ICAEW REPRESENTATION
159/16
TAX REPRESENTATION

REFORMS TO THE TAXATION OF NON-DOMICILES: FURTHER CONSULTATION

ICAEW welcomes the opportunity to comment on the consultation paper *Reforms to the taxation of non-domiciles: further consultation* published by HM Treasury (HMT) on 18 August 2016.

This response of 21 October 2016 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 31 August, 1, 6, 13, 20 and 23 September we attended meetings with HMT / HM Revenue and Customs (HMRC) jointly with other professional bodies in which we were able to put forward some key comments and concerns and discuss aspects of the consultation document.

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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.

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EXECUTIVE SUMMARY

We welcome the opportunity to comment on the further consultation on the reforms to the taxation of non domiciliaries.

There are some key points we would like to make at the outset that we expand on in the body of our response:

- Inheritance tax changes:
  - There should not be a situation whereby a non UK domiciliary pays more tax than a UK domiciliary in the same position;
  - The issues around valuation still need addressing;
  - The provisions covering the deductibility of loans in respect of a property are inadequate;
  - The interaction with tax treaties still needs to be addressed;
  - Despite an indication in the past that there may be a relief for unwinding existing structures to de-envelope residential property no such relief is included in the consultation and no response has been given to the paper submitted by CIOT, supported by ICAEW on 21 June 2016 (Appendix 2); and,
  - We suggest as an alternative to complex legislation changes that the annual tax on enveloped dwellings be increased to achieve the same fiscal target.
- Deemed domicile
  - Rebasing should be available to individuals deemed domiciled by law in the five years to 6 April 2022 not just those deemed domiciled on 6 April 2017;
  - Rebasing should extend to assets held by trusts and corporates not just individuals;
  - The rebasing requirement of owning the asset at the date of summer budget 2015 seems unnecessary;
  - It is unjust that disposals of assets between summer budget 2015 and April 2017 will be taxed on an arising basis for returning temporary non-residents;
  - We appreciate that the discussions in the consultation meetings were not final but would like to make clear that the "one shot" proposal for cleansing mixed funds would be too restrictive;
  - Given the need to carry out mixed fund analysis and sell chattels the suggested window of opportunity should be lengthened to two years;
  - Treating UK born individuals with a UK domicile of origin who have changed their domicile either by dependency or choice as UK domiciled as soon as they return to the UK is unjust. We have particular concerns with respect to minors whose parents removed them from the UK and they acquired a UK domicile of dependency. There should be a carve-out for such individuals; and,
  - The short grace period allowed for IHT is inadequate.
- Protected trusts
  - An alternative framework for income tax and capital gains tax charges has been proposed and discussed in the meetings with HMRC and HMT (Appendices 3 and summarised in para 106 to 111) as we have significant concerns about the proposals in the consultation document (though they are better than the proposals in the September 2015 document which would have introduced a dry tax charge); and,
  - Not all offshore trusts are located in non or low tax jurisdictions and the double taxing issues of those trusts in tax paying jurisdictions needs to be addressed.
- Business investment relief
  - The current rules are too complex;
  - The anti-avoidance provisions are disproportionate in their severity and reach (the "involved company" definition for example);
  - The current investment opportunities are too narrow and the incentives to invest insufficient.

INHERITANCE TAX ON UK RESIDENTIAL PROPERTY

MAJOR POINTS

Key point summary

1. The consultation document outlines the government's plans to bring UK residential properties held within an overseas structure within the charge to inheritance tax (IHT). The overall intention behind these proposals is to bring the taxation of non-domiciliaries investing indirectly in UK residential property more closely into line with the tax consequences suffered by its UK domiciled and resident population.

2. Whilst we understand that consideration is on-going given the complexities (not least of which are the treaty issues), from what has been released to date it is understood that the government intends to achieve this policy objective by changing the definition of excluded property for the purposes of the IHT legislation.

3. Our understanding is that the government’s aim is to align the IHT treatment of UK and foreign domiciliaries. As such, we assume that these provisions will not take priority over Business Property Relief (BPR) where the conditions at IHTA 1984, s 105 are all met. We would appreciate confirmation of this point.

4. The new rules will only apply to UK residential property as distinct from commercial property. Accordingly a general apportionment rule between the two types of property on a just and equitable basis would be required where 'mixed property' is held. The selection of a two year holding period in order for property to qualify as commercial property seems to be fairly arbitrary albeit a two year holding period is as good as any.

5. The need to attribute value to shares in companies holding UK residential property highlights the drawbacks of adopting the proposed course of action, as it will mean that that the taxpayer will need to monitor their structures taking into account events that are relevant for IHT purposes in relation to what might be a small fraction of the overall wealth held in the offshore structure. However, retaining the valuation point at the level of the share or interest held is fundamentally important if a taxpayer is to be charged only by reference to the commercial value of his or her holding or interest in the property concerned. It is also important that the valuation is at the company level where there are minority interests, so the discount applied is the same as for UK domiciliaries (foreign domiciliaries should not be worse off than UK domiciliaries as a result of the changes).

6. As acknowledged it will also be necessary to introduce rules to prevent fragmentation of interests in property holding companies where shares are held by related entities or parties. This will increase complexity and the risk that innocent arrangements will be caught.

7. It will be important to introduce a whole range of exemptions and exceptions along the lines set out in Schedule CI TCGA 1992 in relation to non-resident capital gains tax to ensure that bona fide investors in UK residential property are not deterred from continuing to do so in the light of the proposed new rules.

8. The position as to how the value of property is to be determined by reference to debt used to acquire (or “related” to) the residential property concerned is particularly complex, and potentially unsatisfactory. Various issues need urgent consideration.

9. The consultation document appears to only allow very restrictive reductions for debt with no mention of “allowability” if debt is taken out to acquire shares in the offshore company.

10. The situation will need to be addressed where a company has incurred indebtedness in order to make investments, some of which are UK residential property and some are not. It is possible that investors will simply find that the need to monitor their investments in the UK, as well as potentially disclosing their entire offshore structures to the UK tax authorities, as being far too intrusive, and decide that investments in residential property or other assets can be better made in other jurisdictions.

11. Any definition of connected party lending would need to take into account investment partnership arrangements which include a bank or other financial institution which lends to the partnership. Otherwise the entire indebtedness would be disallowed under the connected party rules. Depending on the rules introduced there is also the possibility of great unfairness as there could be credit (liability) disallowed and a debt (asset) subject to IHT.

12. The targeted anti avoidance rule (TAAR) is far too all-embracing, as it is automatically engaged where the purpose or one of the purposes of the arrangement is to simply secure a tax advantage. This is far wider than the general anti abuse rule and yet has none of the safeguards provided for in that legislation. Seemingly, it would be engaged where property was acquired using a commercial loan in order to reduce the value of the property subject to tax.

13. It is not clear how the new provisions will be policed. The weakness of the system is that the various powers held by HMRC will only be engaged when HMRC become aware that a charge has arisen and has taken steps to enforce the liability. Non-compliance is likely to arise because the ultimate owners of the UK residential property are not aware that a liability to tax has arisen rather than as a result of some avoidance intent.

14. Having said all of the above we consider that a simpler and more effective way of achieving the wider policy objectives would be to increase the annual tax on enveloped dwellings (ATED) - which is known to work since the funds raised were so much higher than originally anticipated - in order to take into account the IHT charge that would otherwise arise on death, or be suffered periodically by trustees.

15. The lack of any form of de-enveloping relief is also a serious drawback to the current proposals as it will prevent many who would like to exit older structures from doing so because of the onerous tax liabilities that would be crystallised. Since a relief would have deferred rather than relieved capital gains tax (CGT) we regret that the government did not think granting relief was appropriate at this time. We would at least ask for a response to our various requests for HMRC's current position on the stamp duty land tax (SDLT) issue (see paragraph 62 and Appendix 2).

General comments

16. The consultation document outlines the government's plans to bring UK residential properties held within an overseas structure within the charge to IHT. This charge is to apply both to individuals who are domiciled outside the UK and to trusts with settlors or beneficiaries who are non-domiciled. Such changes are to come into effect from 6 April 2017 being legislated as part of the 2017 Finance Act.

17. The approach taken in the draft clauses released is to adjust the definition of excluded property so that where there is a UK interest in residential property within the structure the offshore company or partnership is deemed in whole or part (where there are other assets within the structure) to not be excluded property.

18. Historically, non-domiciliaries investing in UK residential property have done so using either non-resident companies or discretionary trusts under which they can benefit, which in turn acquire the property concerned using non-UK resident corporate envelopes.

19. The new approach of changing the definition of excluded property so as to bring the value of the offshore company into the IHT net (or at least the value attributed to the UK residential property) faces the difficulty that such investments are not made by its domestic population using discretionary trusts because of the penal tax implications of doing so. This is especially so where the settlor retains an interest under the terms of the settlement concerned. Here the settlor is treated as owning property for the purposes of the gift with reservation of benefit provisions, whilst the trustees continue to suffer exit and ten year anniversary charges on the UK property held. Bringing this legislation in without relief to allow structures to be wound up is, therefore, quite unjust.

20. Or to put it another way, the proposals do not, in practice, level the playing field as they place non-domiciliaries in a position in which a UK domiciliary would never find themselves simply because the tax treatment is so disadvantageous. We consider it is highly unfair to put non-domiciliaries in this type of position at short notice whilst making no allowance for them to unwind their existing structures in a tax neutral way.

21. Non-domiciliaries should not have to pay more UK tax than UK domiciliaries as a result of a past decision to access a beneficial regime provided by Parliament. Changing the taxation position now, after the event, for decisions which may have been taken decades ago and not facilitating an unwinding of the structures is retroactive and could be construed to be discriminatory. All that is being asked for is a relief to allow de-enveloping to avoid immediate tax charges, with the CGT base cost being passed to the owner of the offshore company.

22. The non-domiciliary perspective means that the use of debt to reduce the value of property owned by a company comes sharply into focus. Often such properties are funded by debt loaned by the shareholder to the offshore company purchasing the property. Under the terms of proposals this debt would be disallowable as it would be provided by a connected party. We do not have the detailed provisions with respect to the disallowances for debts provided by connected parties but it seems certain that this would be caught under the current proposals. There is significant concern that the reference in the consultation document to a connected person rule to disallow debt will see the introduction of a general rule rather than just a rule applying for the purposes of the extension of IHT to UK residential enveloped structures. As discussed during the consultation meetings we do not see why any rule is required (since there are already disallowance rules enacted in Finance Act 2013) and we would be particularly concerned if a general rule were to be enacted as this could catch many innocent transactions..

23. As can be seen from the comments made below, the issue of debt deductibility is likely to cause a number of difficulties some of which may not be easily solved. This calls into question whether the approach adopted in framing the way that the charge to tax is to operate is the best way of tackling the perceived unfairness of allowing non-domiciliaries to invest indirectly in UK residential property without suffering a charge to IHT.

24. Simply because the objective is to provide broad parity of treatment between non-domiciliaries investing in UK residential property and the UK's domestic population, it does not mean that non-domiciliaries have to be taxed in precisely the same way as UK domiciliaries or by precise analogy to such rules especially when the technical issues are unduly complex and the ramifications far ranging. As mentioned above, in many respects it would be far easier to simply increase the ATED charge in order to take into account the IHT charge that would otherwise arise on death, or by reference to trust related charges.

25. In this respect it is useful to remember that the IHT ten year anniversary charges on a discretionary trust are geared to mimic the tax that would arise every generation had the asset been held personally rather than in a discretionary trust. The maximum charge is 6% every ten years. So increasing the effective annual rate of tax on ATED income tax to take this into account might be a more appropriate and cost effective way of dealing with this aspect. There is a precedent for levying a charge to IHT on an annual basis where a foreign trust holds UK situs property directly. In the (distant) past the ten year anniversary charge was collected in advance on an annual basis. This is not to suggest that the effective ATED tax rate should be increased by a further 0.6% a year. The current rate of tax could be increased by a smaller fractional element and still result in the necessary tax yield required.

RESPONSES TO SPECIFIC QUESTIONS

Q1: Are there any difficulties in introducing the IHT charge by amending the legislation in this way?

26. Answering this question is not straightforward as the draft legislation is incomplete. Following what is set down in the current consultation document it appears that the government proposes to remove from the excluded property definition offshore close companies and similar entities if, and to the extent that, the value of any interest in the entity is derived directly or indirectly from residential property in the UK. This will apply whether or not the overseas structure is owned by an individual or a trust. As currently proposed, the intention is not to introduce a separate charging provision. However, this brings with it a number of difficulties in that the balance of the IHT legislation is not properly geared to levying a charge to tax in this way (see below and the key and general points above).

27. The width of the definition is also a concern. We would appreciate confirmation that it could not apply to:

- A loan from an offshore company to a UK resident foreign domiciliary which the individual used to acquire a UK residence; and
- Land situated outside of the UK. One question raised at the consultation meetings, was whether it, could for example apply where an offshore company owned a life size copy of Anne Hathaway's Cottage situated say in the US?

The concern in both cases being that the legislation refers to offshore shares whose value is attributable to UK residential property and taken to the extreme both of the above cases would be caught. We would appreciate confirmation that neither of the cases above was intended to be caught by the legislation. In addition we feel that the legislation should be adjusted to make to clear that it only applies to actual immovable UK property.

28. The drafting will also need to ensure that a close company with an interest in a diverse fund that has an interest in UK relevant property is not caught.

29. As discussed during the meetings there are also specific issues with some of the tax treaties (India and Pakistan).

Q2: Are there any reasons why the extended charge should not apply to all chargeable events?

30. For new structures there is no reason why all the tax charges should not apply. However, a fundamental issue is whether the charge to tax should exactly mimic the way that IHT is imposed on UK domiciliaries by looking through an overseas structure to impose a charge to tax on the ultimate owner of the property. Such owners might include overseas trustees or individuals. The difficulty here is that attributing ultimate ownership of UK residential property to a discretionary trust can produce highly unattractive tax consequences.

31. For existing trusts there is undoubtedly a problem; they simply would not have been set up like this if the individuals concerned had known the rules would be changed like this (and particularly without transitional provisions of any kind).

32. To illustrate the point, no non-UK domiciled settlor would have considered funding an offshore trust, which in turn would fund an offshore company that acquires a UK residential property if he or she had realised the consequences would be that:

- the UK residence would be relevant property meaning there would be ten year and exit charges; and,
- the settlor occupying the property would trigger the gift with reservation of benefit rules meaning that as well as relevant property IHT charges, the property would be within the individual's estate on death.

33. The effect of the gift with reservation of benefit rules is to treat the property as being subject to IHT on his or her death. HMRC's practice in such cases is to disallow any debt charged on the property concerned. As a result, the position of the settlor would be materially worse than had they simply purchased the property personally using commercial debt.

34. However, the position is still worse in that a potentially exempt transfer (PET) would be triggered in the event that the reserved interest ceases.

35. In addition all of the usual discretionary trust related charges apply in full, such as exit and ten yearly charges. This makes the comparator framework by which non-domiciliaries will be taxed particularly harsh. A far fairer and more efficient way of dealing with the charge to tax would be to extend the amount charged under the ATED rules. If that route is not followed, we suggest that at the very least that the gift with reservation of benefit rules are excluded from operation in such cases or further thought is given to transitional provisions to allow for de-enveloping (see paragraph 62). The consequences of not doing so will be to cause fiscal policy to act as major disincentive for non-domiciliaries to invest in the UK using family or dynastic trusts.

36. Looking specifically at the bullet points in the consultation document, there needs to be some transitional provisions for the death of a donor making a gift of shares in an overseas close company which owns UK residential property. If he gave the shares away 3 years ago at a time when it was clearly excluded property it would hardly be fair to try and bring such transactions back within the IHT net now.

37. It would also be helpful if it could be clarified what is meant by a "redistribution of the share capital" in bullet point number 2.

Q3: Do you agree that the definition of a dwelling introduced for the purposes of non-resident CGT would provide the most suitable basis for the extended IHT charge?

38. We consider that the definitions would be appropriate. In particular it will be important to:

- introduce a whole range of exemptions and exceptions along the lines set out in Schedule C1 TCGA 1992 in relation to non-resident capital gains tax to ensure that bona fide investors in UK residential property are not deterred from continuing to do so in the light of the proposed new rules; and,
- ensure the definition does not extend to stock held by property developers, or extend to other forms of trading activity.

Q4: Do you agree that this is the most suitable approach for dealing with situations where the use of a property is mixed or has changed over time?

39. A general apportionment rule, on a just and equitable basis, would be required where mixed property is held, such as a flat located above business retail premises.

40. The selection of a two year holding period seems to be largely arbitrary. There is no real merit in making reference to the business property relief holding period, as the residential property relief rules have no linkage or relevance to those rules. If a period of time has to be relied upon, a two year period would seem as reasonable as any.

