has been rejected. We consider that the limit is too low to deal even with relatively simple cases. The calculations are administratively costly and, we suspect, there is widespread non-compliance.

DETAILED COMMENTS

Schedule 1 Part 1 Increased remittance basis charge

17. We welcome the proposed adjustments to s 809V, ITA 2007 to permit the payment of the £50,000 remittance basis charge from remittance basis income or gains without incurring a tax charge.

18. We also welcome the confirmation, at para 2.128 of the summary of responses to consultation, that consideration will be given to removing the charge to tax on inadvertent remittances, that are not within the principle established in *Duke of Roxburghe's Executors v CIR* 20 TC 711, with a view to implementing any changes in Finance Bill 2013.

Schedule 1 Part 2 Remittance for investment purposes

19. Section 809VB(1)(a) requires that any investment in share/securities must be made by way of a subscription or the introduction of new capital rather than a purchase from a third party. We think this may cause problems where additional investment is required but it is first necessary to buy out existing shareholders. As a minimum we would suggest that this restriction is eased to permit arm's length third-party sales where the investor is acquiring a stake of 20% or more in the company. We understand from our meeting that consideration will be given to amending this section.

20. We appreciate that the draft legislation has broadened the original consultation proposals but we remain concerned that there remains uncertainty as to whether a company holding residential property will be an 'eligible trading company'. We understand the intention is that a company developing residential properties would qualify but not one that let such property, unless that activity formed less than a 'substantial' part, which we understand is to be less than 20%, of the company's total business activities. Section 809VC(5)(b) will be amended to reflect this.

21. The definition of 'substantial should be included in the legislation not relegated to guidance. It should take account of companies holding properties where there is mixed commercial and residential use. The legislation should also set out clearly the period for which the 'substantial' test needs to be satisfied.

22. It is not clear what the situation is when a share for share exchange is undertaken (which meets the requirements of s 127, TCGA 1992) and shares in a qualifying UK company are acquired by a non UK domiciliary swapping shares in their foreign company, such shares having been acquired using remittance basis income/gains, for shares in the UK qualifying company. We understand that it was not the intention that only a cash investment would qualify. We also understand that further consideration will be given to the situation outlined above as, while there would not be a remittance when the shares in the UK qualifying company are acquired, there would be a remittance when the UK shares, received as result of the exchange, are sold. The provisions of s 809VG, the grace period, would not apply to allow the withdrawal of the remitted income or gains or reinvestment within the 45 day period.

23. We find the definitions of ‘eligible trading company’ and ‘eligible stakeholder company’ to be too simplistic and potentially denying relief in the case of more complicated group structures. For example, it appears that relief would not be available where an investment is made in the holding company of a UK trading group, as this would fall outside the definition at s 809VC(1)(a) as extended by s 809VC(2). It seems to us in this situation that, in order to qualify, the investment would have to made in the trading subsidiary, which may be unattractive to an investor whose position is far less secure than if they had invested in the holding company. The legislation needs to take into account the fact that it is now comparatively unusual for modern trading companies of any size to operate as single trading companies. We recognise that a balance needs to be struck between the legislation achieving the underlying policy purpose and simplicity. We therefore suggest that the Entrepreneurs’ Relief provisions could be adapted to ensure that investment in UK trading groups can be undertaken for the purposes of this relief.

24. We note from our meeting that s 809VA(4) is to be amended. As it stands it would deny relief where there is an investment in specie and the property has previously qualified as ‘exempt’ under the existing provisions. We understand that the intention of the draft legislation was to prevent the temporary importation rule (s 809Z4, ITA 2007) having effect so as to extend the allowable investment period by 275 days. As currently drafted it goes further than this and thus requires amendment.

25. Section 809VA(5) requires an investment to be made within the period of 45 days beginning with the day on which the money or other property is brought to or received in the UK. There will be occasions when a prospective investment falls through and in this situation when money etc has already been brought to the UK there would appear to be a remittance as no ‘relevant event’ under s 809VA(1)(a) has occurred. We would ask that consideration be given to allow the prospective investor in this situation to remove the monies from the UK within a specified period so as not to incur a remittance basis tax charge.

26. The interaction between s 809VA(5) and s 809VB(7) needs to be clarified. Where a loan is made to a company, and can be drawn down over time, s 809VB(7) specifies that the loan is treated as being made when the first amount is drawn down. If this is read back to s 809VA(5) it would appear that the balance remaining undrawn after 45 days will also qualify for relief. We understand that this is not the intention and the draft legislation will be amended.

