STEP Comments on Finance (No. 2) Bill 2017-19  
Clause 35/schedule 10  
Offshore trust anti-avoidance provisions

Introduction

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.

Comments

STEP has previously commented on the draft legislation published on 13 September 2017. We are pleased to see that a number of our comments have been taken into account in the legislation contained in the Finance Bill which was published on 1 December 2017 and in the proposed government amendments to the settlements code provisions published on 20 December 2017. We do however remain very concerned that the legislation is extremely complex. It is very difficult to understand the meaning and effect of some parts of the legislation. This is likely to result in significant areas of disagreement between HMRC and taxpayers/their advisers.

In addition, the legislation still contains loopholes which open up potential avoidance opportunities. Whilst these may in some circumstances be countered by the GAAR, it does not seem to us to be sensible to put in place such complex legislation which contains these sorts of defects.
Although we accept the need to have appropriate anti-avoidance rules, we would strongly urge the government and HMRC to give further thought to these changes in order to ensure that they work as intended. Indeed, in our view, the whole anti-avoidance regime relating to offshore trusts has become too complicated. We understand there are relatively few individuals within HMRC who are specialists in this area. Equally, there are many advisers who will find it difficult to keep on top of all of the anti-avoidance provisions and so ensure that their clients are fully compliant.

We note that the government has announced that a review of the taxation of trusts will take place in 2018. This would be an ideal opportunity to review all of the anti-avoidance provisions which relate to offshore trusts with a view, if possible, to simplifying the existing regimes as well as to tackle any avoidance opportunities, including those at which schedule 10 is currently aimed.

We appreciate that withdrawing clause 35/schedule 10 is politically sensitive but we believe a government commitment to address these issues as part of an overall review of the taxation of trusts would be preferable to complicating an already extremely complicated piece of legislation. It would make sense in terms of ensuring that we have a tax system which is coherent as well as hopefully being simpler, fairer and which does not leave open significant avoidance opportunities.

There is also an issue here as to the competitiveness of the UK as a destination for wealthy individuals. More and more countries have beneficial tax regimes for new residents, many of which are much simpler to understand than the UK rules. It is clear from what our members have told us that foreigners are leaving the UK as a result of the changes which have been made to the non-dom rules. Introducing further anti-avoidance provisions which advisers will find it difficult to explain to clients either with clarity or with certainty will encourage more people to leave as well as discouraging people from coming to the UK.

For the reasons set out above, our current position is that schedule 10 should be reconsidered and should therefore be withdrawn from the current Finance Bill. However, we understand that the government may still decide to go ahead with the changes and we therefore set out our main comments on the legislation below in case the parliamentary timetable and the availability of parliamentary counsel allows for further changes to be made.

1 Capital gains tax – onward gifts
1.1 New section 87J divides a capital payment into a matched part and an unmatched part of the payment. It then divides the matched part into a taxed portion and an untaxed portion.

Not surprisingly, the main rule is that the taxed part of the matched amount of the capital payment is the amount on which the recipient is subject to capital gains tax (as a result of being UK resident and, if a remittance basis user, having remitted all or part of the payment to the UK).

However, section 87J(5) contains different provisions where a capital payment is matched against the schedule 4C pool. In those circumstances, the whole of the matched amount is treated as “taxed” even if the recipient is a remittance basis user who does not remit the capital payment to the UK (and has not therefore paid tax on the gains in the schedule 4C pool which have been matched to the capital payment).

We are unsure why this should be the case given that the remittance basis clearly applies to gains from the schedule 4C pool which are matched to a capital payment in the same way as it applies to ordinary gains (see paragraph 8AA of schedule 4C to TCGA 1992).

The effect of new section 87J(5) is that the capital gains tax conduit rules can never apply to a capital payment which is matched to gains in a schedule 4C pool as there is no “untaxed part” of the matched amount.

1.2 The interaction between new section 87K and new section 87M is very unclear.

Broadly speaking, the effect of section 87K is that the subsequent recipient is treated as receiving a capital payment and/or as if gains had accrued to them and the “otherwise-liable person” (the original recipient or, if the close family member rule applies, the settlor) is treated as not having received the relevant part of the capital payment and/or as if the relevant gains had not accrued to them. This means that the “otherwise liable person” cannot be taxed in the future by reference to what they have given away.

Section 87M deals with the position where the subsequent recipient is a remittance basis user.
Sections 87M(1) and (2) apply where the subsequent recipient is treated as having received a capital payment from the trustees. The effect of section 87M(2) appears to be that the subsequent recipient cannot be taxed on the capital payment (whether or not it is remitted) as sections 87K(2)(a) and (b) are disapplied. Instead, the subsequent recipient is treated for the purposes of section 87I (the main onward gift rule) as if they had received a capital payment (and so will themselves be capable of making an onward gift).

This cannot be what is intended and it may be that we are misinterpreting section 87M(2) but if this is not what is intended, section 87M(2) needs to be clarified.