41. If there is concern about residential properties being reclassified as commercial property around, say, the 10 year charge then we would suggest this is entirely misplaced; the scale of works required to achieve this would be considerable and then they would need to be reversed as well. If this is the rationale behind the proposal we do not think it is required at all; it adds unnecessary complexity, attempts to resolve a very remote risk which in any event could be challenged by HMRC using other tools and is not consistent with the general snapshot operation of the IHT legislation.

42. If the proposals are retained, we consider that refinements will have to be made if the rules are to operate in an even handed manner. For example, it would be unfair if a purchaser acquires property which had been residential within the previous period of two years but currently has a business use. The purchaser would run the risk of suffering an IHT charge where they held shares in the non-resident company concerned and dies within 2 years of having made the acquisition. It would be fairer if the rules provided that the period of ownership was the period of two years or since the date the interest in the property was acquired if shorter. We accept that in order to safeguard the Exchequer, rules would have to be introduced to guard against connected party transactions which were undertaken simply to reduce the holding period, making the charge to tax more difficult to police and administer.

Q5: Are there any potential difficulties in this approach?

43. The valuation issues (this question and question 6 below) highlight the drawbacks of adopting the proposed course of action (i.e. treating shares as not being excluded property), as it will mean that that the taxpayer will need to monitor their structures taking into account dates that are relevant for IHT purposes. This might be in relation to what is a relatively small portion of the overall wealth held in the offshore structure. The value of the shares that indirectly reflect the value of the UK property concerned will need to be valued. HMRC will also need to value the shares if they are to properly police the charge to tax, all of which will incur costs both for the Exchequer and the taxpayer. This will all be particularly difficult if a minority interest in the company is in point.

44. Where the company is not held entirely by the foreign domiciled individual or trust it will be necessary to establish the valuation point by applying the appropriate discount. This is an important decision as the discount for shares and for a residential property are different, so the choice as to which discount is appropriate is fundamental. **In our opinion the discount has to be that for shares, as this is the basis on which a UK domiciliary would be taxed and to enact legislation taxing a non-domiciliary in a different (more penal manner) would be discriminatory**.

45. A practical point that should be considered is a *de minimis* level where small minority shareholders (provided they are genuine minority holdings and not fragmented positions) are excluded from the charge to IHT. Anything under say 10% (taking into account related person holdings) could be ignored. The precedent for this is the way that s13 TCGA 1992 applies in the capital gains tax context when non-resident closely held companies realise gains.

46. As recognised, it will be necessary to introduce rules to prevent fragmenting of interests in property holding companies where shares are held by related entities or parties. This will introduce complexity, which unfortunately increases the risk that innocent arrangements will be caught, especially where such arrangements are of a longstanding nature.

47. It also makes the process of enforcing and policing the rules more onerous and intrusive, as well as making the likely cost of enforcement and administration higher. In cases where the overall shareholding level is low the *de minimis* suggested in paragraph 45 may be helpful.

Q6: Are there any difficulties in this approach to determining the value of property chargeable to IHT?

48. The position as to how the value of property is to be determined by reference to debt used to acquire the property concerned is particularly complex and potentially unsatisfactory (though the position is set out so briefly that it is difficult to be sure what is intended).

49. The IHT legislation is not well adapted to 'looking through' a complex holding structure and allocating tax liabilities, whether in whole or in part, to a taxpayer. It already has a complex series of anti-avoidance provisions that deal with the deductibility of debt and it is not clear that new rules are necessary or how they will interact with the existing rules.

50. Additionally, what does debt "relating" to property mean? No colour is provided by the consultation document – does it mean debt secured on the property, debt used to buy the property, debt used to improve the property etc?

51. Consequently, it is not clear that there will be any relief where the loan has been taken out to acquire the company rather than the loan being in the company to acquire the property.

52. The situation will need to be addressed where a company has incurred indebtedness in order to make investments, some of which are UK residential property and some are not. How will the debt be allocated to the UK property? The consultation document suggests that a pro-rata approach might be required but there is a question mark as regards to whether any relief would apply unless the debt was specifically charged in any event under existing rules.

53. A pro rata approach means investors in UK residential property will have to disclose their entire holding structure and the way they have financed the acquisition of the property concerned. It is possible that investors will simply find this is far too intrusive, and decide investments in residential property can be better made in other jurisdictions. This would not seem to be in the economic interests of the UK.

54. If the connected party debt is not disallowed, the corollary is that any debt which would otherwise be treated as being foreign (because the debtor is non-resident) would have to be characterised as being UK situs in so far as it related to UK property. Were this approach to be adopted, it would mean that inter family loans between non-resident family members or family entities could cause the IHT net to widen, further encompassing lenders who would have no reason to know how the money was invested or that they might encounter an IHT liability as a result. Such an approach, if adopted, is likely to simply encourage lenders to insist the funds lent are not invested in UK residential property. This would have a detrimental effect to the UK economy.

55. Any definition of connected party lending would need to take into account investment partnership arrangements which include a bank or other financial institution which lends to the partnership, as otherwise the entire indebtedness would be disallowed under the connected party rules.

56. Again, we would reiterate that non-domiciliaries should not find they are paying more UK tax than UK domiciliaries as a result of decisions taken long ago when Parliament made it clear it had no objection to non-domiciliaries purchasing UK residential property via a foreign corporate and, as a result, the UK residential property sitting outside the scope of UK IHT.

Q7: Will the proposed anti-avoidance rule be an effective way of countering attempts to avoid the IHT charge?

57. The TAAR is far too wide, as it is engaged where the purpose or one of the purposes of the arrangement is simply to secure a tax advantage. This is far wider than the general anti abuse rule and yet has none of the safeguards provided for in that legislation. Seemingly, it would be engaged where property was acquired using a commercial loan in order to reduce the value of the property subject to tax.

58. We therefore urge this is reconsidered and either pared back substantially or cut in its entirety as it is unlikely to be workable in practice.

59. It is unclear what policy objective is being served through the introduction of the TAAR, and why it was thought necessary to produce something along these lines.

Q8: Do stakeholders agree that these steps will effectively ensure compliance?

60. It is not clear how the new provisions will apply or be policed. The weakness of the system is that the various powers held by HMRC will only be engaged where HMRC are aware that a charge has arisen and have taken steps to enforce the liability. Non-compliance is likely to arise because the ultimate owners of the UK residential property are not aware that a liability to tax has arisen rather than as a result of some deliberate avoidance intent. This will mean that HMRC will have to educate these ultimate owners as to their responsibilities. This is likely to be resource intensive and there will be no guarantee that such an approach will succeed. A far easier approach is simply to increase the ATED element (which has raised far more than HMRC anticipated so we assume there must be significant compliance) to include an IHT related element.

Q9: Are there any hard cases or unintended consequences that will arise as a result of there not being any tax relief for those who want to exit their enveloped structures?

61. The potential for double taxation is significant, and it is considered that it is extremely unfortunate that no relief has been introduced. More than this, the change to IHT is fundamental and taxpayers will have set structures up in good faith that now have penal tax consequences (see paragraph 18 *et seq*). Not allowing transitional provisions so they can get out of the structures could undermine how the UK is seen in terms of a place to do business.

62. We are concerned there has still not been any announcement as to the way the SDLT rules will apply to de-enveloping arrangements despite the continuing requests from the professional bodies for such guidance to be forthcoming. In addition to raising the issue repeatedly at meetings and in the response to the last consultation, it was formally raised again in a submission from CIOT with support from ICAEW and various other professional bodies in addition to the Stamp Taxes Practitioners Group (see Appendix 2 which re-produces the submission).

63. As a related point we are seeing hardship with respect to relatively low value historic structures set up many years ago where UK domiciliaries live in the dwellings. These dwellings were not an issue when ATED was originally introduced but now that the tax applies to residences valued in excess of £500,000 these individuals have significant issues. The CGT is such that without relief exiting the structure is not possible and the annual ATED charge is very difficult to fund as often the individuals are cash poor. As mentioned in earlier paragraphs we are only asking for a deferral of the tax. The entire gain could crystallise on the earlier of the individual's death or when the property is disposed of and the IHT would be due in full when the death occurs.

64. We do not see what has changed between now and the initial de-enveloping announcement such that a relief is now ruled out but was initially mooted as a genuine possibility. It seems to us that false hope was given to individuals (both UK domiciliaries and foreign domiciliaries) who cannot now collapse their structures without onerous CGT liabilities. It would have been better to have just said at the beginning that there would be no de-enveloping relief. This would not have been welcomed but at least affected individuals would not have been waiting for over a year hoping for something that has not materialised.

DEEMED DOMICILE FOR LONG-TERM RESIDENTS - EXCLUDING TRUSTS

Using the SRT for Determining Residency for the Period Prior to the SRT being in Place

65. While we do not object to the stated position, we would just point out that the proposals (and especially the rebasing election) offer both incentives and disincentives to meeting the 15/20 test depending on a taxpayer's particular circumstances. And while the statutory residence test (SRT) gives a relatively clear result as to a taxpayer's residency position, the old residency rules are considerably greyer especially in the initial years of arrival. Our concern is that using the old residency rules could lead to taxpayers attempting to re-visit their residency position for years long passed with a view to either falling in or out of the 15/20 test.

Years Spent During Childhood

66. No comment.

Disregarding Split Years

67. No comment.

Treatment of Assets Sold during a Period of Non-Residence when the Remittance Basis would have applied under the Current Rules

68. We welcome this transitional provision although we do note that it is very narrowly drawn in that the disposal must have occurred before Summer Budget 2015. We would question whether this is necessary.

69. The individuals affected will, by definition, be deemed-domiciled and so able to access the rebasing election (we assume) so disposals from 6 April 2017 are not likely to pose issues as any gains accruing thereafter should be quite low.

70. However, disposals between Summer Budget 2015 and 6 April 2017 seem to be unfairly impacted in that they will be taxed on the arising basis and not subject to rebasing. Had the taxpayer known what we now know, he or she would invariably have deferred the disposal. It therefore seems a strange result to catch transactions falling in a narrow period of time which have occurred largely due to the absence of information about the proposed changes.

71. With this in mind we would ask for the transitional rules to be amended to include disposals up to 5 April 2017; the position is still less favourable than having access to the rebasing election so we do not think this poses any threat to the Exchequer.

Treatment of those who left the UK before they Became Deemed-Domiciled for IHT under the 17/20 Year Rule and then returned here

72. We welcome the clarification that a transfer of excluded property will not become a failed PET if the disponer dies within 7 years while deemed-domiciled.

73. Although on a different topic, we would welcome a similar approach in the proposals on UK residential property. The consultation document appears to suggest that a transfer of what was exempt property (i.e. shares in a foreign company owning UK residential property) before 6 April 2017 can become a failed PET if the settlor dies after 6 April 2017 and within 7 years of the transfer. We believe that this is very unjust and we would welcome a sensible transitional provision similar to the above.

The Rebasing Election

Corporates & Trusts

74. We very much welcome the rebasing election as it goes some way to rectifying the unfairness we highlighted in our TAXrep 59/15 (ICAEW response to the Reforms to the Taxation of Non-Domiciles consultation document).

75. However, we believe that, to be effective, the rebasing election should also rebase assets held by corporates and trustees, not just personally held assets.

76. It is not unusual for non-domiciliaries to have a foreign holding company and for there to be a disparate mix of subsidiaries, some trading, some investment holding, some UK resident, some foreign resident, sitting underneath the holding company.

77. The problem is that it will never be possible to sell the holding company (which is the only asset which will be rebased under the current proposals) as no purchaser would wish to acquire all the underlying subsidiaries. As such, a sale of the individual subsidiaries or even the assets of the subsidiaries will be the eventual exit route. If the rebasing election does not rebase company assets as the FA 2008 rebasing election did within trust structures, then for many non-domiciliaries it will not be effective.

78. Rebasing across the board will go a long way to encouraging compliance and make the law simpler; it will remove the arbitrage incentive between personal ownership and ownership by other entities. The lack of a level playing field will undoubtedly lead some advisors to seek to move assets. We therefore believe that, in order to deliver the policy intention, it is necessary to extend the rebasing election as outlined above.

Date of Ownership

79. The consultation document states that “The protection will be limited to those assets which were foreign situs at the date of the Summer Budget 2015”. We understand from the subsequent stakeholder meetings that this also means that the asset must be owned by the taxpayer on that date.

80. If this is correct we would question whether such a restriction is really necessary? Presumably the intention behind this cut-off date is to prevent non-domiciliaries disposing of assets post Summer Budget 2015 and replacing them with foreign situs assets. But the gain in such circumstances would be minimal so the tax effect would not be significant. Disposals to spouses and holdover claims would mean the tax at stake is higher but the policy intention is to allow non-domiciliaries to rebase assets so we are not sure why this should be seen as an issue.

81. If a cut-off date is felt necessary we would mention that the rebasing election was not announced until Budget 2016 so if a date is to be chosen perhaps it should be midnight on Budget Day 2016.

82. And finally, a cut-off date could lead to some extremely inequitable results where gains have been rolled-over or share for share swaps have occurred. As these are statutory reliefs, we would expect that the new assets acquired will be treated for the purposes of the rebasing election as having been acquired when the old asset was acquired.

Offshore Income Gains

83. As discussed in the stakeholder meetings, we believe that the rebasing election should also apply to offshore income gains. These are in reality capital disposals that happen to be charged to income tax rather than CGT. As such, we believe they should be within the scope of the rebasing election.

Partnerships

84. We also believe that the rebasing election should apply to partnership (and LLP) assets as these are treated as transparent for CGT purposes.

Deemed-Domiciled on 6 April 2017

85. As has been discussed in the various stakeholder meetings since this current consultation document was published, we believe that only allowing taxpayers who are deemed-domiciled on 6 April 2017 to access the rebasing election is very unfair.

86. As we understand it, the policy rationale behind the restriction is that it is felt unfair for non-domiciliaries who have been UK resident for extended periods (say 30 years) to suddenly become taxable on gains accruing in that period under the new regime. On the other hand, it is deemed to be permissible or at least less of an issue for those non-domiciliaries who have been here for shorter periods (less than 15 years).

87. We would just point out that, while this is sensible in and of itself, it misses the point. Non-domiciliaries who have been here for 13 years may very well have owned a foreign company for 30 years (meaning a significant period of ownership will have been outside the UK). When they become deemed domiciled in 2018/19, they too will be exposed on UK CGT on gains which have accrued over the last 30 years; in contrast to many other jurisdictions there is no uplift in base cost for CGT when an individual comes to the UK.

88. We would therefore hope that the rebasing election would be made available for anyone becoming deemed-domiciled within, say, 5 tax years of 6 April 2017 i.e. between 2017/18 and 2022/23. We believe this would go some way to smoothing the cliff edge of the current proposal.

The requirement to pay the Remittance Basis Charge (RBC) to qualify for rebasing

89. As has been discussed in the various stakeholder meetings held since this current consultation document was published, we do not believe that it is right that paying the RBC should be a condition for accessing rebasing when the individual would not have been able to pay the RBC by virtue of meeting the automatic remittance basis user criteria.

90. A minor cannot pay the RBC but since all years as a minor are counted for deemed domiciled purposes a minor can be deemed domiciled as at 6 April 2017. In such circumstances it is not fair that rebasing relief is not available.

Offshore Funds of Foreign Income and Gains -“Cleansing”

91. We very much welcome this proposal. Trapped capital has long been an issue with the remittance basis rules, particularly as they were recast in FA 2008 and it has undoubtedly meant that inward investment into the UK by non-domiciliaries has been considerably lower than it might otherwise have been, depressing both VAT receipts and UK plc more generally.

92. In the stakeholder discussions that have taken place since the consultation document was published, the idea of a “one-shot” approach to cleansing bank accounts has been raised i.e. once a bank account is cleansed of one category of funds it cannot be cleansed of that category again even though the window may still be open.

93. During the meeting the various practical issues that the one shot approach could throw up (particularly where there is first a sale and deferred consideration) were discussed. We cannot see any Exchequer risk in allowing multiple transfers of one category of funds during 2017-18 and see no reason why the rigidity of a “one shot” approach” should be adopted. This is clearly an exceptional relief and the provisions should be as flexible as possible so appropriate use can be made of it and funds freed up for bringing into the UK to bolster the economy.

94. Moving on from our comments in the paragraph above, we very much welcome the proposal, as outlined in the meetings, that mixed funds can be cleansed to whatever degree a taxpayer desires i.e. capital and the rest, or capital and income and gains, or so on. This sensible approach will allow taxpayers the flexibility they require.

95. The one note of caution we would sound is around the evidence required to support a cleansing of a mixed fund. We would welcome a pragmatic approach akin to that taken during the Liechtenstein Disclosure Facility.

96. We would also welcome confirmation that other relevant persons (such as corporates and trusts) can also cleanse funds in a similar manner to that described above. We think this is important, as it will allow these relevant persons to segregate out clean capital so that they may bring capital into the UK (which might not necessarily qualify for business investment relief) without fear of triggering a remittance for the taxpayer.