27. We question the need for s 809VA(6) which disallows the relief where the investment is made ‘as a part of or as a result of a scheme or arrangement the main purpose or one of the main purposes of which is the avoidance of tax’. The provision introduces considerable uncertainty – not least because a literal interpretation of it would make the legislation inoperable. We do not see what avoidance a purposive interpretation would catch that the other provisions in the legislation do not. We hope that, should a General Anti-Avoidance Rule be enacted, clauses such as s 809VA(6) will no longer be required. The provision should either be removed or its impact clarified so that it is properly targeted.

28. Section 809VC(2) defines an ‘eligible trading company’. This provides, inter alia, that such a company is one that carries on commercial trades, or does so as a substantial part of what it does. This condition is a particular problem for minority shareholders who will often not be in a position to judge if the test is breached and a tax charge is triggered by the company changing the way it undertakes its trading operations. We suggest that the 'wholly or mainly' test used in the Inheritance Tax legislation for Business Property Relief (s 105(4), IHTA 1984) would operate in a fairer manner; this is because it should be more apparent to a minority shareholder that there has been a fundamental change in a company's business activities which might breach the test. We understand that this suggestion will be given due consideration and we welcome this.

29. We appreciate that it is intended that the 45 day grace period will only run from 'the day on which a relevant person became aware or ought reasonably to have become aware of the potentially chargeable event' (s 809VG(10)(c)). However, this still leaves open the prospect of disputes where HMRC suggest that the investor should have known even where they did not. Our suggestion at para 28 above would help to avoid such disputes and reassure investors, particularly those with a minority shareholding. We understand that consideration is already being given to extending the 45 day rule where the changes in the way a company undertakes its trading operations are outside the control of the investor.

30. Section 809VC(7) provides that the carrying on of research and development (R&D) will in certain circumstances be treated as the carrying on of a commercial trade. An individual investing in such a company may therefore benefit from the proposed relief. We are concerned, however, that if a UK based R&D company is set up to service an offshore group and invoices for those services (which it would have to do to help ensure that it does not run into any transfer pricing issues), there may be a remittance problem when those invoices are paid. The monies used to settle the invoices may be traced back to remittance basis income/gains of a UK resident foreign domicile. We suggest that in such cases the relief is extended to the payment for the R&D work. Without this extension we think that the attractiveness of the scheme for investment in R&D companies will be undermined.

31. An investment in a limited liability partnership is not a qualifying investment under s 809VB by virtue of s 809VC(4)(b). It seems to us, however, that an investment in a private limited company which is itself a partner in a limited liability partnership could be a qualifying investment.

32. In s 809VD, which sets out Condition B for an investment to count as a 'qualifying investment', we consider that there should be a test to exclude any related benefit received that is charged to income tax, as for the extraction of value rule at s 809VF(3).

33. We understand the decision not to extend the relief to an investment in a company quoted on a recognised stock exchange. We do not understand, however, why a listing of a company should constitute a 'potentially chargeable event' under s 809VF. This provision forces an investor to dispose of the investment, within the 45 day grace period, to avoid a tax charge on the monies originally invested. It will not be beneficial to any company to have tax legislation that incentivises investors to dispose of their investment so close to the date of floatation. In many cases it will be impossible to make such a disposal as there is frequently a 'lock in' of capital when a company is floated. If the listing of a company is to remain a 'potentially chargeable event' then consideration needs to be given to significantly extending the 45 day grace period, we suggest that three years is appropriate in this situation.

34. We are unclear about the operation of s 809VE, which sets out the circumstances in which income and gains are treated as remitted to the UK, and s 809VF which defines a 'potentially chargeable event' for the purposes of s 809VE(1). There appears to us to be some ambiguity over who 'P' is in the two sections. It appears from the draft legislation that P is the investor, however, P may not be the taxpayer to whom the original remittance basis income or gains arose, that individual may be a relevant person under s 809M, ITA 2007. In this situation we assume that the tax charge where there is a potentially chargeable event and no mitigating action is taken falls on the relevant person rather than P.

35. In addition, at s 809VF(2)(a) the words ‘for the benefit of P or another relevant person’ are too vague. It needs to be made clear that one considers relevant persons in connection with the individual to whom the original remittance basis income or gains arose and not in relation to P.