Sections 87M(3) and (4) look at the situation where chargeable gains are treated as accruing to the subsequent recipient (rather than the subsequent recipient being treated as having received a capital payment).

In this case, the subsequent recipient is taxable if the gains (presumably the onward payment, or something deriving from it) are remitted to the UK in the tax year in which the onward gift is made.

However, if the gains are not remitted to the UK in the tax year in which the onward gift is made, the effect of section 87M(4) appears (similar to the effect of section 87M(2) mentioned above) to be that the subsequent recipient will not be taxed on the gains which were treated as accruing to them even if they are remitted in a subsequent tax year as sections 87K(3)(a) and (b) are disapplied. Instead, the subsequent recipient is treated for the purposes of the onward gift rule as if they had themselves received a capital payment (and so can make a taxable onward gift).

These provisions would of course make it very easy to avoid the capital gains tax onward gift rules in their entirety where the subsequent recipient is a non-domiciliary.

Example

Jemima has always lived in Hong Kong, where her family come from. In June 2018 (when she is age 25), she moves to the UK and elects to pay tax on the remittance basis. Many years ago, her grandmother in Hong Kong set up an offshore family trust. The trust has significant
accumulated gains. Jemima would like to buy a house in the UK for about £1 million. Her father in Hong Kong agrees to help her with the purchase. In order to facilitate this, the trustees of the grandmother’s trust make a distribution of £1 million to the father in October 2018. In December 2018, the father transfers the £1 million to Jemima’s Swiss bank account. Jemima brings the money to the UK in January 2019 in order to pay for the house.

As the father is not resident in the UK, the distribution is not matched with any trust gains as a result of new section 87D. In principle the conduit rule applies but, as a result of section 87M(2), Jemima is not liable to tax even though the money has been remitted to the UK.

1.3 The interaction between section 87K and the rules relating to temporary non-residence in new section 87E and 87P needs to be dealt with. This can be done by inserting a reference to sections 87E and 87P in the opening words of section 87K(2).

2 Settlements code – benefits charge

2.1 The benefits charge looks at whether an individual is a close family member of the settlor when a benefit is received and not (if it is later) when the benefit is matched. The effect of this is that an individual could be subject to tax (or the close family member rule could apply) in a tax year when the beneficiary in question is no longer a close family member (e.g. a former spouse who is now divorced or a child who is over 18 when the matching occurs). Is this what is intended?

2.2 Whilst we can see the purpose of new sub-sections 643B(4)-(7), we are not convinced that these provisions add anything to the concept of a “benefit provided by the trustees to the individual”. They also represent a further unwelcome discrepancy between the settlements code on the one hand and the equivalent provision in the transfer of assets abroad rules, on the other. The implication of the additional sub-sections is that the concept of a “benefit” for the purposes of the settlements code benefits charge is wider than what would constitute a “benefit” for the purposes of the transfer of assets abroad rules (which do not contain similar provisions). Is this really what is intended?

2.3 It is welcome that PFSI in relation to a particular individual no longer includes income which cannot be used to benefit that individual. It is not however clear why the same restriction does not apply in the case
of income which would be treated as the settlor’s (but for the trust protections) as a result of distributions to minor children. The effect of this could be that where there is a settlement which has two separate funds, one for each of the settlor’s children, a child who receives a capital payment from their own fund could be taxed on income which has arisen (and been retained) in their sibling’s fund.

In order to remedy this, section 643C(2)(a)(iii) should be replicated in section 643C(2)(b).

2.4 Whilst section 643D deals with the situation where a capital payment is matched against gains (because, at the time of receipt, there is no trust income to match against the capital payment), there does not seem to be any equivalent provision which deals with the situation as far as section 87/87A TCGA is concerned where the capital payment is matched against income in a year after the tax year in which the capital payment is received. In these circumstances, the amount of the capital payment should be reduced for capital gains tax purposes by the amount of the income which is matched against it. The equivalent provision for the transfer of assets abroad benefits charge is contained in section 97(3) TCGA 1992. This could be amended to insert the words “or section 643A of ITTOIA 2005” after the words “section 733 of ITA 2007”.

2.5 The remittance rules in new section 643G have been amended to try to make it clear which items of income received by the trustees relate to the income which is deemed to arise to an individual who has received a benefit.

Section 643G(3) contains provisions which allow the specific income to be identified where it has been matched under the transfer of assets abroad rules. However, there is no equivalent provision which allows income within section 643G(2)(cb) to be identified. This means that there is no way of knowing which items of protected income are to be reduced in accordance with section 643G(2)(cb). The approach taken for the purposes of section 735A ITA 2007 is, in effect, to allow this to be determined on a just and reasonable basis (see section 735A(1)(d) and section 743(1)/(2)). This could be replicated in section 643G.
3 Settlements code – close family member rule

New sections 643A(3) and (4) appear to be inconsistent. If the close family member is a remittance basis user who does not remit any part of the benefit to the UK, all of the income attributed to the close family member is treated as the income of the settlor but also continues to be treated as the income of the close family member (who can presumably be taxed if a remittance basis user and the benefit is subsequently remitted to the UK).

