



The Law Society

Attributions of gains to members of non-resident companies and transfer of assets abroad

Response of the Law Society of England and Wales

February 2013



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Comments of Tax Law Committee of the Law Society of England & Wales

Introduction

The Law Society is the representative body for over 166,000 solicitors in England and Wales. It negotiates on behalf of the profession, and lobbies regulators, Government and others.

This response has been prepared on behalf of the Society by members of the Tax Law Committee, which is made up of senior and specialist tax lawyers practising in this field.

The Law Society welcomes this opportunity to comment on the proposed changes to section 13 TCGA 1992 and the Transfer of Assets provisions for both transferors and non-transferors.

Generally, we are in favour of section 13 being amended, given our longstanding concerns that the current provision is non-EU compliant. It also can give rise to issues in commercial practice, especially in the areas of investment funds, and where a decision is being taken as to whether to situate a holding company in the UK. As such, any change is to be welcomed. Our detailed comments are set out below.

It is also helpful that some clarification has been provided as to the way in which the Transfer of Assets provisions and the “matching rules” work. However, the draft legislation fails to address a number of concerns which we set out in our original response to the Consultation, where double taxation can continue to arise.

In particular:

- there can still be a double charge to tax where a settlor is taxable under the settlements legislation in ITTOIA and a beneficiary is taxable under the Transfer of Assets provisions;
- in the case of UK arising income, the trustees may be liable for tax on general principles and the settlor can still be taxed under the Transfer of Assets rules;
- such UK income on which the trustees have paid tax may also be relevant income in relation to a non-transferor beneficiary, resulting in high effective rates;
- there is no relief for foreign tax paid by the trustees resulting in high marginal rates on beneficiaries to whom income or gains are “matched”.
- There could potentially be a charge to income tax and capital gains tax on the same amount where a non-transferor beneficiary receives a benefit matched with income which is then actually distributed to the settlor;
- there remain issues in relation to double tax relief/treaties which we discuss below along with our other detailed comments.”

SECTION 13 TCGA 1992

Introductory remarks

We welcome the opportunity to comment on the proposed changes to section 13 TCGA 1992. Generally, we are in favour of section 13 being amended, given our long-standing concerns that the current provision is non-EU compliant. It also can give rise to issues in commercial practice, especially in the areas of investment funds, and where a decision is being taken as to whether to situate a holding company in the UK. As such, any change is to be welcomed.

Compliance with EU law

However as noted below, we are not convinced that the changes will result in a section that is EU compliant, or which offers clarity or certainty for taxpayers. We of course recognise the need for there to be appropriate tax avoidance measures but they should be targeted, clear and EU compliant.

In terms of EU compliance, we will not repeat the analysis. We consider that the provision should only apply to tax gains arising on wholly artificial arrangements (as per *Cadbury Schweppes*). The two saving provisions - the economically significant activities (ESA) test contained in the new section 13A and the main purpose test contained in section 13(5)(c b) go far beyond this and do not, in our view, mean that it is so compliant. Further challenges may therefore be forthcoming.

Approach of draft legislation

In terms of offering certainty to business, we consider that the provisions are not clear and inevitably will require some form guidance to be issued by HMRC as to their operation or interpretation. This is of course is an inherently unsatisfactory position, for both HMRC and taxpayers.

In particular, we would question why it is necessary for the exemption from the CGT charge to be an “all-or-nothing”. In other words, it should be possible for part of the gain to be subject to tax and part not, depending on the extent to which the tests are satisfied in whole rather than in part. This would apply both to the new provisions and to the requirement that any asset is used wholly for the purpose of a non-UK activity.

Looking in more details at the substantive two new changes, namely the proposed economically significant activities (ESA) test and we comment as follows:

The “ESA” test

Introductory remarks

This test seems to us to import a new and (in our view) unclear test to the tax legislation which may be exceedingly difficult to apply in practice; how for instance will it be possible to measure whether economic value has to be added to a person to whom goods or services have been supplied?

We can understand the reference to staff having competence but to what is authority intended to refer?

In one sense, this could be taken as implying that they have the ability to bind the company contractually, but we assume that it is not intended to have this meaning.

Application to investment funds

How is this test intended to operate in the investment funds arena? While a non-UK investment company would of course have directors, it would not be expected to have staff and in many cases premises and/or equipment. In many cases the fund will buy in services it requires.

That is not to say that it would not have substance and directors, who would be in a position to assess the merits of any investment recommendation put to them and take a reasoned decision as whether to reject or accept the proposal or to make a decision in relation to any investment held.

In practice, it is likely to be difficult for any non-trading entity to satisfy this test and reliance would have to be placed on the TAAR or the requirement to have a 25 per cent economic interest. In relation to the latter, it is of course the case that while a fund is widely held, this is not an issue.

