STEP response to HMRC’s consultation on Tax Avoidance Involving Profit Fragmentation.

About us

STEP is the worldwide professional association for those advising families across generations. We help people understand the issues families face in this area and promote best practice, professional integrity and education to our members.

Today we have over 20,000 members across 95 countries, with over 7,000 members in the UK. Our membership is drawn from a range of professions, including lawyers, accountants and other specialists. Our members help families plan for their futures: from drafting a will or advising family businesses, to helping international families and protecting vulnerable family members.

We take a leading role in explaining our members’ views and expertise to governments, tax authorities, regulators and the public. We work with governments and regulatory authorities to examine the likely impact of any proposed changes, providing technical advice and support and responding to consultations.

STEP welcomes the opportunity to respond to this consultation.

Response

General

STEP welcomes the opportunity to provide comments on HMRC’s consultation document, which outlines the government’s intention to further tackle ‘arrangements entered into by individuals, partnerships or companies that aim to place profits proper to the UK outside the scope of UK taxation’. We note that ‘profit fragmentation’ does not appear to us to accurately encapsulate this.

We note, however, that in common with a number of recent consultations, HMRC appear to have bypassed stage 1 of the consultation process (setting out objectives and identifying options) and have instead gone straight to stage 2. We consider that it would greatly improve the way tax policy and legislation is developed if stage 1 of the consultation process could be followed as it allows consideration of other options at an early stage.

We agree with the premise that it is right and fair that everyone pays all the tax they owe, including on offshore income, gains and chargeable transfers. Importantly, however, any fair tax system needs to strike an appropriate and proportionate balance between collecting the right amount of tax due under the law and the right of taxpayers for clear and comprehensible legislation, giving both certainty and finality in their affairs where they have acted openly and honestly with the tax authorities.

We note that, as was acknowledged by Mr David Richardson of HMRC in his evidence to the Committee considering Tax Evasion and Avoidance Enquiry on 17th April 2018, the amount of tax
avoidance activity in the UK economy has declined enormously since the enactment of the rules relating to the disclosure of tax avoidance schemes in the Finance Act 2004.

In addition, there are now a whole raft of penalties which have recently been introduced both for taxpayers and for enablers which are intended to (and no doubt will succeed in) deterring both taxpayers and advisers from entering into and/or promoting these sorts of arrangements.

We also note that, as recognised in paragraph 2.7 of the consultation document, in practice, all the examples set out in the consultation document would be vulnerable to challenge under existing legislation, particularly under the transfer of assets abroad legislation contained in Chapter 2 of Part 13 Income Tax Act 2007 (‘TOAA’). Paragraph 2.16 recognises that challenges are also possible under the rules relating to transfer pricing, disguised remuneration and other legislation (including the disguised investment management fees rules (‘DIMF rules’) and the General Anti Abuse Rule (‘GAAR’)).

The consultation document notes, however, in paragraphs 2.4 and 2.16 that the necessary enquiries consume considerable resources and can take several years to resolve and one aspect of the proposals is to remove cash flow advantages for users of the defined arrangements.

That being noted, we have concerns that another level of wide ranging anti-avoidance legislation which duplicates elements of pre-existing legislation adds complexity without removing the necessity for both HMRC and taxpayers to consume considerable resources and time. See for example, paragraph 4.6 of the consultation document, which in dealing with the ‘excessive profits’ condition notes ‘It is proposed that this “excessive profits” test will involve examining all of the facts around the arrangements’.

We also have concerns (set out below) regarding the scope and drafting of the notification and advance payment provisions and its interaction with pre-existing legislation. We consider that a possible alternative approach would be to introduce a DOTAS hallmark to deal with this type of avoidance. This would then feed in to the pre-existing notification provisions and the accelerated payment provisions introduced in Finance Act 2014 (which is acknowledged should take priority) or under the GAAR.

**Description of proposal:**

HMRC are concerned with the case where A, who carries on a business or trade in the UK, causes profits to be alienated to an offshore vehicle, V Ltd, which pays tax at a low rate, and there is some means by which the profits paid to V Ltd can benefit A or a person linked to A.