97. As a final comment we would make the point that in a number of situations matters such as establishing the breakdown of a mixed fund, organising asset sales (particularly when you want to ensure a good price is obtained so you have to wait for the right auction), receiving the proceeds from a sale (which could be deferred or paid in tranches) all takes time. Even with the notice we have now a one year window is a very short period of time. **We would therefore ask that the window is extended to two years**.

The £2,000 De-Minimis Rule

98. We appreciate that the administrative burden for both taxpayers and HMRC made retaining this *de-minimis* rule worthwhile.

Foreign Capital Losses

99. No further comments.

Implications for IHT

100. We welcome this change. Our only comment is that presently, individuals lose their deemed domicile on day 1 of year 4 of not being UK resident not the end of year 4. We would therefore welcome an additional change to restore the status quo.

101. We also query whether it is the policy intention that an individual who leaves the UK towards the end of their 15th year of residence should acquire a deemed domicile in the following year when not resident. This is how the draft clauses appear to work and this seems strange to us.

Spousal Election

102. We are pleased that no changes are being made to the time frame.

DEEMED DOMICILE FOR LONG-TERM RESIDENTS – PROTECTED TRUSTS

103. As you will be aware from the stakeholder meetings we are pleased that there has been a move away from the provisions in the September 2015 consultation document, which could have resulted in tax charges with respect to structures where there were no income or gains. However, we believe that the neither the CGT nor Transfer of Assets Abroad proposals in the current consultation document deliver the policy pledge made by the former Chancellor.

104. Given the significant concerns over the CGT proposals the issue has been discussed at all the consultation meetings apart from the meeting specifically on extending IHT to enveloped properties. Various proposals have been made to HMT and HMRC. Prior to the 20 September meeting we drafted and shared with members from a number of the other professional bodies, four case studies (two with respect to CGT and two with respect to Income Tax). The case studies were amended for their comments and sent round to all the attendees at the meeting. These are now at Appendix 4.

105. Drawing partly on these case studies, a separate paper (the Paper) was produced for the 20 September meeting (this is reproduced in Appendix 3). We understand that the Paper is being given very careful consideration by HMRC. We support most of the Paper but we cannot support it all (there is one particular important paragraph we are concerned with), so we have produced a commentary (at the start of Appendix 3). **The commentary (which we have shared with the other professional bodies and changed to reflect their comments) taken together with the Paper reflects our view on the protection framework (taking into account the various discussions at the consultation meetings).**

106. To summarise our proposals for the alternative framework are set down in the following paragraphs.

107. For Income Tax (foreign income):

- one aligned regime for non-domiciliaries switching off ITTOIA s624 and s720 (unless additions to the trust fund are made);
- new ITTOIA s628A and ITA 2007 s731 apply charging provisions where benefits paid (separate rules for trust level and company level income with the motive defence for company level income);
- trustees can remit income arising within the trust; and,

- the settlor is subject to tax on worldwide aggregate capital payments made not just to him or her but also to partners, minor children (and, if HMRC consider that it is necessary, minor grandchildren).

108. Regime applying for CGT when the settlor is deemed domiciled:

- TCGA 1992, s86 switched off in all cases unless prohibited additions are made (see comments below about what should not be taken as an addition and protections);
- TCGA 1992, s87 continues to apply;
- the settlor is subject to tax on worldwide aggregate capital payments made not just to him or her but also to partners, minor children (and if HMRC consider that it is necessary minor grandchildren); and,
- whilst the settlor remains deemed domiciled capital payments made to a non-resident are disregarded so the s87 pool is not reduced.

109. No inconsistency between CGT and income tax proposals - we appreciate that the income tax proposals (para 106) will change the way that all foreign domiciled settlors are taxed. To our minds, this is acceptable in a way that having one system for foreign domiciled settlors would not be for CGT. The existing income tax legislation is already different and there are also positives for the taxpayer arising as a result of the new income tax proposals to balance the negatives (as mentioned above the ability of the trust to invest income in the UK). However, if HMRC feels that adopting the income tax proposition but not the CGT proposals is unacceptable then we believe that the proposals sent round in the case studies that we prepared (see Appendix 4: Case Studies 3 and 4) can be used as an alternative for the income tax framework.

110. Points of detail:

- Generally consideration with respect to transitional and straddling rules will be required (change of domicile, residence, temporary non-residence etc).
- Additions: We feel that the “addition” definition has to be widened.
    - We appreciate that legislating SP5/1992 may not be possible. We would, however, welcome HMRC guidance confirming or reiterating that the relevant parts in SP5/1992 relating to additions apply for the proposed tainting rules. The tainting rules posed practical issues back in the 1990’s and the more clarity around what is considered tainting the better.
    - We also think that it is important that the definition of “expenses”, that is additions that would not taint the trust, is extended to cover all trust income and capital expenses (as long as the payment of these expenses does not increase the value of any of the assets comprised in the trust fund). In addition any funds paid directly to underlying trust entities (such as companies) to cover such expenses should be within the “expenses” definition.
    - In addition to this we would like **both** a *de minimis* amount (say 1% of market value of the trust property) where any addition below such an amount is ignored and a grace period (running from the date the inadvertent tainting is uncovered - be it by the taxpayer/trustee or by HMRC during the course of an enquiry/discovery etc to remove additions above the *de minimis*).
    - If it is felt that only one such relief should be provided then we would prefer the grace period.
    - **Any addition to a trust by a different settlor should not result in protection being forfeited, since there is a different settlor subject to his or her own set of tax provisions.**
    - We do not believe there should be an issue where the transaction simply involves the transfer of funds from the protected trust to a new trust; we cannot identify what the targeted mischief is. In such cases we think both trusts should have protected status.
- Close family members: We understand the reason for including partners and minor children. We would though prefer the definition did not cover minor grandchildren as

this adds a level of practical complexity and unwitting complications that could result in unwitting non-compliance and difficulty.

- The issue of valuations for tax purposes is much wider than the rules currently under review and we would suggest that this is an area which, if it is going to be reviewed, should be reviewed as a standalone topic at a later date. Given how close we are to “L-day”, attempting to reconfigure how benefits are valued in such a tight timeframe would be incredibly difficult.

111. If our proposals (which from our discussions we understand are broadly agreed by the other professional bodies) are not acceptable we would prefer the proposals in the Paper sent round prior to the 20 September meeting to those in the August 2016 Consultation Document. We do not consider that the proposals in the September 2015 Consultation should be implemented under any circumstances, as we do not believe there should be a dry tax charge.

OFFSHORE LIFE BONDS

112. Offshore life bonds are clearly foreign assets and income received is clearly foreign income as a result of this. However, the legislation has specific provisions such that individuals cannot benefit from the remittance basis on the receipt of such income regardless of whether the holding is direct or through a trust they have settled and retain an interest in (ITTOIA 2005, s 624). We consider that since foreign income arises in such cases the protections should apply. If the government does not want protection to apply to the income then we believe a specific provision is required to make the point that it is excluded from protected status albeit that it is foreign income.

DOUBLE TAXATION

113. The effect of the proposed reforms has been to bring a number of issues to the fore that were previously masked by the practical way that the remittance basis applied. These practical issues are likely to have a profound impact on the way that the rules will apply and be perceived by individuals who become deemed domiciled on 6 April 2017.

114. We understand the policy issues that have caused the government to consider changing the treatment of long term resident non–UK domiciliaries. Equally we think that any new framework that is introduced should take into account that non-UK domiciliaries will necessarily have an international context, so that where changes are made to normalise the basis upon which they suffer UK taxation by comparison to UK resident domiciliaries they do not suffer excessive overall rates of taxation as a result.

115. This topic of double taxation is addressed in an indirect manner in the case studies (see Appendix 4) but we feel it does merit a separate discussion here. **We consider there are issues which need to be addressed and we would stress again that while these may seem like minor points to be tidied up later, they are in fact very important to how non-domiciliaries will respond to these changes in practice and have the potential to generate considerable ill-will**. **We therefore believe that these do need urgent attention**.

116. Trust income or gains could very well suffer four levels of tax on the same income/gains:
1) Local taxes in the trust jurisdiction (not all trusts are located in tax havens);
2) Taxes on the settlor under a system similar to the US system;
3) Taxes on the close family member of the settlor receiving a capital payment; and,
4) Taxes on the settlor in the UK on the payments made in step 3.

117. The above leads to the following three issues:
1) Reimbursement from the trust fund to the settlor to pay foreign taxes arising on trust income and gains;
2) Double tax relief where a close family member receives a payment which is taxed in their jurisdiction of residence and then also taxed on the UK resident settlor; and,
3) Credit for local taxes suffered by the trustees.

118. In respect of the first issue, the problem arises when the income and gains of the trustees or their underlying non-UK resident companies are taxed on a UK resident and non-UK domiciled settlor under the laws of another jurisdiction.

119. In such cases, it would not be unusual in the past for the tax to be reimbursed to the settlor from the trust to cover that foreign tax liability. As the settlor would have been taxed on the remittance basis, this did not pose any issues. However, under the current proposals, the reimbursement would be subject to UK tax which can be seen as a tax on the payment of foreign tax.

120. Therefore, in addition to having credits for withholding taxes and tax paid by the trustees/underlying companies (see below), we would propose a change to the definition of a benefit for the purposes of s731 ITA 2007 (as well as that of a capital payment for s87 TCGA 1992) so it does not extend as far as the payment by the trustees (or one of their non-resident companies) of taxes which are levied on a settlor by a foreign state in relation to the gains or income received by the trustees or their companies. This would remove the prospect of unfairly doubling up the effective rate of tax. This does not mean that the Exchequer would be losing revenue to which it is justly entitled; rather we would argue that it is not justifiable to levy a charge to tax in such instances.

121. In respect of the second issue, in some instances income or gains are taxed on a beneficiary under the laws that relate to the foreign residence of that individual, whilst UK taxation might seek to tax the same income or gains on the settlor who is UK resident. Since different individuals are subject to tax for different reasons there is no current double taxation relief but there is definite double taxation. Suffering double taxation (with no remedy) on what is economically the same amount is likely to generate considerable ill-will towards the new regime.

122. Generally speaking the best and easiest solutions to these "deeming" issues is actually to "follow the money". Therefore, as a potential solution, we think that the same principle should apply in that, if the income or gain has already been taxed on another individual under the law of another state, the same income or gains should not be brought back into charge on a UK resident. We accept that the government might want to impose a hurdle such that the income or gain would have had to have suffered tax at or above a certain % for it to be ignored. Where tax has been suffered but the hurdle is not reached we think that the settlor should get a credit for the foreign tax paid by the beneficiary.

123. If the solution in the paragraph above is not palatable then an alternative is for the settlor to get a full credit for the foreign tax paid by the recipient.

124. Finally, as regards the third issue, the UK operates a "tax pool" for UK resident trusts. Perhaps a similar system can be operated for foreign taxes in that the income and gains are grossed up and matched and a tax credit for the foreign tax also attaches when the matching occurs. This would help to ensure that the same income and gains is not suffering multiple levels of taxation.

BORN IN THE UK WITH A UK DOMICILE OF ORIGIN

125. As set down in our previous TAXrep 59/15 we do not believe that an individual's place of birth and domicile of origin should impact on their tax situation in this penal way. Both place of birth and domicile of origin are facts that an individual has no control over. Penalising someone who has established a domicile of choice elsewhere and may not have set foot in the UK for 40 years just because he or she happened to be born in the UK with a UK domicile of origin makes no sense (and certainly will not send out the signal that the UK is open to business).

126. While we have been told that the government will not re-think its plans on this, one sensible modification, which we do not think undermines the government's aim, would be to only apply this new rule in cases where the individual was born in the UK and at birth has a domicile of origin in the UK which is not displaced in their minority by a domicile of dependency outside the UK.

127. This would remove children who are taken overseas and whose parents change domicile whilst the children are minors from the impact of the proposals which seems fairer as they have no control before that age.

IHT Grace Period

128. As it stands, the grace period could be very short if a taxpayer were to return to the UK at the end of a tax year, inadvertently become tax resident and die on 6 April following.

129. In this case, he would be tax resident in the UK in 1 of the preceding 2 tax years and the estate would be charged to UK IHT in full. This would also be an issue if the death caused a trust IHT issue (either as a result of the trust having been a qualifying interest in possession or the death triggering capital distributions and, therefore, IHT exit charges).

130. As such, purely for IHT purposes we would favour a longer grace period. However, as set down in our previous TAXrep 59/15, our ideal would be a general grace period of three tax years across the taxes to also allow a normal secondment for employment purposes.

Impact of IHT reforms on Non-Resident Trusts

131. No further comments.

BUSINESS INVESTMENT RELIEF (BIR)

Key points summary

132. When it was announced BIR was warmly welcomed and it was thought that it would be good for UK plc. Unfortunately, in its current form it is too complex and the anti-avoidance provisions are disproportionately severe. This means that advisers rarely feel that it is appropriate to recommend it to clients. This is particularly so in the case of high net wealth clients who, whilst they have the most to invest, also have the most complex affairs, often with offshore family. There is also the risk of losing relief where various family members having established offshore companies where benefits will be taken so the UK clients through no fault of their own are inadvertently caught by the disproportionate anti-avoidance provisions and lose all relief.

133. As such, the most crucial change is to amend the anti-avoidance legislation so it does not undermine the relief in the way it is doing at present. The issues are technical and are discussed in paragraphs 158-159 below.

134. Once this critical change has occurred it will be time to consider broadening out and incentivising investment in the UK. The paragraphs below go through this in some detail. Focusing on the key issues we would like to see BIR broadened so that:

- it applies to investments in partnerships;
- it applies to hybrid companies;
- it is not necessary to take the appropriate mitigation steps when a company becomes listed (the shares should be able to be retained);
- BIR extends generally to listed shares and securities; and,
- it is possible to buy shares from third parties.

In terms of the key incentives we should like to see the following

- the two year ownership period for IHT business property relief waived for qualifying BIR investments; and,
- after five years the tainted funds used for the investment are “cleansed” so that upon disposal of the investment they can remain in the UK as clean capital.

RESPONSES TO SPECIFIC QUESTIONS

Q10: In what ways might the current scheme be changed to encourage greater investment in the UK?

135. A number of changes to the scheme are required to encourage the take up that the Chancellor would like to see. The current legislation is over complicated, has unnecessary anti-avoidance provisions and is unduly narrow. This question considers the narrowness of the scheme and what might be done to improve this.

136. There is no current formal clearance system but HMRC will give a view under the CAP 1 procedure. Individuals, particularly high net worth individuals, like certainty. A formal clearance procedure would give greater comfort without meaning that HMRC had to commit additional resource now as it gives clearances under CAP 1 anyway.

Widening the scope

137. The definition of business could be widened to include investment/loan businesses and it could be made clear when certificates are issued for EIS and SEIS that the shares will also qualify for BIR.

138. The decision to not allow investment into partnerships should be re-considered (the production of accounts could be a condition). Generally concerns over remittances mean that some offshore investment funds (set up as a series of partnership structures) simply do not invest in the UK. Bringing them and other partnership businesses within the relief would, we believe, result in greater inward investment to the UK.

139. The three categories of company that can be invested in (an eligible trading company, stakeholder company or holding company) do not work in the real world context where you will often have companies that are a mixture of at least two if not all three. There appears to be no good reason why hybrid companies should not qualify; it is just a fault of the current legislation that it is drafted too narrowly.

140. Rather than just allowing for relief where new money is put in there should be relief for acquiring shares or taking over an existing loan. This is because the individual may be buying out a disruptive shareholder or he/she may not be willing to put further funds in without having acquired a certain stake in the company already.

141. Providing relief for investment in listed shares and government stock could prove attractive to both individuals and trustees (who may have the settlor's remittance basis income or gains as a result of the initial settlement or income as a result of the settlement's code).

142. Removing the current rules that mean investment is lost and corrective action has to be taken if a company becomes listed would be welcome. This should not be an issue and just adds unnecessary complexity to the rules (see question 12).

Incentives to invest

143. We appreciate that the government is most interested in the wealthiest taxpayers with the most funds to invest. These individuals have a choice of where in the world to go, which means that for them to invest in the UK there must be appropriate incentives as well as the promise of the required investment performance. The following three incentives are suggested.

144. The two year time period for business property relief (BPR) could be waived so that where the shares are UK situs they are sheltered from the UK IHT tax net by BPR from the beginning.

145. In addition if the investment is retained for five years treating the original tainted funds as clean capital that can remain in the UK would provide a very significant incentive. We consider five years is an appropriate period of time; it is long enough to show there has been a significant investment with genuine commercial exposure but not so long as to put the investor off (the incentive must be pitched at the right level or it will not have any impact).

146. Finally, removing a BIR company from the relevant person category in relation to the investor would prevent any remittance issues if the company ever had any funds offshore of the investor's that did not come within the relief (which could be the case if the company was offshore and the transferor of assets abroad provisions applied)

Removing disincentives

147. Where BIR funds have been put in for shares or a loan and non-BIR funds for something else the current rules which assume the BIR funds come out first act as a disincentive even when it can be shown that this is not the fact (the funds having gone into different accounts and being traceable). This is, therefore, something we think should be amended.