36. For a number of reasons we do not consider that the relevant person who made the investment ceasing to be the relevant person should be a potentially chargeable event under s 809VF(1)(b). First, it could discourage the UK investment of gifted funds on behalf of minor children or grandchildren. Second, a tax charge could arise on a divorce. As the legislation provides for a potential tax charge on the disposal of the investment this appears to be the appropriate time for any tax charge to arise. There is also concern that the death of the investor would trigger a tax charge. We think this is inappropriate.

37. We suggest that a provision be inserted to defer a chargeable event where transactions occur between relevant persons. As currently drafted, we think that a tax charge would arise on the transfer of a qualifying investment to a spouse or civil partner.

38. Section 809VF(6) defines the two-year start-up rule which applies to an eligible stakeholder company (s 809VC(3)). This rule will be breached if within two years of the investment being made ‘the company has held no investments in any eligible trading company, or no eligible trading company in which it has held investments has carried on any commercial trade’. We read this section as only requiring some portion of the monies invested to be used to keep within the two-year start-up rule. We understand that this was not the intention and the sub-section will be amended..

39. It is not unusual for an investment to be made in a company who will then transfer the new trade into a subsidiary. We should be grateful for confirmation that the provisions of s 809VF(1)(a), to deem this a potentially chargeable event, do not apply in this situation.

40. We understand that amendments will be made to s 809VF to ensure that the interaction of ss 809VF(1),(8) and (9) do not interact in the event of a company ceasing to trade or becoming insolvent – this would incentivise the investor to remove their investment, thus making the situation worse.

41. The purpose of s 809VH(5) is unclear to us. We fail to understand why it is necessary for the proceeds to be taken offshore ‘in the form in which they are received’ to constitute an appropriate mitigation step. We suggest that the condition should be accepted as being met when property equivalent to the value of the proceeds is exported. This would also enable a taxpayer to take the appropriate mitigation steps in the following situations. The first is where the disposal of the investment has been made by a relevant person of the taxpayer who cannot be persuaded to export the funds. The second is where a tax charge is triggered under s 809VF(1)(b) and the person who ceased to be a relevant person cannot be persuaded to dispose of the investment and export the proceeds.

42. Section 809VH(6) requires amendment to deal with the situation when proceeds are taken offshore within the grace period but are subsequently imported to satisfy warranties under the sale contract.

43. We understand that s 809VJ(1)(b), which deals with the order of disposals, is being reviewed because in the case of a qualifying investment in an eligible stakeholder company, the individual has investments in that company not the eligible trading company in which the stakeholder company has invested. We agree and believe that this provision needs to be amended.

Schedule I Part 3 Sale of Exempt Property

44. We welcome the proposed exemption for the sale of exempt property. This should be of assistance to the UK arts market but there are changes that need to be made to ensure the exemption operates as intended.

45. Section 809YA(5) requires that the whole of the sale proceeds are paid to the seller within a period of 95 days if the provisions of s 809Y(1), ITA 2007 are not to apply. We understand that a number of sales are on deferred terms, which may breach the 95 day rule. This is often the case for expensive items and has the effect of increasing the pool of potential bidders. If the ability to offer deferred terms is difficult in the UK, because of the tax consequences, vendors will simply go elsewhere. There will also be occasions when a purchaser pays late, in breach of the contract. An auction house will generally only release the proceeds after they have been paid. We therefore suggest that s 809YA(5) is removed and the grace period at s 809YA(6) starts with the day that the sale proceeds are freely available to the seller.

46. In connection with s 809YA(8) we would refer you to our comments at para 41 above. As no clearance procedure is envisaged under these provisions, this type of unclear anti-avoidance rule is likely to undermine confidence in this relief.

47. In para 809YA(6) we suggest that words '(or both)' should be substituted by '(or a combination of the two)' to be consistent with para 809VH(6)(b).

Schedule 1 Part 4 Nominated Income

48. These provisions amend s 809I, ITA 2007 to permit an individual to remit the first £10 of income or capital gains which they nominate free of tax and without becoming subject to the identification rules. In general we are happy with these provisions, although we would have liked the test to be set at a higher level.

49. We ask that these provisions be extended to include an election to permit individuals to amend previously nominated income/gains, the time limit for the election to be four years after the end of the relevant tax year. Such a provision would assist in reducing the large number of small bank accounts that are currently ring-fenced.

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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/Files/Technical/Tax/Tax%20news/TaxGuides/taxguide-4-99-towards-a-better-tax-system.ashx).