HMRC’s concern is that V Ltd is not carrying on a trade or profession in the UK and therefore is over-rewarded. In reality the profits derive from A’s trade or profession and hence should be declared in the UK.
HMRC propose a scheme whereby if the following conditions are satisfied, the profits will be added to A’s UK profits:

**Condition 1:** There are profits attributable to the trading or professional skills of an individual (A) who is resident in the UK.

**Condition 2:** Some or all of the profits end up in an off-shore entity (V Ltd), resulting in “significantly less tax” being paid than would have been payable had the profits accrued to A.

This will involve a comparison between the real tax rate suffered on the alienated profits and the tax rate that would have been suffered had profits accrued to A. If the former is 80% or less of the latter, the second condition is satisfied.

**Condition 3:** Either (1) A, or (2) a connected person, or (3) a person acting together with A or the connected person, is able to enjoy the economic benefits from the alienated profits. Although the consultation paper is not entirely clear on this issue, it appears that condition 3 can be satisfied by one of two tests:

1. **“Power to enjoy”**

   Condition 3 can be satisfied if A has a “power to enjoy”. This is meant to cover situations where A benefits from the profit in some indirect way. This will use the definitions in 809EZDA – 809EZDB of ITA 2007, which provide that A has the power to enjoy when:

   a. a sum is dealt with by a person so as to enure for benefit of A or a person connected with A;
   b. a sum is used to increase the value to A or a connected person of an asset which A or a connected person holds or has a beneficial interest in;
   c. A or a connected person receives or is entitled to receive any benefit provided out of the sum;
   d. A or a connected person may become entitled to beneficial enjoyment if a power is exercised (by anyone);
   e. A or a person connected with A is able in any manner to control the application of the sum.

2. **“Acting together”**

   Separately from the above, the consultation document will also introduce the concept of “acting together”. This is meant to capture the situation where A and V Ltd are not formally
connected, but they engage in a transaction that would not occur at arm’s length between commercial parties:

e.g. A provides a service to B, B then pays V Ltd, and A receives no salary (or anything else) from V Ltd. In this case, the court might presume that A is closely connected to V Ltd in some way.

The consultation document suggests that the legislation will apply to this example by providing that A enjoys the alienated profits if, as a matter of fact, A is able to control V Ltd. Factors that will suggest A has control over V Ltd will be:

a. A can influence where funds go and how they are allocated, or
b. A can influence how V Ltd conducts its affairs, or
c. “Persons will also be connected if they are able to act together in ensuring that funds are allocated in a particular way”.

**Condition 4**: Some or all of V Ltd’s profit is excessive having regard to the profit-making functions it performs. This is based upon test in section 850C(3) of ITTOIA 2005.

**Consultation Questions**

**Question 1**: The government would welcome any evidence and information about these and similar arrangements to assist it in designing legislation that is properly targeted and does not bear inappropriately on businesses that pay all the taxes due in the UK.

We do not have any further additional information but note that STEP has signed up to the "professional conduct in relation to taxation" code and that, as a result, it would not expect its members to be advising on these sorts of arrangements where they are uncommercial, lack substance and are probably caught by existing anti-avoidance rules.

**Question 2**: The government would welcome comments on whether any additional conditions are required to ensure that the approach set out above is effective and robust.

We do not consider any additional conditions are required, but please see responses below. In addition, the consultation document is not clear on the precise implications for foreign domiciled taxpayers (see paragraph 3.12) and it would be helpful to understand what HMRC consider these to be in order for meaningful comment to be made.

**Question 3**: Will the proposed conditions allow most businesses to decide quickly and simply whether or not they are caught by the legislation?

As noted above, both the recognition that all the facts need to be examined and the expressed priority of the existing anti-avoidance legislation (see paragraph 4.21 of the consultation document)
will not, in our view, allow most businesses to decide quickly and simply whether they are caught by the legislation. A detailed examination will now need to be made of the factual matrix as applied to the differing requirements of the pre-existing anti-avoidance legislation (such as the TOAA and/or DIMF legislation) and the additional different requirements of the proposed new legislation. Detailed professional advice will often be necessary.