148. Clients are very concerned about investing because, like EIS and SEIS, the company can take action that will result in their relief being lost. They either do not want to or cannot remain close enough to monitor the company to establish when there is an issue. Significantly extending all the grace periods would be very helpful in this respect.

Q11: Are you able to provide any evidence which might indicate that these changes will lead to a significant increase in UK investment?

149. It is difficult to provide accurate evidence. We know that with the current system many of our members do not feel happy advising their clients to use BIR as there are too many risks and investments can be made elsewhere. Where the issues are discussed with clients the complexities are often such that even the most experienced decide it is not worthwhile. If the complexity and risk can be cut away and the relief is opened up with the incentives described above then things could change considerably.

150. It is easier to point to evidence with respect to hybrid companies that would not currently qualify for relief. A relatively quick examination of the Companies House Group accounts will probably find a number of companies that have both subsidiaries and minority interests and would not, qualify.

Q12: What aspects of the scheme might usefully be simplified while maintaining its policy objective and encourage greater take up?

151. We do not see why the relief should only be available if the actual investment by the individual results in a remittance, as opposed to the individual paying funds into the company's offshore account and the company (a relevant person) bringing the funds to the UK. This is a trap, which we understand HMRC is as well aware of as we are and we do not think that it was ever intended that this should be an issue.

152. As mentioned above, currently relief is lost if corrective action is not taken by the set deadline in a case where the company becomes listed. This is another trap for the taxpayer and listing should not result in the relief being lost and the need for corrective action.

153. There are a number of inconsistencies/anomalies; for example, it is not clear why preparing to carry on research and development activities should not be treated as carrying on a commercial trade, but that is what the legislation says.

154. The requirement to start trading within two years of the funds being injected could also be a problem for the bigger investments (which as discussed above the government is most concerned about). In the larger cases where there is significant capital infrastructure required it may take longer to be ready to trade.

155. More time should be given to allow a company that has become operational to find something else to do.

156. We understand that HMRC has said that it will look through nominees (such as fund managers/custodians). The legislation (ITA 2007, s809VA(3)(a)) refers to use of “money or other property” by a relevant person, so adjusting the legislation to make the point clear would be helpful.

157. As discussed below the anti-avoidance legislation is far too complex and undermines the relief. This needs to be changed or take up will continue to disappoint.

Q13: What changes would you make to ensure the anti-avoidance provisions are properly targeted to prevent tax avoidance?

158. As mentioned above, the current anti-avoidance provisions are undermining the take up of the relief. The specific issue being the extraction of value rule. We accept that it is a key concept to prevent the relief being abused but it goes too far (as discussed during the consultation meeting on this).

159. There are various issues:

- the risk that relief might be lost by reference to a disproportionality small benefit (say £10) leading to the loss of all relief (say £10 million);
- the fact that the extraction of value rule can be breached not just by a benefit going to the investor but to any relevant person in connection with him or her; and,
- that the company from which the value is extracted is not just the company invested in but any company that falls within the “involved company” definition (any company connected with the target). This, when taken together with the lack of any proportionality, is perhaps the biggest concern as connected has its normal wide meaning so takes in not just subsidiaries of the target but companies that would be entirely independent apart from the investor and individuals connected to him (so family companies will be caught).

160. For BIR to be attractive to high net wealth individuals the legislation has to be amended, so that their family structures do not pose a high risk to their claims for BIR relief. As discussed at the consultation meeting we would recommend introducing proportionality, removing the involved company rule and looking to condition B at ITA 2007 s 809VF both at and after the investment (that is, there would be an issue after the event if condition B was to be breached but if it is a small benefit then the relief lost will be proportional).

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 via http://www.icaew.com/en/about-icaew/what-we-do/technical-releases/tax).

APPENDIX 2

REMOVING BARRIERS TO DE-ENVELOPING RESIDENTIAL PROPERTY

THIS IS THE SUBMISSION CIOT MADE WITH OUR SUPPORT TO HMRC/HMT ON 21 JUNE 2016

Chartered Institute of Taxation

Excellence in Taxation

REMOVING BARRIERS TO DE-ENVELOPING RESIDENTIAL PROPERTY

1 INTRODUCTION

1.1 This submission is made with the support of the ICAEW, the Stamp Taxes Practitioners Group, STEP and the Law Society. It concerns the barriers to de-enveloping high value residential property in the light of the proposals outlined at the 2015 Summer Budget for new Inheritance Tax rules on UK residential property held indirectly by non-UK domiciliaries.

1.2 HMRC's Technical Note of 8 July 2015 indicates that the proposed changes to the IHT rules will change the IHT treatment, so some non-doms and trusts may wish to remove the envelope and move into a simpler more straightforward structure outside the scope of future ATED charges, ATED reporting or ATED-related CGT. If the property is mortgaged or has increased in value since 2013 there may however, be significant costs in de-enveloping. Taxpayers who have begun the process of dismantling structures are hindered by the uncertainties around a possible SDLT charge where debt is secured on the property. Others are waiting to see if a statutory relief will be forthcoming.

1.3 This submission points to the advantages of facilitating the transfer of high value residential property from indirectly held offshore structures to direct ownership of both the legal and beneficial interest in the property either by a form of statutory relief or the alleviation of the SDLT uncertainty through a limited clearance facility. It is understood that the forthcoming IHT consultation will consider stakeholders' concerns in this area. The purpose of this submission is to point to the advantages of mitigating the difficulties around de-enveloping in the light of the IHT proposals.

2 De-enveloping

2.1 On 8 July 2015 HMRC published a note providing further detail of the proposals outlined at the 2015 Summer Budget to bring all indirectly held UK residential property into the charge to IHT from April 2017. Paragraph 7 of the note, dealing with the de-enveloping of a property is reproduced below.

2.2 **Paragraph 7 : Enveloped properties – de-enveloping**

Properties held in companies or other envelopes can be 'sold' by transferring the shares of that company. Such a transaction is not subject to any Stamp Duty Land Tax (SDLT). ATED was introduced in Finance Act 2013 to ensure that people enveloping residential property in corporate vehicles pay a price for that privilege by a higher SDLT rate on entry into the corporate structure and ATED. ATED is targeted only at residential property held through a company where it is occupied rather than let out to an unconnected person. Properties let to unconnected parties qualify for relief and are therefore exempt from the ATED charge.

HMRC's research suggests that the most common reason for enveloping properties is IHT planning undertaken by non-doms. Under the present IHT regime many non-doms would not consider de-enveloping primarily because the cost of ATED does not outweigh the current benefits of the envelope and in the case of let property ATED does not apply anyway.

The proposed changes to the IHT rules will change the IHT treatment, so some non-doms and trusts may wish to remove the envelope and move into a simpler more straightforward structure outside the scope of future ATED charges, ATED reporting or ATED-related CGT. If the property is mortgaged or has increased in value since 2013 there may however, be significant costs in de-enveloping.

The government will consider the costs associated with de-enveloping and any other concerns stakeholders may have during the course of the consultation regarding de-enveloping.

2.3 This acknowledgement of the potentially significant tax costs involved in dismantling a structure to transfer property into direct ownership is welcome. It is important that the tax costs are not underestimated; in particular for most structures the CGT cost is not restricted to the increase in value since April 2013 (text of email to Philippa Staples – Appendix 1).

2.4 We consider two ways in which such costs could be mitigated:

1) The preferred solution is a statutory relief from the CGT and, where the property is mortgaged, from SDLT (potentially with a sunset clause); or

2) A clearance facility for SDLT, again time limited, and dealing with the particular uncertainties that arise in relation to the potential application of FA 2003 sections 75A-C and Schedule 4, para 8(1A) where there has been third party debt secured on the property.

2.5 The second option offers a pragmatic short-term solution to the significant uncertainty that arises in de-enveloping in the absence of a statutory relief. Although there is an obvious resourcing cost in offering this facility (albeit one that can be limited by the period and terms on which it is offered) there are substantial benefits in doing so that we outline below.

3 Advantages of removing the costs of de-enveloping as above

3.1 The main advantages are :

1) Facilitating enforcement and collection of taxes particularly IHT

2) Furthering government policy to the extent that it is a policy objective to encourage direct ownership thereby removing the potential for perceived SDLT avoidance in the sale of shares in existing structures. Although HMRC commissioned research indicates a reduction in the number of high value residential properties being transferred into corporate or other entities, the de-enveloping of existing structures is hampered by the costs and uncertainties of doing so. It appears that a core policy aim may be in danger of being compromised by the existing barriers to de-enveloping.

3) Removal of uncertainty in relation to the application of FA 2003 section 75A – C and Schedule 4 para 8(1A) where a property is transferred into direct ownership and debt has been secured on the property. The uncertainty acts as a significant barrier to de-enveloping.

4 Facilitating enforcement and collection of taxes particularly IHT.

4.1 Direct ownership offers clear benefits to HMRC in the collection and enforcement of IHT in that :

1. If a person owns a property in his or her own name, and dies, the deceased’s executors cannot transfer the property without probate and the payment of any IHT liability.

2. If a person owns the property through an offshore structure, it may be very difficult for HMRC to gain knowledge of transfers in the shares or other interests from generation to generation and so experience difficulty in investigating a potential IHT liability.

Therefore, there is a significant benefit to HMRC in encouraging de-enveloping to ensure that properties are owned personally.

4.2 Government proposals to require foreign companies acquiring or owning UK property to disclose their beneficial ownership will assist HMRC in identifying IHT chargeable transactions, however there remains the question of enforcement. If Mr X owns Company Y which owns property Z in the UK, then even if Mr X’s name appears on a register of beneficial ownership, it will be difficult, perhaps impossible for HMRC to know if Mr X dies.

If Mr X had owned the property directly, then his executors could not have sold the property without first getting probate and they could not obtain probate without paying the IHT. But Company Y will still have directors, so probate will not be needed for Company Y to sell the property. Company Y will then have cash so the beneficial ownership registration will disappear. If, subsequently, Mr X’s heirs inherit that cash, HMRC will have to be proactive in checking that information back against other countries’ records rather than simply relying on the need for probate to self-police the system for them.

Therefore, we believe it would assist government policy in enforcing IHT liabilities on the death of shareholders in residential property owning companies to promote de-enveloping of such company structures.

5 Furthering and facilitating government policy

5.1 The 2012 Budget announced three measures to 'tackle the 'enveloping' of high value properties into companies:

- With effect from 21 March 2012 a 15 per cent rate of SDLT to be applied to residential properties (initially) over £2 million purchased by non-natural persons such as companies.
- the introduction of an annual charge from April 2013 on residential properties valued at (initially) over £2 million[1] owned by these persons; and
- the extension of the capital gains tax regime to gains on the disposal of UK residential property in such property by non-resident, non-natural persons from April 2013.

5.2 The 15% rate was introduced by Finance Act 2012, section 214 and schedule 35. (The £2 million threshold that applied initially was reduced to £500,000 for transactions effected on or after 20 March 2014, subject to transitional rules.)

The Explanatory Notes[2] for section 214 state the policy objective in the following terms:

59. The measure forms part of a package designed to ensure that individuals and companies pay a fair share of tax on residential property transactions and to reduce avoidance.
60. This measure aims to dis-incentivise the ownership of high value residential property in structures that would permit the indirect ownership or enjoyment of the property to be transferred in a way that would not be chargeable to SDLT.
The intention is to stop or reduce the number of properties that will enter such complex ownership structures. ***Taken together with the introduction of an annual charge in 2013 on such property owned by the same sorts of non-natural persons, this will result in a reduction in the number of high value properties owned in such structures.*** (Our emphasis)

5.3 The 'Ensuring the fair taxation of residential property transactions' consultation on the introduction of the annual charge published in May 2012 had the following background policy statement:

'The Government is concerned at the prevalence of enveloping of high value residential properties and the potential for SDLT avoidance on subsequent changes of ownership of the properties. ***The annual charge is a new tax being introduced to encourage those who own UK residential properties valued over £2 million in envelopes to take them out of those envelopes****. This will ensure that any future transfers of the property will be subject to SDLT, and that a fair share of tax is paid on these properties.'*

Similarly at paragraph 2.59 of the same consultation:

[1] When introduced ATED applied to dwellings with its scope valued at over £2 million. From 1 April 2015, this threshold was reduced to £1 million and from 1 April 2016, the threshold is set at £500,000.
[2] http://www.legislation.gov.uk/ukpga/2012/14/section/214/enacted?view=interweave

'*2.59 The aim of the annual charge is to ensure the owners of high value residential property do not avoid paying their fair share of tax* ***by encouraging the de-enveloping of property*** *and imposing a significant charge on those individuals who chose to keep their property within an envelope'*.

(All parts in bold are our emphasis)

5.4 On the afternoon of Thursday 13 June 2013 the Exchequer Secretary to the Treasury, Mr David Gauke opened the Public Bill Committee debate on Part 3 of the Finance Bill 2013 introducing the new annual charge on enveloped dwellings with an overview of the background to its introduction including this statement:

'*Her Majesty's Revenue and Customs estimates that the stock of enveloped residential properties valued at more than £2 million in 2011-12 was more than 5,000. About 300 further properties were enveloped during 2011. Research published in April 2012 by the estate agent Savills, to which the hon. Member for Newcastle upon Tyne North referred, indicates that some 12% of sales of £2 million-plus residential properties are effected at share level or involve a company as vendor or purchaser. That is a high-profile form of tax avoidance that creates a cost to the Exchequer and needs to be addressed to maintain the long-term credibility of stamp duty land tax. I remind the Committee that that is the purpose behind the provisions before us.*'[3]

He continued at Column 500 :

'*I was asked whether there were ways in which ATED could be avoided, for example, by de-enveloping or by using a trust structure instead.* ***It is worth reiterating that if a property is taken out of an envelope, ATED has achieved its purpose; that is what we seek to address.'***(Our emphasis)

5.5 Research carried out by IFF Research for HMRC was published in September 2015: 'Views and behaviours in relation to the Annual Tax on Enveloped Dwellings'. The results are summarised on GOV.UK in the following terms:

The qualitative research findings suggest that ATED has been successful in discouraging the initial enveloping of properties, with agents stating they would not advise enveloping to their clients in the future. However, it seems that where an envelope already exists few are de-enveloping their property as the ATED rate does not warrant losing the benefits of the envelope, such as Inheritance Tax (IHT) and privacy protection.

5.6 It is clear that since 2012 the government's policy has been to discourage the enveloping of residential property held for private occupation in an offshore corporate structure. It appears to follow from policy statements that a reduction in the number of existing 'envelopes' should be encouraged and any barriers to dismantling such structures evaluated in that light.

5.7 If, however, the government's policy has changed, perhaps in response to the higher than expected yield from ATED, it would be helpful to publish any such change.

6 Removal of uncertainty that acts as a barrier to de-enveloping

6.1 On 23 December 2013, HMRC published guidance on the SDLT implications of de-

[3] http://www.publications.parliament.uk/pa/cm201314/cmpublic/financeno2/130613/pm/130613s01.htm Column 494

enveloping property (SDLTM04042).The guidance acknowledges that property may be transferred out of the company for a number of reasons including to remove the company from the scope of ATED. In summary, HMRC confirms that it will not consider that there is any chargeable consideration on the transfer of the property where:

- A liquidator distributes a property in specie and the property holding company has no debt such that its only liabilities are issued share capital, or

- Where a liquidator distributes a property in specie and the shareholders have provided a shareholder loan secured on the property, but the company has no other liabilities other than issued share capital. HMRC have confirmed that they do not regard the existence of the loan (which will be cancelled) as constituting consideration within Schedule 4 paragraph 8

However, if there is third party debt secured on the property when the company is liquidated, the chargeable consideration will be equal to the debt where there is an assumption of debt by the transferee within paragraph 8(1A), Schedule 4, Finance Act 2003).

The guidance also makes it clear that if any third party debt is repaid before liquidation of the company and the property is transferred, both as a result of shareholder action, section 75A of the Finance Act 2003 may apply so that SDLT is nonetheless chargeable. Whether section 75A applies will depend on the facts of each case.

6.2 The question of whether or not section 75A applies to a given situation engenders a great deal of uncertainty not least because of the lack of a motive test but also in relation to fundamental aspects of interpretation such as whether in fact a single land transaction can generate a section 75A substitution on its terms and the scope of ‘involved in connection with’.

6.3 FA 2003 Schedule 4 paragraph 8(1A) potentially affects any transfer of residential property subject to a secured debt, even though the transferee as a matter of law does not assume a personal liability for the debt secured. The key question is what amounts to a change in 'the rights and liabilities' in relation to that debt. Almost every transfer of property subject to a debt can affect the rights and liabilities of the parties. On a literal interpretation, there could be a deemed assumption of liability and thus a tax charge, despite an express exclusion of the transferee's liability to actually assume the debt.

