STEP Guidance Note: Clarification on certain aspects of the draft legislation on the taxation of non-domiciliaries and offshore trusts published on 5 December 2016 and 26 January 2017

The draft legislation that has been published for consultation relating to the changes to the taxation of non-domiciliaries and offshore trusts is extremely complex and leaves a number of areas of uncertainty, many of which have been highlighted in the formal responses which STEP Technical Committee has submitted to HMRC. HMRC have given further clarification on the issues set out below.

STEP query to HMRC relating to rebasing (para 41 Sch 1 FB 2017)

There has been some uncertainty as to whether the small change to the draft legislation issued on 26 January relating to rebasing for those resident non-domiciled individuals (RNDs) who will become deemed domiciled in the UK on 6 April 2017 (as a result of having been UK resident for 15 out of the previous 20 years) was intended to allow rebasing to apply to gains on non-reporting status offshore funds (offshore income gains).

STEP's UK Technical Committee has confirmed with HMRC that this is indeed what was intended. See query and response below.

QUERY: STEP UK Technical Committee

'We are writing to clarify the change to what is now paragraph 41(5) of the draft legislation which was issued on 26 January 2017.

The opening words now read: 'In computing, for the purposes of TCGA 1992', rather than: 'In computing, for the purposes of capital gains tax'.

Our understanding is that the purpose of the change is to clarify that rebasing will apply to non-reporting status offshore funds.

The change tallies in with the *Offshore Funds (Tax) Regulations 2009* which provides (regulation 39(1)) that the starting point for calculating an offshore income gain is to work out the amount which would be the gain on the disposal in question 'for the purposes of TCGA 1992'.

The effect of this is that, in accordance with paragraph 41(5), the question as to whether or not an offshore income gain arises on the disposal of a non-reporting status offshore fund must be calculated on the assumption that the asset was acquired on 5 April 2017 for a consideration equal to its market value on that date assuming the normal conditions for rebasing set out in paragraph 41 are satisfied and that the taxpayer has not elected for paragraph 41 not to apply to the disposal.

We would be very grateful if you could confirm that we have understood this correctly.

RESPONSE: HMRC Specialist Personal Tax, Assets and Residence Policy

Yes the change does mean (subject to the other conditions at Part 3 to the Schedule) that gains chargeable to income tax can be rebased to 5 April 2017.

STEP query in relation to cleansing rules (para 44 Sch 1 FB 2017)

QUERY: STEP UK Technical Committee

In relation to the draft amendments to the mixed fund rules set out in para 44 of Schedule 1 FB 2017 (as published on 26 January 2017), could you confirm whether or not it is intended that these rules will apply to mixed funds which contain income and capital gains which arose prior to 6 April 2008? We have heard that an indication may have been given by HMRC that such income/gains cannot be cleansed.

This is not however apparent from the draft legislation, which places no limit on the taxpayer's ability to nominate what income/gains/capital are to be treated as contained in the offshore transfer. We appreciate that the mixed fund rules do not apply to pre-2008 income/gains but para 44 (4) seemed to be intended to be wide enough to deal with this.

In our view, if the position is that cleansing by nomination will not apply to pre 6 April 2008 income and gains in a mixed account, then this will limit substantially the usefulness of these provisions. In particular, it would reduce the amount of capital which can be made available for investment into the UK, which we understand was one of the main policy reasons for introducing the ability to segregate mixed funds in the first place.

It is also important that the position should be made clear as most advisers are currently under the impression that pre-2008 income/gains can be segregated.

It would be very useful if HMRC could publish some examples showing the position in relation to accounts with pre and post 6 April 2008 income and gains.

RESPONSE: HMRC Specialist Personal Tax, Assets and Residence Policy

I can confirm that the cleansing only applies for the application of section 809Q(3) of ITA 2007 in relation to the individual. Because pre-2008 funds are not caught by section 809Q(3), they are not affected by the new cleansing rules.

Detailed guidance including worked examples will be published later in the Spring.