The fact that it is intended that ‘if [existing anti-avoidance] legislation only leads to a charge to tax in a later year or accounting period, the proposal is that the new legislation will apply in the earlier year or accounting period’ with later adjustments (see paragraphs 4.22 and 4.23) adds to the complexity.

In addition, the Condition 1 requirement currently applies where there are profits attributable to the trading or professional skills of an individual (A), not the offshore company, V Ltd. There is, however, no discussion of what it means for profit to be *attributable* to an individual in this context.

In particular, if A is an employee of V Ltd (see paragraph 2.7), A’s acts are, *prima facie*, attributable to V Ltd, that is V Ltd acts through A. As such, we do not think it is entirely clear to ask whether the profits are attributable to the employee (A), rather than the company (V Ltd) in this scenario.

We note that the “attribution” test in Condition 1 is derived from rules concerned with taxation of partners (where it does make sense to ask if profits are attributable to the services provided by one partner rather than another) but we do not consider that they work in a case involving a company (V Ltd) and its employee (A).

**Question 4. Will this test of a lower rate of tax be effective?**

We note that it is not clear whether this test will be by reference to corporate rather than individual UK tax rates. In addition, we note that a trigger ‘in the region of 80% of the UK tax that would have been paid’ is, at present, imprecise. As noted above the additional proposed comparison and time apportionment provisions will mean that compliance costs are likely to be considerable, contrary to the aims set out in paragraph 4.2 of the consultation document.

**Question 5. Are there any alternatives which should be considered?**

We do not consider that there are any alternatives that should be considered as the existing anti-avoidance provisions are sufficient to deal with the problems identified.

**Question 6. The government would welcome views on any genuine activities carried on in low tax territories which might require special consideration.**

We consider that there will be a number of genuine activities that will need consideration, depending on the precise drafting of the legislation; for example, charities may need an express
exemption. In addition, there has been recent specific legislation in relation to investment management groups and although it may well be that Condition D is not satisfied due to the commerciality of their arrangements, the notification and advance payment proposals (considered below) will cause concern.

**Question 7. Any comments on the excessive profits test would be welcome.**

The “excessive profit” test is found in Condition 4, and provides that some or all of V Ltd’s profit is excessive having regard to the profit-making functions it performs (i.e. that it is over-rewarded). This test is based on section 850C(3) of ITTOIA 2005, which is concerned with taxation of partnerships, and has the purpose of ensuring that that partners cannot swap profits/losses in order to lower their tax bill.

Translated to the context of profit fragmentation, we consider that there are difficulties with both limbs of this test. As to the first limb, this essentially asks whether the profit is attributable to A’s work, or to V Ltd’s work and there may be some duplication with Condition 1. As noted above, if A is an employee of V Ltd, then it is (arguably) proper to attribute the profits to V Ltd in any event.

As to the second limb, A would receive “excessive profit” if he has a “power to enjoy” V Ltd’s share of the profit. Again, this repeats an earlier aspect of the test, as Condition 3 is satisfied if A has a “power to enjoy” V Ltd’s share of the profits.

**Question 8. Is the use of “power to enjoy” as a test the best way of addressing these schemes?**

The “power to enjoy” test is found in Condition 3, which is satisfied either if there is a “power to enjoy” or if the court is satisfied that A and V Ltd are “acting together”.

The “power to enjoy” and “acting together” tests are quite different. The former (which is to be based on the DIMF provisions) asks whether A is in fact enjoying the profits of his work, whereas the latter asks whether A is in fact controlling V Ltd. We note that the present provisions in the Taxes Acts dealing with ‘control’ are complex.

As noted above, there are already a number of anti-avoidance provisions which utilise ‘power to enjoy’ tests which could apply to the proposed arrangements. It would be helpful if HMRC could clarify if the “power to enjoy” and “acting together” are intended to be cumulative or alternative conditions.

**Question 9. Will the “power to enjoy” rules catch all likely targets?**

We will need to consider the precise legislation. As noted above, HMRC recognise that all their present examples will be within the TOAA provisions in any event.
Question 10. Will they risk bringing in arrangements where no tax avoidance is involved?

We do consider that, depending on the precise drafting of the provisions, the width of the proposals will risk bringing in arrangements where no tax avoidance is involved.