6.4 It is recognised that, in accordance with longstanding practice, HMRC would not wish to provide a clearance facility where there is an avoidance motive. We note in this context the dicta of Patten LJ in *Project Blue Limited v HMRC* [2016] EWCA Civ 485 at paragraph 39

‘*Although, as the side-note to s.75A makes clear, the provisions were clearly introduced to combat the avoidance of SDLT, they operate according to their terms and nowhere in s.75A is there any reference to the purpose of the scheme transactions being tax avoidance or any requirement to establish the existence of such a purpose or objective as a pre-condition to the operation of the section.*’

What is proposed therefore is a limited SDLT clearance facility in circumstances where, as a matter of statutory interpretation, there is significant uncertainty in practice. Although, as the dicta in *Project Blue* indicates, no avoidance motive is required, the result still needs to be an avoidance of SDLT. In a de-enveloping situation, the result is that the original ultimate economic owners of the property remain the same – there is no substantive change in ownership for consideration in respect of which SDLT would be due in normal circumstances. In that situation, section 75A should be interpreted in the context of its purpose.

6.5 Attached, as Appendix II, are some common situations that occur in practice to provide an indication of the nature and extent of that uncertainty and therefore the likely scope of such clearances.

6.6 We consider that a specific clearance mechanism is required to give certainty in individual cases. However, it would be helpful if HMRC's guidance could be updated in the light of the Court of Appeal's judgment in *Project Blue* setting out HMRC's view on all the common scenarios set out in Appendix II.

7 The Chartered Institute of Taxation

7.1 The Chartered Institute of Taxation (CIOT) is the leading professional body in the United Kingdom concerned solely with taxation. The CIOT is an educational charity, promoting education and study of the administration and practice of taxation. One of our key aims is to work for a better, more efficient, tax system for all affected by it – taxpayers, their advisers and the authorities. The CIOT's work covers all aspects of taxation, including direct and indirect taxes and duties. Through our Low Incomes Tax Reform Group (LITRG), the CIOT has a particular focus on improving the tax system, including tax credits and benefits, for the unrepresented taxpayer.

The CIOT draws on our members' experience in private practice, commerce and industry, government and academia to improve tax administration and propose and explain how tax policy objectives can most effectively be achieved. We also link to, and draw on, similar leading professional tax bodies in other countries. The CIOT's comments and recommendations on tax issues are made in line with our charitable objectives: we are politically neutral in our work.

The CIOT's 17,500 members have the practising title of 'Chartered Tax Adviser' and the designatory letters 'CTA', to represent the leading tax qualification.

The Chartered Institute of Taxation
21 June 2016

APPENDIX I

Text of email to HMRC dated 12 November 2015

Dear Philippa

Thank you very much for your time yesterday – I will come back to you shortly once I have gauged interest at this end in an event to demonstrate the new ATED filing system in early February 2016.

We also touched briefly on the HMRC commissioned research on why properties are held in corporate 'envelopes' posted on GOV.UK at: https://www.gov.uk/government/publications/views-and-behaviours-in-relation-to-the-annual-tax-on-enveloped-dwellings

As discussed, it would be helpful to clarify what is perhaps a misunderstanding as set out at paragraphs 8.5-8.6 of the report. These paras state:

'8.5 Though there are occasional circumstances where the CGT charge goes beyond this, in most circumstances CGT is only payable on any increase in value since April 2013, rather than being charged on any profit made since the property was purchased. It may have been that some of the owners of envelopes interviewed were unaware of this stipulation.

8.6 As owners of envelopes were largely advised by their agents, it was important to consider whether agents themselves were aware of this. Although some agents' comments may have been in reference to the rare occasions when a wider CGT charge is payable, it is possible that some agents may have misunderstood, as several mentioned that de-enveloping would require prohibitively high amounts of CGT to be paid.'

The point of particular concern is that para 8.6 suggests that 1) it is only on rare occasions that a 'wider CGT charge may be payable' and 2) that there was perhaps a misunderstanding by agents about the level of CGT costs of de-enveloping as ATED-related CGT applies only in respect of a chargeable gain accruing from April 2013, and therefore is not expected to be high.

In fact the 'wider CGT charge' referred to is likely to be more usual rather than rare because it is commonplace for high value residential property to be held in a structure involving a non-resident trust. On de-enveloping a property out of such a structure, a potentially substantial CGT charge arises on a resident beneficiary of the trust under TCGA 1992 section 87 based on the gain accruing from 6 April 2008 (assuming that the offshore trustees elected to re-base the trust's assets to market value at 6 April 2008). This CGT charge is in addition to the ATED-related CGT charge at 28% levied on the gain accruing between 5 April 2013 and the date of deemed disposal.

To take a hypothetical example of a common structure, a non-domiciled resident individual is a settlor and beneficiary of an offshore discretionary trust. The trust holds 100% of the shares in a non-resident company which in turn owns a high value residential property in London, the value of which has risen steeply in the past 10 years. The property is used as a private residence by the settlor / beneficiary of the trust. The company is subject to ATED. In deciding to de-envelope the property and transfer it into the individual's direct ownership, one common option could be to liquidate the company transferring the property in specie to the trustees who then appoint the property to the beneficiary. The liquidation of the company will give rise to ATED-related CGT based on the gain accruing from April 2013. The trust will crystallise a gain on the liquidation of the company that is matched to 'capital payments' to the beneficiary being the receipt of the property and the benefit of the beneficiary's rent free occupation of the property thereby creating a substantial additional CGT charge.

Where there has been a significant increase in value, the CGT cost of de-enveloping is therefore likely to be significantly greater than the ATED – related CGT cost. Clearly this is something which needs to be taken into account in any evaluation of the costs of de-enveloping and a possible relief or grace period to promote de-enveloping in accordance with the government's policy intent.

(In passing we were surprised to see the comment that “agents did not provide a full definition of what they meant by the term domicile” (in the definitions of Wealthy and Very Wealthy). Obviously we were not a party to the discussions but would have imagined that if UK tax agents referred to 'domicile' they would use it in its UK tax meaning. At any rate we would have thought it would have been normal for a researcher to ask about a term which they felt was imprecise?)

END

APPENDIX II

1 COMMON 'DE-ENVELOPING' SCENARIOS

1.1 Each of the following scenarios is based on the following fact pattern/ assumptions:

(a) The de-enveloping of a residential property which may be freehold or long leasehold.

(b) None of the exemptions from ATED (eg commercial letting; farmhouses; employee accommodation etc.) apply.

(c) The property is owned by an offshore company. The share capital of the offshore company may be owned directly by an individual, or it may be owned by a trust.

1.2 Below are a number of common scenarios. The list is not exhaustive but is intended to illustrate the need for, and the limited scope of, a proposed SDLT clearance facility.

(a) Scenario 1 :Straightforward liquidation of offshore company

(i) In the first scenario, no borrowing or assumption of a debt is involved. The existing company is put into liquidation and, as part of that liquidation, the property is transferred by the liquidator to the shareholders in proportion to their shareholdings. Typically this will be to a single shareholder although in some cases there may be more than one shareholder.

(ii) Depending on the jurisdiction, the liquidation process may be as little as a single day or it may be a much longer process (perhaps a couple of months or more). Typically, however, there is a relatively short process commencing with the appointment of the liquidator, followed shortly by a resolution to transfer the property and the actual transfer of the property shortly after that.

(iii) The liquidator will often be a professional insolvency practitioner qualified in that jurisdiction. However, in some jurisdictions the shareholders themselves may be permitted to act as liquidators in their own right. Alternatively in some jurisdictions there may be a liquidation process without a formal office of liquidator being involved at all.

(iv) HMRC will be aware that the 'liquidation exemption' which applied prior to 2003 for Stamp Duty purposes (Category I, Stamp Duty Exempt Instruments Regulations 1986), was not directly carried across into SDLT. However, in most cases we understand that liquidation does not[4] involve any consideration and therefore benefits from the exemption provided by Finance Act 2003 schedule 3 paragraph 1.

(v) For English companies this approach appears to be the correct legal treatment. The *Laird Group plc* case[5] confirms (see paragraph 37, for instance) that a distribution from an English company – whether on liquidation or during the company's life - merely returns to a shareholder what was already his. It does not involve the shareholder giving any consideration - for instance in the form of giving up rights. Nor does the process of appointing the liquidator give rise to any debt in

[4] Absent the assumption of debt which is addressed below.
[5] [2003] 4 All ER 669

consideration of the extinguishment of which the liquidator releases the assets to the shareholders.

(vi) It is recognised that the answer may depend upon the particularities of the foreign law concerned. It is anticipated that HMRC will have experience of the main offshore jurisdictions (typically offshore companies will be BVI, Bahamas and Jersey companies) and will have a settled view on whether the liquidation process in those jurisdictions either:

A. creates any form of debt due from the liquidator to the shareholders; and/or

B. involves any other form of consideration being given by the shareholders

in either case thereby preventing the schedule 3 paragraph 1 exemption from applying.

(vii) We are not aware of HMRC ever taking this point when it comes to the liquidation of foreign companies owning UK real-estate.

(b) <u>Scenario 2: Capitalising shareholder loan prior to liquidation, then liquidation and distribution</u>

(i) In the second (very common) scenario, the company will have been funded partly by way of share capital and partly by of shareholder-loan (or possibly by a connected party loan eg from the settlor in a case where the company is held in a trust created by the settlor).The shareholder will, as mentioned above, potentially either be the individual(s) concerned or the trustees of a trust.

(ii) In this scenario there is no external (commercial) borrowing. (See later scenarios below to cover situations where there is external commercial borrowing)

(iii) If such a company were liquidated, it is recognised that the satisfaction or release of the shareholder-debt[6] in consideration of the transfer by the liquidator of the property would amount to chargeable consideration pursuant to FA 2003 paragraph 8 schedule 4.

(iv) With a view to avoiding such a result, shareholders may be willing to capitalise such loans prior to liquidation of the company. In the alternative the debt may be simply released by the settlor creditor

(v) It is anticipated that the process will vary depending upon the jurisdiction involved and the exact nature of the debt. However, it will typically involve:

A. A release of any security which may have been given for the shareholder loan[7], a subscription for and allotment/issue of additional shares the price for which will be satisfied by the extinction of the existing debt. In simple cases it is anticipated that the shares will typically be ordinary shares of the same class as

[6] Or the changing of rights in relation to that debt (where it is secured on property immediately before and after a transaction).

[7] This may or may not have been given depending upon the exact facts. Alternative scenarios may be that the loan is not secured prior to the exercise, or that there is no loan (and therefore no security) after the exercise.

the existing shares, but – depending upon local requirements – may be of a different class or type (eg preference shares).

(vi) The liquidation of the company (with an enlarged share capital) will then typically commence fairly quickly (in some cases potentially later on the same day).

(vii) In this scenario the areas of uncertainty are;

A. whether or not the capitalisation (or release) of the debt prior to the transfer of the property on liquidation is caught by FA 2003 schedule 4 paragraph 8[8]; and

B. whether the capitalisation of the shareholder-debt or the release is a 'scheme transaction' within the meaning of s75A FA 2003 or, alternatively, that in HMRC's view it would not be reasonable to apply[9] section 75A in this scenario.

(viii) Again the answer to these questions may depend in part upon the exact provisions of foreign law and/or the exact liquidation process and/or the class or type of shares involved. However it is hoped that HMRC may have a settled view of the position in BVI, Bahamas and Jersey being mainstream offshore jurisdictions.

(c) <u>Scenario 3: Repayment of commercial borrowing prior to liquidation/ distribution</u>

(i) The third scenario is the same as the second save that:

A. The property is charged to secure a loan from a third-party commercial lender rather than a shareholder loan[10]

B. The shareholder introduces other existing funds[11] - typically by way of subscription for share capital[12] - to enable the commercial loan to be repaid and the security released.

(ii) The remainder of the steps are then as in the second scenario above.

(iii) The areas of uncertainty are the same as in the second scenario above.

(d) <u>Scenario 4: As above, but with possible subsequent re-mortgage</u>

(i) The fourth scenario is the same as the third, save that at some point after the above steps have been completed, the new owner of the property may seek to re-mortgage the property[13]. This may or may not be from the same lender.

[8] HMRC's guidance dated 23 December 2013 refers only to a 'cancellation' of the loan with no further indication for the basis of their view that the existence of the shareholder loan will not constitute consideration within Schedule 4 paragraph 8

[9] An e-mail from Keith Brown to Sean Randall of the Stamp Taxes Practitioners' Group dated 20 December at 16:11 appears to confirm this HMRC's position at that time.

[10] Alternatively there may be some additional shareholder loan in addition to the commercial borrowing

[11] Where the shareholder is an individual, it is assumed that the addition of funds is from his or her own resources. Where the shareholder is a trust the addition may either be from the trust's existing resources, or additions may first be made to the trust by the settlor.

[12] In the alternative the shareholder or perhaps a third party may make a gratuitous capital contribution to the company, a concept recognised in many foreign jurisdictions eg BVI.

[13] ie borrow additional funds secured against the property.

(ii) Such a re-mortgage might be for a number of reasons. These might include reducing the net value of the property in the new owner's hands for inheritance tax purposes. Or it may simply be that interest rates on secured lending are attractive.

(iii) In this fourth scenario the discharge of the old debt takes place without recourse to the new borrowing and the re-mortgage is undertaken for reasons entirely unconnected with the de-enveloping.

(iv) See further scenarios below for where this is not the case.

(v) The areas of uncertainty are otherwise the same as those above save for the additional question of whether the re-mortgage somehow creates a form of circularity which makes the transaction more vulnerable to s75A or some other anti-avoidance doctrine being applied.

(e) <u>Scenario 5: Repayment of mortgage using alternative borrowing followed by liquidation and distribution.</u>

(i) The fifth scenario is the same as the third, save that the shareholder cannot afford to repay the existing commercial borrowing from his, her or its own resources.

(ii) Consequently, alternative borrowing arrangements are made by the shareholder. These might include unsecured borrowing or borrowing secured on a different property or borrowing secured on other assets[14]. In each case the property which is being de-enveloped is NOT security for the borrowing.

(iii) The shareholder then introduces the borrowed funds into the company as in the above scenarios to enable the existing secured borrowing to be repaid. The liquidation then proceeds as above.

(iv) The new (alternative) borrowing remains in place.

(v) The areas of uncertainty are the same as those above.

(f) <u>Scenario 6: As above but with possible subsequent remortgage</u>

(i) The final scenario is a combination of the fourth and fifth, namely:

A. The property is charged to secure existing commercial borrowing which the shareholder cannot afford to repay from his, her or its own resources;

B. The shareholder therefore borrows from an alternative source (as in the fifth scenario above)

C. The shareholder introduces the newly borrowed monies into the company as above which are then used to repay the existing borrowing and release the security over the property

D. The company is then liquidated and the property transferred, on that liquidation, to the shareholder

[14] Eg 'Lombard lending' secured on financial assets.

E. The shareholder may, potentially after a relatively short gap[15], seek to re-secure[16] the new borrowing on the property in question[17].

(ii) This final scenario is, commercially, little different to the fourth and fifth scenarios and - arguably - it would be un-commercial for a borrower to maintain alternatively secured finance (eg Lombard borrowing) when it would typically be cheaper to re-secure such lending against the property in question.

(iii) However, in this scenario the property was secured both before and after the above steps and the intermediate (alternative) loan is put in place as a temporary expedient.

(iv) Uncertainty around the SDLT consequences arise in this scenario because:

A. Economically the property (or at least its value) belongs to the same person before and after the transaction;

B. The property is not being purchased from an unconnected 'third party' which was the underlying purpose behind paragraph 8(1A) schedule 4 FA 2003 in the first place;

C. In addition a taxpayer is taking steps to do what government policy appears to encourage him or her to do – namely to de-envelope albeit in a manner which incurs the least transactional taxes in the process.

2 GENERAL APPLICATION OF SECTION 75A

2.1 We have already touched on this above, but briefly to summarise our views on the technical position.

2.2 In our view, the capitalisation of debt should not comprise a 'scheme transaction' for the purposes of Section 75A. Ownership of shares is clearly a pre-requisite to distributing the property out by way of liquidation but this could be by virtue of its existing shareholding. There is no need for the capitalisation to establish the shareholding necessary for the distribution. The capitalisation will clearly be a step in the transfer of the property, but it does not affect the nature or interest of the property which is being transferred on the liquidation.

2.3 We therefore do not believe that Section 75A should apply, since the capitalisation is not a scheme transaction and consequently the only transaction which takes place is the real transaction, namely the transfer of the property from the company to the individual or trustee.

2.4 Furthermore, we note that HMRC's current guidance on Section 75A, published on 1 March 2011, states that:

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[15] Not on the same day, but perhaps at earliest on the following day. More commonly a week or so later.
[16] Depending upon the procedures of the bank in question this 're-security' may in practice involve taking out a new (third) secured loan to repay the alternatively-secured (second) loan.
[17] Typically, at present, borrowing secured on property will be cheaper than unsecured or alternatively-secured lending.

'Section 75A Finance Act 2003 is an anti-avoidance provision that is intended to counter certain schemes which have the effect of reducing Stamp Duty Land Tax Liability.'