Further clarification on rebasing, cleansing, offshore trusts and UK residential property

Clarification of certain points by HMRC speakers made at IBC Tax Conference on 25 January 2017, chaired by barrister Patrick Soares and featuring HMRC speakers Craig Mason and Antonio Zagara

It was stressed that the legislation was just that – draft. There is likely to be more legislation published in January *(subsequently occurred)* but until the Finance Bill is published after the Budget in March 2017, practitioners should proceed with caution as things could change.

A. Rebasing

1. Confirmed that rebasing extends to assets held through partnerships, including LLPs, and held through nominee.
2. It is necessary that the RBC is paid this year or in an earlier year to obtain the benefit of rebasing.
3. Includes assets acquired between 6 March 2016 and 6 April 2017

Subsequently confirmed in revised legislation published on 26 January and by HMRC that rebasing will apply to offshore income gains (OIGs).

B. Cleansing and rebasing

1. Cleansing can apply to any foreign domiciliary who has been subject to the remittance basis in the past (other than a formerly domiciled resident) if they have mixed fund accounts. Cleansing still available even if a domicile of choice has now been acquired. *Note: it seems anomalous that a formerly domiciled resident cannot get the benefit of cleansing of mixed funds but an individual with a foreign domicile of origin who has now become domiciled here as a matter of general law can do so.*
2. There is no ordering rule in the statute and so you transfer out what you want to transfer out provided you can be clear that it constitutes the amounts of income, gains and capital in the transferring account. *Subsequent changes to cleansing made other comments redundant.*
3. The reference to account B in the provisions does not limit the number of accounts into which a transfer can be made.

C. Offshore trusts

1. Look to the 1991 rules for interpretation of additions / tainting. Golden trusts should be regarded as a jewel to be preserved and not much sympathy from HMRC if tainted. People should be careful.
2. Loans made after April would have to be demonstrably commercial on arms-length otherwise caught as tainting.
3. Interest free loans repayable on demand and made before April would in HMRC's view constitute tainting in the light of the 1991 interpretation and ESC D41 but HMRC recognised there were alternative views and considering this issue and the basis of liabilities further. Raises difficult points including matters such as power to revoke which is not exercised – is this tainting?
4. Additions from parties who are not settlors do not taint the settlement as far as the original settlor is concerned although the addition may have other implications for the funder.
5. Capital payments: If capital payments are made in earlier years to non-residents <u>and matched</u> prior to April, is there a problem? Para 19 (4)(b) suggests that they have to be recomputed and those payments not treated as matched against gains. HMRC said this is not the intention and will review the relevant para. The intention is that payments to non-residents made before April <u>that are matched</u> pre-April are unaffected. It is only unmatched payments to non-residents that are ignored post April, i.e. a large unmatched capital payment made now to a non-resident (unless temporarily NR) cannot be used to match and wash out future gains arising after 6 April.

D. UK Residential Property

1. The aim is to alter the definition of excluded property without doing major surgery on IHT rules.
2. Relevant loan widely defined and intended to be so, but HMRC interested to hear practical situations where it is perceived the rules go too far.
3. Important to distinguish between loans to individuals and trusts caught by para 4 and loans to close companies (whether by individuals or other close companies) that are caught by para 2 and para 9.

4. Collateral given for loans recognised as going too far and HMRC will look again at this with view to cap. Generally collateral not intended to be caught insofar as it exceeds the loan it is securing. Rights of set off also need to be examined.
5. Commercial loans and investments by unconnected third-party investors into UK residential property are relevant loans within para 4 or potentially within para 2 but generally will not be charged unless the third party investor is itself an individual, trust or closely controlled bank.
6. Two-year rule for individuals deliberately intended to apply to disposal of company shares not to disposals of the residential property. Disposal of shares is caught under the two-year rule quite deliberately because it avoids other taxes such as SDLT and non-residents CGT. A sale of shares cannot therefore be done as a deathbed measure. Disposal of property itself does not avoid other taxes and therefore the two-year run off does not apply.
7. 1% de minimis rule – HMRC have yet to receive any representations on this point.