Of most concern in this respect are the advance notification and payment provisions which are intended to apply before it is established whether Condition 4 is, in fact, satisfied.

Question 11. The government would welcome comments as to whether this [“acting together”] connection test is appropriate.

See the response to Question 8.

Question 12. Will this connection rule bring in any arrangements where avoidance is not involved?

See the response to Question 10.

Question 13. Do you have any other comments on this proposed rule?

We have no further comments, except to note that, as set above, we consider the existing anti-avoidance provisions are sufficient to deal with the problems identified.

Question 14. What potential double taxation should be taken into account in the legislation?

We note that the consultation paper does not make clear precisely how relief for double taxation is to work. For example, in a case which fell within the rules, will A’s UK tax be net of the foreign tax? i.e. if V Ltd paid tax at 70% of UK rate, would A be given credit for this in his tax return?

We note that it is intended to also give relief for overseas tax.

Question 15. Any comments on interaction with other anti-avoidance legislation would be welcome.

See our response to Question 3.

Question 16. The government would welcome comments on the features which should be included in the notification requirements.

As noted above, we are concerned that the proposed notification provisions which will be set deliberately wider than the conditions required to bring the sums into charge (Condition 4 not needing to be satisfied at the first stage: paragraph 4.26 of the consultation document), will bring
commercial arrangements with no element of tax avoidance into a costly and time consuming regime.

We are also concerned at the proliferation of more (and possibly duplicative) legislation and the indirect widening of the Finance Act 2014 accelerated payment provisions in additional (and different) legislation, particularly as the precise scope of the FA 2014 provisions has itself resulted in a plethora of litigation and consequent uncertainty.

The consultation document also recognises at paragraph 4.30 that work is also in progress in the EU and at the OECD on the upcoming "mandatory disclosure requirement" which will require UK advisers/service providers to report CRS avoidance arrangements and opaque offshore structures to the UK authorities. We question whether there is a need to have yet another disclosure regime for this particular type of arrangement given the pre-existing and upcoming disclosure legislation.

**Question 17. The government would welcome comments on these proposals for payment of tax for users of these arrangements.**

We note that is not entirely clear that it is intended that payment is to be made within 30 days of a ‘preliminary notice’ (see paragraphs 4.31. to 4.35 of the consultation document) but this is alluded to in paragraph 3.18 of the consultation document. In relation to payment of tax within 30 days, we can see some logic in non-UK residents having to pay tax within this period as usually they will not be in the self-assessment regime. However, the position is very different for UK resident taxpayers, whose compliance burden will only be increased, as presumably will HMRC’s, particularly bearing in mind the complexity of the legislation and its interaction with other anti-avoidance legislation. In addition, a 30 day window may not allow a client sufficient time to seek advice.

In relation to the review period, we note that 30 days is a short timetable and our members have very little experience of an HMRC review leading to a different outcome.

We welcome the inclusion of the appeal process at the end of the review period.

**Question 18. Are there any conditions in particular which might impose onerous reporting burdens on companies not involved in avoidance?**

See our response to Question 16.

**Question 19. Views would be welcome on whether there are alternative approaches to preventing the avoidance without affecting genuine commercial arrangements.**

We consider that as the consultation document recognises both that all the examples provided would be subject to challenge under the TOAA provisions and that a detailed fact based analysis will need to be undertaken in establishing whether Condition 4 is, in fact satisfied, the TOAA provisions
(with the motive defence provisions) and the other potentially applicable legislation (such as the DIMF rules, the disguised remuneration rules, the transfer pricing rules and the GAAR) are sufficient to deal with the problems identified.

**Question 20.** Are there any other considerations that the government should take into account when considering the design of this legislation?

We note that where the rules apply, A’s trading profits (or if they act through a UK company, the company’s profits) will be increased by the profits that have arisen to V Ltd. It is not clear, at present, whether all of V Ltd’s profits, or only the excessive proportion will be added to A’s profits.

**Question 21.** Do you have any comments on the assessment of equality and other impacts?

We have no additional comments.

Submitted by STEP Technical Committee on 8 June 2018