'Section 75A is an anti-avoidance provision. HM Revenue & Customs (HMRC) therefore takes the view that it applies only where there is avoidance of tax'

2.5 The de-enveloping strategies outlined above all aim to comply with government policy, and are not intended to avoid SDLT. It therefore seems contrary to stated government objective to discourage de-enveloping by imposing anti-avoidance provisions.

21 June 2016

Removing Barriers to De-enveloping Residential Property

1 Introduction

This note has been prepared by the Society of Trust and Estate Practitioners as a supplement to the submission made by the Chartered Institute of Taxation (supported by STEP and other bodies) on 21 June 2016.

The focus of that submission related principally to possible SDLT charges where debt is secured on the property owned by the company in question.

2 Government policy

As explained in the CIOT submission (paragraph 5), our understanding is that government policy is to encourage individuals to hold residential property in their own names. This includes encouraging individuals to extract UK residential properties from existing offshore structures.

The proposal to extend inheritance tax to non-domiciled individuals who hold UK residential property through offshore companies will put many such individuals in a worse tax position than if they owned the property personally.

This was recognised in the technical note issued at the time of the summer 2015 Budget which hinted at the possibility of some relief for the costs of taking a property out of such a structure.

3 SDLT and loans

The CIOT submission contained an appendix (Appendix II) which set out a number of common de-enveloping scenarios. These scenarios assumed that a UK residential property is held by an offshore company. Scenarios 3-6 assumed that a third party loan is secured on the property.

The additional scenario which we want to put to you is similar to scenario 6 in the CIOT submission except that the new borrowing taken out by the shareholder in order to enable the company to repay the existing borrowing is secured on the property either from the outset (when the property is still owned by the company) or as soon as the property is transferred by the company to the shareholder. In practice, most lenders are likely to require immediate security over the property if they do not have any other security. The scenario is therefore as follows:

3.1 the property is charged to secure existing commercial borrowing which the shareholder cannot afford to repay from his own resources;

3.2 the shareholder therefore borrows from a commercial lender (which may be the same as the existing lender to the company or another financial institution). The company guarantees the borrowing and gives security over the property as security for the guarantee;

3.3 alternatively, the refinancing and liquidation of the company (steps 3.4 and 3.5 below) all take place on the same day so that the new lender takes direct security over the property which is now owned by the shareholder;

3.4 the shareholder introduces the newly borrowed funds into the company by way of a share subscription and the company uses the money to repay the existing borrowing;

3.5 the company is liquidated and the property is transferred as part of the liquidation to the shareholder. If the company has given a guarantee with security over the property as described above, the property would be transferred subject to the shareholder signing a new charge in favour of the new lender contemporaneously with the transfer of the property.

The real issue here (as in a number of the other scenarios put forward by CIOT) is the application of section 75A Finance Act 2003 as it could be argued that the shareholder is, in substance, acquiring the property in consideration of taking over the company's debt even though this is structured as a new loan to the shareholder.

We would argue that section 75A should not apply for the reasons set out by CIOT in relation to scenario 6:

(a) economically the property (or at least its value) belongs to the same person before and after the transaction;

(b) the property is not being purchased from an unconnected "third party" which was the underlying purpose behind paragraph 8(1)A, Schedule 4 FA 2003 – there is therefore no "avoidance";

(c) the taxpayer is taking steps to do what government policy appears to encourage him to do – namely to de-envelope, albeit in a manner which incurs the least transactional taxes in the process.

However, if HMRC takes the view that section 75A would be applied in this situation, we would request that, as suggested in paragraph 2.4 of CIOT's note, consideration be given to a statutory relief from SDLT in this situation. As proposed by CIOT, this could be subject to a time limit so that the relief only applies if the property is de-enveloped within a specified period after the new legislation enters into force.

We would also request that consideration be given to applying the relief retrospectively so that de-enveloping can take place before the proposed inheritance tax changes are implemented.

APPENDIX 3

TRUST PROTECTIONS – Comments on the Trust Protections Paper discussed at the HMRC/HMT/Stakeholder meeting at Macfarlanes on 20 September 2016

Background
At the meeting of the 20 September ("the meeting") a proposal was put forward in a paper ("the Paper") setting out an alternative approach for trust protections to that outlined in the consultation document of 19 August 2016. For ease of reference the Paper is included at Appendix 3(1).

This note sets out our comments in respect of that Paper; to achieve agreement it has been circulated to representatives from CIOT, The Law Society and STEP and adjusted for comments made. For the avoidance of doubt, it must be stressed that the Paper at Appendix 3(1) itself is not a HMT/HMRC proposal although we understand that at present it is being seriously considered and is presently the most favoured approach.

In what follows all references are to the Paper and references to paragraph numbers are references to the paragraphs as numbered in the Paper.

General
We welcome the proposals set out in the Paper, which were also broadly supported by the other attendees and we feel that these proposals go further than those contained in the consultation document to delivering the policy pledge made by the then Chancellor in 2015.

We also favour the proposal that settlements established by non-residents could invest in the UK without concern about the possible remittance of income earned within the settlement (that is aligning the income tax rules with the current capital gains tax rules). We think that this will encourage inward investment and help stimulate the economy and we see the policy rationale as being very similar to that put forward for the BIR review.

Capital Gains Tax
We are very pleased to see that alternative proposals to those contained in the consultation document are being considered. As you know we are in favour of using s87 TCGA and this was the approach we proposed in our two capital gains tax case studies (set out in Appendix 2).

There are however some points in the Paper which either differ from the approach adopted in our case studies or are not covered in our case studies. As such, there are some issues that we would like to raise (hence the comments below). Just to reiterate, whilst we would like the proposals in the Paper to be adjusted, at least for our main comments (with respect to para 1.5), we prefer the proposals in the Paper to the proposals in the August 2016 Consultation Document.

"Washing Out" – Para 1.5
Our main concern is around "washing out". A persuasive argument can clearly be made for the merit of having an integrated system for all offshore trusts and we are of the view that for income tax it can work. However, doing so for CGT is not something we would welcome, as:

- It will lead to anomalies resulting in unfair cases (which could be particularly damaging to UK plc in the context of wealthy international families - where there is only one branch in the UK the proposals may deter the individuals from coming here at all or result in them leaving earlier than planned).
- The changes will apply to everyone rather than just those meeting the 15/20 test, so extend to those who were not previously the target of these reforms. **If the proposal in the Paper below is adopted as government policy, we would expect a clear announcement from the Chancellor signalling that the policy has been changed**

from that previously announced so that the scope of TCGA 1992, s87 is extended for everyone.

We think that the legislative drafting (to alleviate these unfairnesses) would be more difficult than our alternative, which is as follows:

- TCGA 1992, s86 switched off in all cases unless prohibited additions are made (see comments below about what should not be taken as an addition and protections);
- TCGA 1992, s87 continues to apply;
- the settlor is subject to tax on worldwide aggregate capital payments made not just to him or her but also to partners, minor children (and if HMRC feel that it is necessary minor grandchildren);
- whilst the settlor remains deemed domiciled capital payments made to a non-resident are disregarded so the s87 pool is not reduced

Within the time available we feel that our suggestion remains closest to the overall structure of the legislation, whilst doing what the then Chancellor wanted in terms of carving out a class of protected settlements for Deemed Domiciled Settlors only. As mentioned below, and discussed during the 20 September meeting having a system just for Deemed Domiciled settlors risks some transitional issues (particularly where gain and capital payment straddle a change of deemed domicile). However, if this is felt to be a concern, we think that it could be dealt with by applying the no-washing-out-to-non-residents principle if either the capital payment OR the matching of it occurs when the settlor is deemed domiciled.

Tainting Reliefs – Para 1.2
Our preference is for **both** the proposals at paragraphs 1.2.1 and 1.2.2 (though with the *de minimis* being say 1% of market value rather than £5,000). If it is felt that only one such relief should be provided then we would prefer the grace period running from the date the inadvertent tainting is uncovered (be it by the taxpayer/trustee or by HMRC during the course of an enquiry/discovery etc).

We do not feel that the proposal at paragraph 1.2.4 should be a relief as we do not believe that it should be possible for taxpayers other than the settlor to impact the settlor's tax affairs. We do not believe that this would pose any risks to the Exchequer as the act of adding funds to a trust would make the donor a settlor in any event and so bring them with the Income Tax, CGT and IHT provisions.

Tainting – Para 1.2.4
While we appreciate that legislating SP5/1992 may not be possible, we would welcome HMRC guidance confirming or reiterating that the relevant parts in SP5/1992 relating to additions apply for the proposed tainting rules. The tainting rules posed practical issues back in the 1990's and the more clarity around what is considered tainting the better.

We also think that it is important that the definition of "expenses", that is additions that would not taint the trust, is extended to cover all trust income and capital expenses (as long as the payment of these expenses does not increase the value of any of the assets comprised in the trust fund). In addition any funds paid directly to underlying trust entities (such as companies) to cover such expenses should be within the "expenses" definition.

Resettlements – Para 1.4
Unfortunately, where the transaction is purely funds from the protected trust being advanced/appointed to a new trust, we cannot identify what the targeted mischief is. We recognise and support the need for a coherent system of taxation of capital gains but we feel that the proposal will unduly inhibit flexibility given that extended families especially often have good personal reasons for wanting to separate out the assets in a trust. For different branches of a family who require clean breaks for each other a sub-fund psychologically is not the same thing as a new trust.

Close Family Members – Para 1.9 & 1.10
While we appreciate the objective, the Paper contains proposals at paragraph 1.9 which seek to attach the liability to the settlor unless the recipient is UK domiciled or deemed-domiciled in their own right.

This is perhaps a level of complexity too far and we would consider it sufficient to charge the tax on the settlor irrespective of the domicile status of the recipient close family member.
Additionally, our preference is that grandchildren are not included within the definition of Close Family Members as it can lead to unwitting complications.

Recycling
We can see the mischief that these proposals are intended to address. We are not, however, clear how wide the scope of the measure is intended to be. It does seem it will go wider than just considering UK resident foreign domiciliaries, so the extended scope will need to be made clear if the proposal is adopted.

If the proposals go ahead as outlined, we would be of the view that a 2 year time limit should be sufficient. A second option would be to limit the application of the provisions to situations where there were schemes or arrangements.

Valuations
The issue of valuations for tax purposes is much wider than the rules currently under review and we would suggest that this is an area which, if it is going to be reviewed, should be reviewed as a standalone topic at a later date. Given how close we are to “L-day”, attempting to reconfigure how benefits are valued in such a tight timeframe would be incredibly difficult.

Income Tax

As stated at the start of this response we welcome the income tax proposals.

Transitional provisions - Para 1.8 & 2.9 – 2.10
We accept the logic of treating all income as at 5 April 2017 as relevant income (trying to have different pools for the deemed domiciled settlor and beneficiary would be too complicated). However, as discussed during the 20 September meeting, transitional provisions (similar to those in 2008) will be required.

Tax credit proposal - para 2.14
In addition to having credits for withholding taxes and tax paid by the trustees/underlying companies we would propose a change to the definition of a capital payment for s87 TCGA 1992 (as well as that of a benefit for the purposes of s731 ITA 2007) so it does not extend as far as the payment by the trustees (or one of their non-resident companies) of foreign taxes which are taxed on a settlor by a foreign state in relation to the gains or income received by the trustees or their companies.

Protected income & washing out – para 15
We understand that there is no intention to change the current rules so where income and capital is segregated and an income distribution is made to a non-resident, the income distributed will not be part of the “relevant income” for matching purposes. We appreciate that that para 2.16 recycling rule might apply (see our comments on the CGT recycling rule).

No inconsistency between CGT and income tax proposals
Finally, we appreciate that the income tax proposals will change the way that all foreign domiciled settlors are taxed. To our minds, this is acceptable in a way that the para 1.5 (“washing out”) proposals are not as the situations are different. The existing income tax legislation is already different and there are also positives for the taxpayer arising as a result of the new income tax proposals to balance the negatives (as mentioned above the ability of the trust to invest income in

the UK). However, if HMRC feels that adopting the income tax but not the CGT proposals is unacceptable then we believe that the proposals sent round in the case studies that we prepared (see Appendix 4- case studies 3 and 4) can be used as an alternative for the income tax framework.

Conclusion

We hope you find the above helpful. We are of course more than happy to meet to discuss any aspect of the above further.

APPPENDIX 3 (1) THE PAPER

TRUST PROTECTIONS 19th September 2016

1. Capital gains tax

1.1 Section 86 will not be switched on just because a DD settlor receives a benefit. S87 will be used to tax any settlor on benefits as at present but with some modifications. 2008 rebasing will be preserved for foreign domiciliaries not yet DD [and for DD].

1.2 Section 86 will be switched on if there is tainting after the settlor is DD. [It is for consideration whether any or all of the following reliefs should apply:

1.2.1 a grace period such that inadvertent tainting can be corrected and the funds withdrawn within a certain time period
1.2.2 a *de minimis* addition which can be ignored e.g. £5000
1.2.3 an addition by the settlor should only taint the settlement to the extent of the addition (as per the inheritance tax position) provided records can be retained rather than taint all the settled funds
1.2.4 an addition by anyone else should not lose protection for the original settlor's funds in respect of the funds he settled.
1.2.5 an addition by the settlor who has become DD but lost his DD should not taint the trust.]

It was noted that the 1991 legislation on tainting caused many practical problems in commercial situations and that in the present case, unlike the position in 1991, as the settlor is DD anyway any additions are likely to be inadvertent because an inheritance tax entry charge will generally arise on such additions.

1.3 [It is for consideration whether an addition after settlor becomes DD also loses the income tax protections mentioned below such that the settlor is taxed on an arising basis on income as if a UK domiciled settlor.]

1.4 Resettlements. [to discuss – should s86 be switched on and the DD protections (income tax/capital gains tax) be lost if there is a resettlement even if there is no addition of any property but just a movement of property from one trust to another.] General view may be that resettlement after settlor becomes DD should mean the protections are lost particularly as for inheritance tax purposes excluded property status is arguably lost by resettlement anyway. However, it may be possible to amend sub-fund provisions to ensure that if a sub-fund election is made [18]this does not lose trust protections.

1.5 HMRC are still considering whether all capital payments to a non-resident should be ignored for s87 purposes (in which case there is no washing out of gains but there is no charge if the non-resident comes to the UK and matching to trust gains only occurs at that point) or whether only capital payments to a non-resident beneficiary at a time when the trust has a DD UK resident settlor should be ignored. If this provision is adopted at all HMRC may favour the simple option of ignoring all capital payments to a non-resident whatever the status of the settlor unless (possibly) the trust is ended and capital payments are made to UK and non-UK residents in the same year in which case s87 gains can be allocated pro rata to the capital payment.

1.6 Capital payments to a temporary non-resident (whether individual or beneficiary) made while he is abroad will be taxed as under present legislation on his return to the UK. i.e. depending on his status then they will be taxed on the remittance basis if he is not DD on

[18] (e.g. for foreign tax reasons or for trust reasons it may be necessary to separate out funds and treat them as separate settlements)

his return and on an arising basis if he is DD. [This is the case unless the individual left before July 2015 when some relief could be granted if he comes back after April 2017, is temporarily non-resident and would then be DD under the new legislation.]

1.7 Capital payments to a non-resident who is not a temporary NR but who returns before he has lost his DD will be ignored. (e.g. return after five years and a split year but before six years has elapsed.)

1.8 Capital payments made before [6 April 2016/July 2015] but matched to trust gains after April 2017 whether made to the settlor or any other beneficiary will be matched according to the beneficiary's status at the date of payment. This is the case even if the beneficiary is DD after April 2017 and matching to trust gains occurs only after April 2017. If the beneficiary receives a capital payment after [one of the above dates] which is matched to trust gains realised after April 2017, then it will be taxed according to his status at the date of matching. Therefore, such capital payments will be taxed on an arising basis if he is DD at the date of matching.

1.9 Capital payments to close family members of the UK resident settlor [whether settlor is actually domiciled here, DD or non-domiciled) will be taxed according to the status of the settlor unless the family member is already DD or actually UK domiciled in which case the family member is taxed.

1.10 The definition of close family members will include spouse and cohabitee [and possibly minor children and minor grandchildren.]

1.11 Recycling rule. Capital payments to non-close family members will be taxed on the UK resident settlor [or any other UK resident beneficiary] if at any time in the relevant period ([3??] tax years following the tax year of receipt) the property paid to the non-close family member is enjoyed by the UK resident beneficiary (whether the settlor or not) or the property paid to the family member is part of a scheme to give it to a UK resident beneficiary. The recycling rule will not apply if the non-close family member beneficiary has paid tax on the capital payment (whether on an arising basis or because the payment has been remitted). The recycling rule will apply to all UK resident settlors [as well as other UK resident beneficiaries] and the capital payment will be taxed by reference to the [beneficiary's] status in the event that the rule applies. [for discussion]

1.12 [Reporting of all benefits on any beneficiary's tax return even if no immediate charge arises due to the trust being dry.]