Further clarification regarding the new trust protection rules and additions to trusts

During the course of the consultation process, HMRC were asked to clarify whether an addition to a trust would be made (so that the trust would lose its 'protected' status under the new rules) where a loan on 'non-commercial' terms was left outstanding or, in certain circumstances, where the settlor has a power to revoke the settlement. The following response was received from HMRC on 14 February 2017 and they subsequently confirmed that the points set out below would also apply in relation to the income tax provisions.

In relation to the reference to the payment of interest in the highlighted text in point 1, HMRC have been asked about this. A response is expected next week and there is likely to be a slight amendment as a result.

RESPONSE: HMRC Specialist Personal Tax, Assets and Residence Policy

‘1. A repayable on demand loan which was made directly or indirectly to a relevant trust prior to 6 April 2017 on non-commercial terms e.g. at a low or nil rate of interest and which remains outstanding on that date will generally be regarded as a provision of property for the purposes of the settlement. Consequently, where after 5 April 2017 a loan has not been repaid or adjusted to commercial terms, the condition at new sub paragraph 5A(1)(e) would be met. The provision at 5A(1)(e) will apply equally where the loan was initially for a fixed period but falls to be repaid after 6 April 2017 such that it becomes a repayable on demand loan. There will however be a transitional provision so that the condition is not regarded as met where, before 6 April 2018, the loan is either repaid in full together with any outstanding interest or made subject to fully commercial terms, including a commercial rate of interest payable at least annually for the year ending 5 April 2018 and subsequent years and in addition interest at a commercial rate or a sum in lieu thereof has been paid in respect of the year ended 5 April 2017.

2. Certain trusts require the settlor to have the power to revoke the trust to safeguard the position of beneficiaries. HMRC will not regard the failure to exercise such a power the same as an addition of property or value to the trust and therefore it will not cause the trust to lose its protection.’

STEP
ADVISING FAMILIES ACROSS GENERATIONS

Clarification of carried interest – s103KE *Taxation of Chargeable Gains Act 1992*

HMRC has provided clarification on carried interest/relief under s103KE *Taxation of Chargeable Gains Act 1992* (TCGA 1992), and has confirmed that its guidance, when published, will reflect this view.

In short, HMRC has confirmed that credit is available where a fund manager suffers tax on a distribution from an offshore trust that is made to enable the fund manager to pay tax on carried interest held in the trust or to repay a loan taken out to pay the tax on the carried interest.

HMRC Policy & Technical Adviser, Financial Products & Services

We consider that s103KE TCGA 1992 can provide relief where:

- a distribution is made from an offshore trust which holds the right to receive the carried interest arising from performance of investment management services by the investment manager, with the express intention of defraying the tax liabilities charged upon the investment manager under S103KA 1992 for those services; and

- that distribution is made by way of a payment made directly from the trust to the investment manager after the trust has received the payment of carried interest.

Clause 37 of the Finance Bill currently progressing, excludes carried interest gains from the rules within s86 and s87 TCGA 1992. If there is a tax charge resulting from a capital payment made by the trustees to the investment manager to defray the latter's tax charge under s103KA, such that the capital payment is matched against other income, offshore income gains or non-carried interest gains, then tax in respect of the capital payment should be relievable under s103KE.

Where the fund manager has taken out a loan either from the trust itself or from a third party and it can be demonstrated that the payment from the trust is for the express purpose of settling a debt that was taken out to settle a tax charge arising under s103KA TCGA 1992, then we will accept that any associated tax charge on that individual can be relieved under s103KE.

Where this payment is made to another individual because the investment manager is expressly excluded from being a beneficiary of the trust we do not consider that S103KE can apply. Where the payment from the trust is going to another person, we do not consider that the link between the distribution from the trust and the carried interest can be sufficiently strong enough to demonstrate that a charge arising to that individual is in relation to carried interest.

In equivalent circumstances, s809EZG ITA 2007 can provide relief where an offshore trust makes a payment to satisfy a tax liability arising in respect of income based carried interest.

We consider that our position satisfies the policy intention that where another tax arises in relation to carried interest or a DMF, a claim can be made to reduce the carried interest charge or the other tax, under the terms of the relevant statutory provisions.