On the other hand, if the close family member remits part of the benefit to the UK in the tax year in question, the balance of the income is treated as the settlor’s income and is no longer treated as the close family member’s income.

There is no obvious reason for this discrepancy and the correct answer should be that if the income is treated as the settlor’s income, it should no longer be treated as the close family member’s income.

Assuming this is right, the words “in a case within paragraph (a)” need to be deleted in section 643A(3).

4 Settlements code – onward gifts

4.1 The reference in new section 643I(1)(a)(i) to section 643A(1)(a) effectively limits the conduit rule to situations where the original beneficiary is a UK resident remittance basis user (unless the close family member rule also applies).

It seems surprising that the onward gift rule cannot apply if the original distribution is made to a non-resident settlor/close family member (unless the close family member rule applies).

That this is not what is intended can perhaps be inferred from section 643I(1)(f)(i) which contemplates the possibility that the original beneficiary may in fact be non-resident.

If it is intended that the conduit rules should apply where the original beneficiary is non-resident, it will also be necessary (as mentioned above) to amend section 643A(1)(b) to refer to section 643I.

4.2 As with the capital gains tax conduit rule, the position in relation to a subsequent recipient who is a remittance basis user is unclear.
Section 643K deals with the situation where all or part of the onward payment is remitted to the UK in the year it is received (or, if later, in the year in which the original benefit is matched). Not surprisingly, in these circumstances, the subsequent recipient is taxable on the deemed income which relates to the amount remitted.

Any unremitting part of the onward gift is dealt with by section 643K. All this does is treat the subsequent recipient for the purposes of the onward gift rules as if they were themselves a person to whom income was treated as arising under section 643A(1). This means that the subsequent recipient could themselves make a taxable onward gift.

However, if the subsequent recipient does not make an onward gift but instead remits the benefit in a subsequent year, there does not appear to be anything in section 643K which taxes the subsequent recipient on the amount remitted.

This is a significant loophole and presumably cannot be what is intended.

There is a further loophole which can apply if the onward payment is remitted to the UK by the subsequent recipient before the original distribution is matched to income. Section 643J only applies if all or part of the onward payment is remitted to the UK in the “charging year” (being the later of the year in which the gift is made and the year the original distribution is matched with income under section 643A). It is however perfectly possible for the subsequent recipient to remit the onward payment to the UK in a tax year before the “charging year” in circumstances where the original distribution is not matched to income in the year that distribution is made. In this case, section 643J would not apply and section 643K would not, for the reasons above, impose a tax charge.

4.3 There is nothing governing the interaction of section 643K and section 643L. This means that both provisions are capable of applying to the same transaction which could lead to double tax.

Presumably if section 643L applies (so that income is attributed to the settlor following an onward gift to a close family member), section 643K should not apply (i.e. the close family member who is the subsequent recipient should not be able to make a further taxable onward gift).
4.4 We note that a provision has been included in new section 643M which means that this second onward gift rule does not apply if the original recipient is taxable on the original benefit (section 643M(1)(ca).

There is however nothing which explains how the provisions work if the original recipient is taxable on the original benefit in a tax year after the onward gift is made (for example if income and gains only arise to the trustees at a later stage).

The effect of section 643M is that the subsequent recipient is treated as having received a benefit for the purposes of the settlements code benefits charge but there is nothing which treats the original recipient as not having received the benefit for the purposes of, for example, the transfer of assets abroad benefits charge or the capital gains tax benefits regime. This needs to be included in order to avoid the same distribution being taxed twice.

5 Transfer of assets abroad – onward gift rule

5.1 The same issue arises here in relation to a subsequent recipient who is a remittance basis user as is the case for the settlements code. Like section 643K ITTOIA 2005, section 733D ITA 2007 does not contain any provision which taxes the subsequent recipient if the onward gift is remitted in a later tax year.

5.2 In addition, section 733C ITA 2007 has the same problem where the onward gift is remitted to the UK in a tax year before the “charging year” as is the case for section 643J ITTOIA 2005 as described above.

Conclusion

We have endeavoured in this note to identify those parts of the legislation where amendments are necessary to try to ensure that the anti-avoidance provisions operate as intended (or at least as we think is intended). There are a number of other amendments which would be helpful in order to clarify various points and to minimise the scope for future disagreements as to the interpretation of the legislation. However, we anticipate that there will be no appetite for making any such amendments which may not be considered as essential and so have not drawn attention to them in this note.

Given the timetable for the Finance Bill, we would not be surprised to hear that making the changes we have identified is not feasible. As mentioned above,
this is one of the reasons why we believe that it is better to withdraw clause 35 and schedule 10 of the Finance Bill in order to allow further time for reflection and also to consider whether the anti-avoidance regime for offshore trusts as a whole can be simplified.

We would be more than happy to meet with representatives of HM Treasury and/or HMRC in order to discuss the points which we have raised if that would be helpful.

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