1.13 [|Valuation of certain benefits such as art, loans etc. appropriately and on a statutory fixed basis]

2 Income tax – foreign domiciled settlors only whether or not DD

2.1 Section 720, 727 ITA, s624, 629 ITTOIA and [s633] will be switched off for all foreign domiciled settlors whether or not DD from April 2017 in respect of foreign income arising within trust structures including underlying companies. Such foreign income will be "protected income" and will not be taxed on an arising basis even after the settlor becomes DD [unless tainting occurs after the settlor becomes DD] but will be taxed on a benefits basis as per below.

2.2 Remittance of such foreign income to the UK by trust or company will therefore not result in a tax charge on the foreign domiciled settlor (whether DD or not) and trustees are free to invest in the UK without risk of remitting s731 income. Protected income will only be taxed if a benefit is received.

2.3 There will be no requirement to pay up foreign income within the company to the trust to avoid being taxed on an arising basis on such income. Foreign income can be retained at any level and remain protected for foreign domiciled settlors.

2.4 Such protected income can only be matched if "available" to benefit the settlor/or close family member. [close family member to be defined as for capital gains]. Therefore, income which is used to pay expenses, or which belongs to another beneficiary who has an interest in possession or which is distributed to another beneficiary cannot be taxed on the settlor. [note- if settlor and close family member excluded from segregated relevant income is it envisaged that they can receive benefits and not be subject to income tax? - give consideration as to what "available to benefit" means.]

2.5 UK source income in the company and trust will continue to be taxed on the UK resident settlor on an arising basis under s720 ITA and s624 ITTOIA. UK source income in the company which is dividended up to the trust and has already been taxed on the settlor is ignored and does not become relevant income provided the dividend paid up can be clearly identified as comprising the UK source income.

2.6 All foreign domiciled UK resident settlors whether or not DD will be subject to income tax on a benefits basis but only in respect of benefits received by the settlor or close family member after April 2017 and by reference to the settlor's status when the benefit is matched (and subject to the same point as in 1.9 above if close family member already UK domiciled or DD]. The benefits will be matched against available relevant income and taxed according to the status of the settlor at the date of matching. The earlier remittance of s731 income by the trustees/company to the UK will not affect the tax position of the foreign domiciled settlor who will be taxed by reference to whether he remits the benefit to the UK (if not DD)_or whether he has received a benefit anywhere if DD.

2.7 The benefits charge can arise if any benefit is received by the foreign domiciled settlor or close family member (whether provided out of income or capital) and will not apply only when the benefits are provided out of the "protected income" itself.

2.8 The primary matching rule will be under s731 for all foreign domiciled transferors (whether at the trust or corporate level) with s628A operating as a secondary rule where s731 is disapplied by the EU or motive defence.

2.9 Benefits received prior to [April 2017] will be subject to income tax (if at all) under the provisions of the current regime and otherwise matched only to capital gains as in 1.8 above. [Forestalling to be considered].

2.10 All undistributed and unremitted foreign pre April 2017 income [and OIGS] will become relevant income available for matching to any benefits [including income arising before the settlor became UK resident and whether or not the benefit is paid out of the income]. Foreign income retained within the structure but remitted prior to April 2017 and therefore already taxed on the settlor will not be taxed again on the settlor if later paid up to the trust or otherwise retained and can be clearly identified as that income and this income will not form part of the pool of relevant income.

2.11 [Income paid out as it arises or within the following tax year will not be relevant income and will be taxed as income on the settlor according to his status at date of receipt.]

2.12 Any income matched under the transfer of assets abroad provisions will reduce the pool of protected income which can be matched under ITTOIA s 628A. Similarly, income matched under s628A cannot be relevant income for s731 purposes in future years (e.g. if the motive defence is lost). Income paid up from company to the trust will not be regarded as a new source of protected income provided it can be clearly identified as paid out of the income of the company i.e. no double counting.

2.13 Matching will be on a last in, first out basis.

2.14 Where the benefit received is matched to income which can clearly be identified as income on which the settlor has or will pay foreign tax then the settlor will be entitled to the same tax credits/reliefs as if he had received the income directly.

2.15 No washing out of protected income on payments to non-residents (unless temporarily non-resident).

2.16 Recycling rule as in 1.11 above.

APPENDIX 4

CASE STUDIES
(AS SENT ROUND PRIOR TO THE 20 SEPTEMBER 2016 MEETING)

CASE STUDY 1 (CGT)

Introduction

In relation to protected settlements, it is proposed that if and for so long as a settlor is deemed domiciled in the UK by reason of residence here for 15 out of previous 20 years of assessment:

- Gains should be assessed on the settlor based on the operation of s87 TCGA 1992, albeit that the settlor should also be assessed on the benefits imparted to his spouse, minor children and minor grandchildren as well as in relation to any benefits that he or she receives.
- Benefits will be assessed on the settlor irrespective of the location of the country where they are enjoyed.
- S86 TCGA 1992 will only apply to the settlor where property has been added to the settlement after he or she has become deemed domiciled or where he or she becomes common law domiciled within the UK.
- The essential relevant elements of SP05/1992 will be enacted[19] (and brought up to date) and will determine whether a trust has become 'tainted' (this is important to provide certainty); tainting will be relevant for both capital gains and income tax purposes. A Revised SP05/1992 will still need to be retained, and updated.
- To provide for instances of unintended tainting, there will be provision for the settlor to remove any addition to the settlement within a specified grace period (whichever is the later of two years of the addition being made or a year of it first coming to light) and so prevent the trust being tainted[20].
- The definition of capital payment is to be changed so that the settlor should be entitled to be reimbursed by the trustees for any tax liability which incurs as a result of payments to his spouse, minor children or minor grandchildren. Such reimbursement and payment or reimbursement of any foreign taxes should be excluded from the definition of a capital payment.
- It is not possible to 'wash out' gains paid to or for the benefit of non-residents. Whilst the settlor is deemed domiciled, capital payments made to a non-resident will be disregarded for all purposes (i.e. – a capital payment will not be matched with gains in the year it is made or in any future year, nor will it be available to be matched if the non-resident recipient subsequently becomes UK resident). However, if the recipient turns out to be a temporary non-resident, the capital payment will be treated as having been made in the year of return and can then be matched.
- Capital payments made to a UK resident beneficiary whilst the settlor is deemed domiciled will not be matched with gains which arise in a later year whilst the settlor is still deemed domiciled if the recipient of the capital payment is non-resident when the matching occurs. The aim is to prevent washing out of gains to a beneficiary who will/ it is intended will emigrate in the near future/ imminently.
- Rebasing elections under paragraph 126 Schedule 7 FA 2008 will continue to be recognised, as will the transitional provisions of para 124 Schedule 7 FA 2008 in relation to any capital

[19] If enacting SP05/1992 is felt to be too difficult (particularly in the timeframe) consideration can be given to proving the necessary guidance with sufficient in the legislation to allow account to be taken of the guidance.
[20] If this is unacceptable then the tainting should only be proportional.

payment made to a beneficiary who continues to be domiciled outside the UK (including the settlor).

- In this case study in the interests of simplicity:
  - it has been assumed that there is no prior income or offshore income gains;
  - we have assumed there are no unmatched capital payments prior to 6 April 2017.

Facts and analysis

- Mr A is common law domiciled in Ruritania. He becomes deemed domiciled in the UK on 6 April 2017 but continues to be common law domiciled outside the UK. He established the Annabelle Trust resident outside the UK in 1960, which has 100% holdings in 3 non-UK incorporated investment companies which are resident outside of the UK.
- The Annabelle Trust has realised trust gains since 17 March 1998, and these include gains attributed to the trustees by reason of s13 TCGA 1992 from their holdings in the non-resident investment holding companies.
- The trustees have made a valid election for rebasing under para 126 Schedule 7 FA 2008.
- The value of the Annabelle trust fund is now £20m, of which £5m is held in cash. The total amount of unmatched trust gains is £10m. Gains realised by/attributed to the Trustees during 2017/18 total £1m (this is included within the aggregate £10 million figure).
- In 2017/18 the trustees make a capital payment of:
  - £100k to Mr A's adult son who is resident in Monaco;
  - £400k to Mr A's wife who is UK resident but has no personal income or gains of her own;
  - £90k to meet the costs of Mr A's children's UK boarding school fees.
- Mr A is assessed to tax on total capital payments of £490K (the payment to his adult son not being part of the aggregation) less any relief due under paragraph 126 Schedule 7 FA 2008.
- He pays CGT at 20% on the full £490k as all of the gains are current year gains. Had the capital payments exhausted the current year gains, Mr A would still pay the tax on all of the capital payments together with any supplementary charge irrespective of the fact that those trust gains arose prior to the date that he became deemed domiciled. The capital payment to Mr A's non-resident son does not wash out any trust gains.
- The £10 million gains pool is reduced by £490k not £590k. The payment to the adult non-resident son is ignored for the purpose of calculating the continuing pool of gains.
- As the capital payments under s87 TCGA 1992 were not actually made to Mr A himself, but to his wife and children, Mr A will have a new statutory right to recover the CGT paid from the trustees. That right of recovery will not itself constitute a further capital payment
- If Mr A suffers any foreign taxes as a result (e.g. Monaco, Ruritania) then if the trustees reimburse or meet these foreign taxes that also will not constitute a capital payment.

Notes

Consequential adjustments to the Offshore Fund Regulations will be needed to ensure that the offshore income gains rules will continue to mirror the rules under s87 TCGA 1992. It will be important to ensure that offshore income gains are not taxed under s720 ITA 2007 whilst the trust is protected.

The transfer between settlement rules contained in s89-s90A TCGA 1992 will continue to apply as they do now.

The current rules in relation to supplementary charges will continue to apply.

The proposals contain provisions which will allow steps to be taken within certain time limits to withdraw additions from a protected settlement that have the effect of tainting the settlement.

Where the time limits are not observed, the default provision should be that the Protected Settlement is only tainted on a proportionate basis.

It is proposed that gains cannot be washed out where capital payments are made to non-residents. Originally it was also proposed to prevent washing out where capital payments were made to a remittance basis user. However, without further provisions, this would give an obvious loophole as payments to remittance basis users could escape tax altogether. As a result we think that extending the disregard of capital payments should not be extended to remittance basis users because of the uncertainty that this could cause where mixed funds were not immediately remitted to the UK. Also the definition of capital payments is being extended to tax the settlor on payments to his or her immediate family. Capital payments in such instance will be taxable upon the settlor which will help limit the scope for abuse.

CASE STUDY 2 (CGT)

Introduction

The background tax assumptions are set out in the introduction to Case Study 1, and those general provisions are repeated in the notes section below. In this case study the position is considered where the settlor becomes UK domiciled under the common law, or property is added to the Protected Settlement which means that it is 'tainted':

- Where the settlor becomes domiciled under the common law (as opposed to just being deemed domiciled for tax purposes) during the year of assessment, or the settlement becomes 'tainted', gains during that year of assessment (and future years) will be assessed on the settlor under s86 TCGA 1992.
- S87 TCGA 1992 will continue to apply to tax gains that arose prior to the year of assessment during which s86 TCGA 1992 first came to apply. This means that nothing will fall out of the tax net.
- A UK resident settlor will:
  - be taxed under s86 on gains arising to the trust in the tax year; and
  - continue to be assessed on the benefits imparted to his spouse, minor children and minor grandchildren in addition to any benefits that he or she receives until such time as the s87 gains have been exhausted. Benefits will be assessed on the settlor irrespective of the location of the country where they are enjoyed.
- It is not possible to 'wash out' gains paid to or for the benefit of non-residents. Whilst the settlor is deemed domiciled, capital payments made to a non-resident will be disregarded for all purposes (i.e. – a capital pavement will not be matched with gains in the year it is made or in any future year, nor will it be available to be matched if the non-resident recipient subsequently becomes UK resident). However, if the recipient turns out to be a temporary non-resident, the capital payment will be treated as having been made in the year of return and can then be matched.
- Capital payments made to a UK resident beneficiary whilst the settlor is deemed domiciled will not be matched with gains which arise in a later year whilst the settlor is still deemed domiciled if the recipient of the capital payment is non-resident when the matching occurs. The aim is to prevent washing out of gains to a beneficiary who will/it is intended will emigrate in the near future/imminently.
- Rebasing elections under paragraph 126 Schedule 7 FA 2008 will continue to be recognised, as will the transitional provisions of para 124 Schedule 7 FA 2008 in relation to any capital payment made to a beneficiary who continues to be common law domiciled outside the UK.
- In this case study in the interests of simplicity it has been assumed that there is no prior income or offshore income gains.
- For simplicity we have ignored whether there are excess capital payments or trust gains prior to 2019/20

Facts and analysis

- Mr A is legally domiciled in Ruritania. He becomes deemed domiciled in the UK on 6 April 2017 and becomes common law domiciled in the UK in 2020/21. He established the Annabelle Trust resident outside the UK in 1960, which has 100% holdings in 3 non-UK incorporated investment companies that are resident outside of the UK.
- The Annabelle Trust has realised Trust gains since 17 March 1998, and these include gains attributed to the trustees by reason of s13 TCGA 1992 from their holdings in the non-resident investment holding companies.
- The trustees have made a valid election for rebasing under para 126 Schedule 7 FA 2008.

- The value of the Annabelle Trust fund is now £30m, of which £10m is held in investment assets which are sold in 2020/21 realising a gain of £3m. In 2019/20 the trustees realised gains of £8.5m.
- In 2020/21 the trustees make a capital payment of:
  - £0.5m to Mr A 's adult son who is resident in Monaco;
  - £0.5m to Mr A's wife who is UK resident but has no personal income or gains of her own;
  - £6.0 m to Mr A.
- At all times Mr A continues to be UK resident.
- Mr A is assessed to tax under s 86 on the gains realised by the trustees in 2020/21 of £3m on the arising basis as he becomes common law domiciled. As Mr A is common law domiciled within the UK relief is no longer available under para 126 Schedule 7 FA 2008 (the position would be different if he retained his foreign domicile and the protection for lost through either benefits received or additions)
- He also pays tax under s 87 on the value of the capital payment he received personally of £6m, as well as in relation to the capital payment of £500,000 (again no rebasing relief is available) to his wife. No supplementary charges are due in relation to these payments, but they could have been had the gains been made in earlier years. The rate of tax due on each payment is 20% making the total amount of tax due of £1.9m (£600k + £100K + £1.2m).
- The capital payment to Mr A's non-resident adult son does not wash out any trust gains.
- Mr A would be entitled to recover the CGT he paid in relation to the capital payment to his wife from the trustees. This recovery and any foreign taxes suffered as a result would not constitute further capital payments.

Notes

Consequential adjustments to the Offshore Fund Regulations will be needed to ensure that the offshore income gains rules will continue to mirror the rules under s87 TCGA 1992. It will be important to ensure that offshore income gains are not taxed under s720 ITA 2007 whilst the trust is protected.

The transfer between settlement rules contained in s89-s90A TCGA 1992 will continue to apply as they do now.

The current rules in relation to supplementary charges will continue to apply.

To provide for instances of unintended tainting, there will be provisions which will allow steps to be taken within a specified grace period (whichever is the later of two years of the addition being made or a year of it first coming to light) to withdraw any additions from a protected settlement that have the effect of tainting the settlement.[21]

It is proposed that gains cannot be washed out where capital payments are made to non-residents. Originally it was also proposed to prevent washing out where capital payments were made to a remittances basis user. This was subsequently abandoned because of the uncertainty that this could cause where mixed funds were not immediately remitted to the UK. Also the definition of capital payments is being extended to include the settlor, and his or her immediate family. Capital payments in such instance will be taxable which would help limit the scope for abuse.

[21] If this is unacceptable then the tainting should only be proportional.

Whilst protection has not been lost and the individual retains their foreign domicile under common law:

- deemed domiciled gains should be assessed on the settlor based on the operation of s87 TCGA 1992, albeit that the settlor should also be assessed on the benefits imparted to his spouse and minor children and minor grandchildren as well as in relation to any benefits that he or she receives (receipt of benefits by such individuals should only result in a tax charge on the settlor).
- benefits will be assessed on the settlor under s87 TCGA 1992 irrespective of the location of the country where they are enjoyed.

During such period s86 TCGA 1992 will only apply to the settlor where property has been added to the settlement (with the grace period applying so the property can be removed to avoid loss of the protection), or where he or she becomes common law domiciled within the UK.

The essential relevant elements of SP05/1992 will be enacted[22] (and bought up to date) and will determine whether a trust has become 'tainted' (this is important to be provide certainty); tainting will be relevant for both capital gains and income tax purposes. A revised SP05/1992 will still need to be retained, and updated.

The definition of capital payment is to be changed so that the settlor should be entitled to be reimbursed by the trustees for any tax liability which incurs as a result of payments to his spouse, minor children or minor grandchildren. Such reimbursement and payment or reimbursement of any foreign taxes should be excluded from the definition of a capital payment.

The effect of a deemed domiciled UK resident settlor ceasing to be a beneficiary will not defeat the way that s86 TCGA 1992 will operate, nor the way that he or she is assessable on capital payments made to close family members.

Once the deemed domiciled UK resident settlor dies, or ceases to be UK resident, his liability to tax under s87 TCGA 1992 and s86 will cease. The assessable person will be the UK residents who receive the capital payments. The position of close family members will now be the same as regards capital payments to non-close family members where they have continued to be the assessable person under the rules.

[22] If enacting SP05/1992 is felt to be too difficult (particularly in the timeframe) consideration can be given to proving the necessary guidance with sufficient in the legislation to allow account to be taken of the guidance.

CASE STUDY 3 (INCOME TAX)

Introduction

We understand that the overall policy objective is that UK resident individuals who become deemed domiciled on or after 6 April 2017 should pay a fair share of UK taxation, whilst not discouraging them from continuing to be resident in the UK.

This case study has been prepared to show how the tax rules could be configured in a way that supports this approach.

We believe the most intuitive and pragmatic way to implement the policy intention is as follows:

1) S.624 ITTOIA 2005 to apply to UK source income arising in the trust;
2) S.720 ITA 2007 to apply to UK income arising in underlying subsidiaries;
3) For foreign income arising in the trust s731 ITA 2007 should apply with appropriate transitional provisions and recognition of the underlying tax credits of the underlying income involved; if it is felt that s731 is not appropriate we have set out an alternative new income tax settlements provision in the Appendix to this case study which would fulfil the same function but without having a statutory defence as in the case of s731 and,
4) S.731 to apply to foreign income arising within underlying companies ideally changing matching to last in, first out) with similar recognition of the underlying tax credits.
5) In all cases (but not the alternative proposition for trust income contained in the Appendix to this case study) the normal defences within s736-s742A ITA 2007 should continue to be available as regards the transfer of assets abroad provisions generally.

In summary:

	Trust	Underlying Company
UK Source	s624 ITTOIA as now	s720 ITA as now
Foreign Source	TA or alternative drafting at Appendix2(1)	s731 ITA

We consider that in applying these rules regard must be had to the types of non-resident trust that are used by non-domiciliaries. Typically they fall into two types. The first is a widely drafted discretionary settlement and the second are life interest (or interest in possession) settlements.

The key characteristics of the first is that income can be retained by the trustees, whereas in the second the net income of the trustees (after expenses) must be distributed to the beneficiary holding the income entitlement. However, the distinction can be blurred where underlying investment companies retain income that would otherwise be available to a beneficiary with the income entitlement.

In the following case study, the trust is a discretionary trust, albeit the difference in practical terms is limited given that s624 ITTOIA 2005 applies in both cases.

Owing to the potential overlap between s633 ITTOIA 2005 and the way that the revised charging rules will apply under s731 ITA 2007 (or the proposed alternative in Appendix 1), only one of those charging provisions will be able to apply. For the purpose of this case study it is assumed that s633 will be switched off in respect of income arsing whilst a settlor is deemed domiciled (as distinct from being common law domiciled within the UK). Given the difficulties with the current s633 ITTOIA 2005 legislation we feel that it should not be used as the primary taxing provision for these changes (as set down in the earlier paper submitted with cross professional body support).

Whilst the case study does not show it, in line with capital gains tax there will be aggregation of benefits so the settlor is subject to tax on all benefits paid to a spouse, minor child or minor grandchild.

Facts and analysis

Mr A is legally domiciled in Ruritania. He becomes deemed domiciled in the UK on 6 April 2017. He established the Annabelle Trust resident outside the UK in 1960, which has 100% holdings in 3 non-UK incorporated investment companies that are resident outside of the UK.

The companies receive a total of £100K UK source income each year. The Annabelle Trust is a discretionary trust, under which Mr A and his family are eligible to benefit. The Annabelle Trust has received foreign income ever since it was first established. S720 ITA 2007 applies to all of the income received by the trustees and their non-resident investment holding companies.

As Mr A has a retained interest under the terms of the Annabelle Trust, prior to becoming deemed domiciled he was assessable on its UK source income as it arose under s624 ITTOIA 2005, and on any foreign income received by the trustees on a remittance basis (as he was a remittance basis user at that time). The Trustees have segregated the foreign income, so it is readily identifiable.

Mr A was also assessable under s720 ITA 2007 in relation to the income received by the non-resident investment holding companies as he has the power to enjoy the income concerned.

The Trustees receive interest that accrued on the client account of their solicitors in London of £50k in 2025/26. This is assessable on Mr A under the income tax settlement rules (s624 ITTOIA 2007).

The trustees' non-resident investment companies have retained a total of £3m of income since Mr A became deemed domiciled. This is taxable under the revised s731 ITA 2007 on a Last In First Out (LIFO) basis. The accompanying pool of tax credits (arising since 6 April 2017) totals £500K which will be attributed to benefits on a LIFO basis as well.

During the course of 2025/26 Mr A receives the following payments from the trustees and from one of the investment holding companies concerned:

- the trustees make an appointment of income of £200K to Mr A
- the trustees appoint £500K capital to Mr A outside the UK
- the investment company makes an interest free loan of £2m to Mr A outside of the UK

At all times Mr A continues to be UK resident.

Mr A is assessed to tax on the payments/benefits received in the following manner:

- The appointment of income by the trustees of £200K is taxed on him under general principles of receiving income from a foreign source.

- The capital appointed to him of £500K is not taxed as a capital payment under the CGT rules; it is taxed as a benefit matched with retained income that arose after the time he became deemed domiciled (the s731 pool).
- In theory, the loan of £2m is capable of being taxed as a CGT capital payment on the interest foregone, or as an income tax benefit under the revised s731 ITA 2007 rules. However, the income tax rules take priority, and the revised s731 rules apply to tax the benefit in the form of the interest foregone. As mentioned above.
- Mr A is also assessed to tax on £100K worth of UK source income received by the companies under s720 ITA 2007, as well as on the £50K worth of UK source income (derived from the solicitor's accounts) received by the trustees under s624 ITTOIA 2005.

Notes

The interaction between the operation of s731 ITA 2007 and foreign income that arose before Mr A became deemed domiciled needs to be set out. This historic s720 ITA 2007 income that arose before Mr A became deemed domiciled will not form part of the "relevant income" pool for the purposes of the s731 charge on the deemed domiciled settlor but will be taxed on Mr A in the event of its remittance to the UK either by Mr A or by another "relevant person" (e.g. the trustees/company). For example, if the cash held in the UK solicitor's account derives from past income, there may have been a taxable remittance of this income.

For clarity, if income is distributed to another beneficiary it will not be available to be taxed on Mr A so that the opportunity for tax to be assessed on Mr A on the remittance basis in relation to this income will be lost unless the beneficiary is a "relevant person" who brings the income to the UK.

The essential elements of SP05/1992 will be enacted (and bought up to date) and will determine whether a trust has become 'tainted'; it will be relevant for both capital gains and income tax purposes. A revised SP05/1992 will still need to be retained, and updated.

There will be provision for the settlor to remove any addition to the settlement within a specified grace period (whichever is the later of two years of the addition being made or a year of it first coming to light). Where the time limits are not observed, the default provision should be that the Protected Settlement is only tainted on a proportionate basis.

APPENDIX: ALTERNATIVE TO s731 ITA 2007 CHARGE AT TRUST LEVEL

If there is concern above motive defence and TFEU freedoms, (albeit that we think that these concerns are misplaced) it could be based on section 628A – section 628C in the draft legislation subject to the following main points (there will also be other points of detail):

(i) Family benefits will be any benefit (whether capital or income) and not just benefits provided out of "protected income".
(ii) The value of benefits will be matched against untaxed protected income.
(iii) Section 628A will take priority over transfer of assets abroad but any income taxed under the transfer of assets abroad provisions in a prior year will reduce the pool of protected income which can be taxed under section 628A if a benefit is received in a future year. Similarly, once a tax charge has arisen under s624, there will need to be provisions which mean that the income ceases to be "relevant income" for s731 purposes.
(iv) Matching will be on a last in, first out basis.
(v) The tax charge will be under section 624 ITTOIA.

(vi) As with “relevant income” for section 731 purposes, protected income can only be matched if it is available to benefit the settlor/spouse/minor children. Therefore income which is used to pay expenses, which belongs to another beneficiary who has an interest in possession or which is distributed to another beneficiary cannot be taxed on the settlor.

(vii) The settlor will be entitled to the same tax credits/reliefs as if he had received the income himself as well as to credit for any tax paid by the trustees.

CASE STUDY 4 (INCOME TAX)

Introduction

The purpose of this case study is to show what would happen if a deemed-domiciled settlor becomes common law domiciled within the UK or if the settlement becomes irreversibly tainted. The notes section sets out the assumptions made in relation to the third case study upon which this analysis is based.

The principal proposition made here is that if s731 ITA 2007 ceases to be applicable in relation to a deemed domiciled settlor because he or she becomes common law domiciled in the UK, or else the trust becomes irreversibly tainted, it will have the effect of: switching on s86 TCGA 1992 as regards the taxation of 'fresh' gains (s87 TCGA 1992 will continue as regards the taxation of benefits until the pool is exhausted); switching on s624 ITTOIA 2005 on the arising basis for 'fresh' trust income; and switching on s720 ITA 2007 on the arising basis for 'fresh' foreign income as regards the settlor/transferor (principally as regards any underlying non-resident company foreign income). S731 will continue as regards the taxation of the settlor on benefits received by the settlor/close family until the relevant income pool (i.e. the income arising while the settlor is deemed domiciled but before the trust is tainted/the settlor becomes common law domiciled) is exhausted.

This case study is based on the facts of case study 3 and shows what would happen if Mr A becomes common law domiciled within the UK in 2025/26 or else the trust becomes irreversibly tainted.

Facts and analysis

- Mr A was originally common law domiciled in Ruritania. He becomes deemed domiciled in the UK on 6 April 2017 and becomes common law domiciled in the UK in 2025/26. He established the Annabelle Trust resident outside the UK in 1960, which has 100% holdings in 3 non-UK incorporated investment companies that are resident outside of the UK.
- The companies receive a total of £100K UK source income each year. The Annabelle Trust is a discretionary trust, under which he and his family are eligible to benefit. The Annabelle Trust has received foreign income ever since it was first established, with a view to avoiding UK taxation. The trustees established the three non-UK resident companies they own with the same intent in mind.
- As Mr A has a retained interest under the terms of the Annabelle Trust, prior to becoming deemed domiciled he was assessable on its UK source income as it arose under s624 ITTOIA 2005, and on any foreign income received by the trustees on a remittance basis (as he was a remittance basis user at that time). The Trustees have segregated the foreign income, so it is readily identifiable.
- Mr A was also assessable under s720 ITA 2007 in relation to the income received by the non-resident investment holding companies as he has the power to enjoy the income concerned.
- The Trustees receive interest that accrued on the client account of their solicitors in London of £50k in 2025/26 as well as £500,000 of overseas income. This is all assessable on Mr A under the income tax settlement rules as he is common law domiciled in the UK. The trustees' non-resident investment companies have retained a total of £3m of income since Mr A became deemed domiciled. This will be taxable under the revised s731 ITA 2007 on a Last in First Out basis (LIFO) basis until the pool of relevant income is exhausted. The accompanying pool of tax credits totals £500K and will be attributed to benefits on a last in first out basis as well.
- During the course of 2025/26 Mr A receives the following payments from the trustees and from the one of the investment holding companies concerned:
  - the trustees make an appointment of income of £100K to Mr A

  - the trustees appoint £500k capital to Mr A outside the UK
  - the investment company makes an interest free loan of £2m to Mr A outside of the UK
- At all times Mr A continues to be UK resident.
- Mr A is assessed to tax on the payments/benefits received in the following manner:
  - The appointment of income by the trustees of £100K is taxed on him under general principles of receiving income from a foreign source.
  - The capital appointed to him of £500K is taxed as a benefit matched with retained income that arose after the time he became deemed domiciled (the new s731 ITA 2007 pool) rather than under the provisions of s87 TCGA 1992. S.633 can only apply to income which arises after Mr A has become common law domiciled in the UK. S.87 TCGA will apply a capital gains tax benefits charge where there is insufficient relevant income to charge the benefit under s731 ITA 2007.
  - The interest free loan of £2m is taxed as a benefit (interest foregone) under s731/s87 which continues to apply until such time as the pool of relevant income/gains is exhausted.
- Finally, Mr A is taxed on all of the foreign income arising within the trustees' three investment companies under the terms of s720 ITA 2007 as he has power to enjoy such income and is now common law domiciled in the UK.

Notes

We believe the most intuitive and pragmatic way to implement the policy intention is as follows:

1) S.624 ITTOIA 2005 to apply to UK source income arising in the trust;
2) S.720 ITA 2007 to apply to UK income arising in underlying subsidiaries;
3) For foreign income arising in the trust s731 ITA 2007 should apply with appropriate transitional provisions and recognition of the underlying tax credits of the underlying income involved; if it is felt that s731 is not appropriate we have set out an alternative new income tax settlements provision in the Appendix which would fulfil the same function but without having a statutory defence as in the case of s731 and,
4) S.731 to apply to foreign income arising within underlying companies (changing matching to last in, first out) with similar recognition of the underlying tax credits.
5) In all cases the normal defences within s736-s742A ITA 2007 should continue to be available (except as regards the provisions in Appendix 1) as regards the transfer of assets abroad provisions generally.

Owing to the potential overlap between s633 ITTOIA 2005 and the way that the revised charging rules will apply under s731 ITA 2007, only one of those charging provisions will be able to apply. For the purpose of this case study it is assumed that s633 will be switched off in relation to income arising whilst a settlor is deemed domiciled. Given the difficulties with the current s 633 ITTOIA 2005 legislation we feel that it should not be used as the primary taxing provision for these changes (as set down in the earlier paper submitted with cross professional body support).

Whilst the case study does not show it, in line with Capital Gains Tax there will be aggregation of benefits so the settlor is subject to tax on all benefits paid to a partner, minor child or minor grandchild.

The interaction between the operation of s731 ITA 2007 and foreign income that arose before Mr A became deemed domiciled needs to be set out. This historic s720 ITA 2007 income that arose before Mr A became deemed domiciled will not form part of the "relevant income" paid for the purposes of the s731 charge on the deemed domiciled settlor but will be taxed on Mr A in the event of its remittance to the UK either by Mr A or by another "relevant person" (e.g. the trustees/company). For example, if the cash held in the UK solicitor's account derives from past income, there may have been a taxable remittance of this income.

For clarity, if income is distributed to another beneficiary it will not be available to be taxed on Mr A so that the opportunity for tax to be assessed on Mr A on the remittance basis in relation to this income will be lost unless the beneficiary is a "relevant person" who brings the income to the UK.

The essential elements of SP05/1992 will be enacted (and bought up to date) and will determine whether a trust has become 'tainted'; it will be relevant for both capital gains and income tax purposes. A revised SP05/1992 will still need to be retained, and updated.

The definition of benefit is to be changed to exclude any payment made to a foreign state in relation to tax due on the settlor on any income or gains of the trustees or their offshore companies.

The proposals contain provisions which will allow steps to be taken within certain time limits to withdraw additions from a protected settlement that have the effect of tainting the settlement. Where the time limits are not observed, the default provision should be that the Protected Settlement is only tainted on a proportionate basis.

The operation of the proposed s731 ITA 2007 pool is beneficial to deemed domiciled settlors because it has the effect of switching off the rules that would tax income on the settlor/transferor on an arising basis - under s624 ITTOIA 2005 or s720 ITA 2007. This however, is the policy intention outlined by the Chancellor. This beneficial effect will come to an end as regards "fresh" income if the settlor becomes common law domiciled within the UK or the trust is tainted.

Appendix: Alternative to s731 ITA 2007 charge at the trust level

If there is concern above motive defence and TFEU freedoms (albeit that we think that these concerns are misplaced) it could be based on section 628A – section 628C in the draft legislation subject to the following main points (there will also be other points of detail):

(i) Family benefits will be any benefit (whether capital or income) and not just benefits provided out of "protected income".
(ii) The value of benefits will be matched against untaxed protected income.
(iii) Section 628A will take priority over transfer of assets abroad but any income taxed under the transfer of assets abroad provisions in a prior year will reduce the pool of protected income which can be taxed under section 628A if a benefit is received in a future year.
(iv) Matching will be on a last in, first out basis. Similarly, once a tax charge has arisen under s624, there will need to be provisions which mean that the income ceases to be "relevant income" for s731 purposes.
(v) The tax charge will be under s624 ITTOIA.
(vi) As with "relevant income" for s731 purposes, protected income can only be matched if it is available to benefit the settlor/spouse/minor children. Therefore income which is used to pay expenses, which belongs to another beneficiary who has an interest in possession or which is distributed to another beneficiary cannot be taxed on the settlor.
(vii) The settlor will be entitled to the same tax credits/reliefs as if he had received the income himself as well as to credit for any tax paid by the trustees.