However, when the fund has seed investors (i.e. in the start-up period) or is winding down (when disposals of investments may take place) the investor base may be such that an apportionment could be made. Similar issues may arise if a UK holding company is to be put in place prior to an IPO or similar event. It may be the case there is a pre-IPO reorganisation, where disposals of assets (not qualifying for SSE) take place.

Use of term “business establishment”

It would be also helpful if an explanation could be given as to why the expression business establishment is used - and which is then defined by reference to permanent establishments. It would be simpler to refer throughout to the permanent establishment test, rather than confuse the issue.

The TAAR

We note that in order for the TAAR not to apply, it will be necessary to prove that neither the disposal, nor its acquisition nor its holding was motivated, in broad terms, by an offending purpose.

We would question (especially in the context of an all-or-nothing test) whether it is appropriate for all **three** tests to be satisfied.

It would be further helpful if confirmation could be given as to whether the reference to corporation tax is intended to refer to corporation tax on chargeable gains only or corporation tax more widely. In the context of the legislation, we would suggest that it should be the former only.

Will HMRC confirm whether a non-statutory clearance procedure will be available?

Finally, in terms of commencement, we note that the intention that the changes should be retrospective but only from 6th April 2012. We would question whether this is sufficient generally and finally whether for corporate taxpayers it should be helpful in compliance terms

for it to be by reference to accounting periods ending after that date, rather than for disposals after that date.

TRANSFER OF ASSETS

We do not propose to comment specifically on Part 1, but comment below on parts 2, 3 and 4 in turn.

Part 2

The proposed draft requires a genuine transaction and a liability to tax by reference to it in circumstances where such liability to tax is in contravention of the stated EU freedom. It is doubted that this goes far enough in terms of EU compliance.

We appreciate that the framing of a suitable exemption is difficult, but the approach adopted here raises the prospect of a taxpayer having a liability to tax in contravention of the stated freedom where such liability arises from a transaction that does not satisfy the genuine transaction requirements in whole or in part.

A better approach might be to concede a more generous exemption available where either of the following is satisfied:

- (i) The EU freedom would be infringed, or
- (ii) The genuine transaction requirements.

Assuming that transaction requirements are clear this potentially provides some welcome certainty; in practice it would be anticipated that most instances falling within the genuine transactions description could also satisfy the EU freedom requirements.

New section 742A(4)

This requires the relevant officer to be satisfied that the transaction must be considered to be a genuine transaction. This looks to impose a high burden on the taxpayer; we suggest that a more reasonable formulation is to require that there be a genuine transaction, ideally where it is for the officer to express dissatisfaction with a taxpayer claim. On appeal it is then a matter of fact for the Tribunal to determine.

New section 742A(5)(a)

Some small degree of flexibility as to possible terms would be helpful, in practice the terms in question may be the same in all material respects yet miss the mark.

New section 742A(7)

Where this applies we note that the taxpayer must also satisfy the additional requirements in (a) to (c). It would be helpful if it could be explained why these additional express requirements are thought to be needed. We note that the without prejudice wording at the start of the section contemplates that some or all may be relevant in any event.

New section 748A(8)

Should the term "staff" also include officers of a company for clarity (as they might not legally also be employees)?

Also, is it intended that an independent agent or contractor might be included? If so, it would be helpful for the legislation to state one way or the other.

Part 3

Part 3 introduces some modest changes to the transferor part of the Transfer of Assets code. While some of the changes are merely clarificatory, others are significant.

Paragraph 10 amendments to section 721:

New subsection (3A)

This makes the income on which the transferor is taxed deemed income equal in amount to the income of the person abroad instead of on income of the person abroad.

This has implications in the double tax treaty context. Although some of our concerns expressed in our previous submissions have been dealt with by further amendments to section 746, some of our concerns remain. We comment on these further below.

New subsection (3B)

This addresses one of our expressed concerns where a transferor is taxed under the transfer of assets provisions and is also taxed by some other provision. This new subsection provides there is no attribution under section 721 if the transferor is already liable for income tax by virtue of some other provision. This would, for example, mean that "income arising under a settlement" taxed under section 624 ITTOIA would not also be taxed under the transfer of assets rules. This amounts to a codification of HMRC's current approach.

New subsection (3B)(b)

This imposes an additional condition that "all income tax for which the individual is liable has been paid". The explanatory notes (paragraph 22) state that there is no further change under section 721 where "that income tax liability on the deemed income has actually been paid".

Clearly, it is intended that the transferor must have paid tax on the income which is taxable under some other provision but in our view the current formulation that "all income tax for which the individual is liable" is too wide. For example:

- It could include income which is nothing to do with the transfer of assets regime and income for previous years or disputed amounts, and
- The provisions of subsection (3B)(b) should be limited to all income tax on the income referred to in subsection (3B)(a).

Further comments on paragraph 10

While this addresses one of our comments, the relief from double taxation only applies if the transferor is subject to **income tax** and it only applies where the **transferor** is taxable under some other provision.

It does not therefore address our concerns where:

- Another, non-transferor, beneficiary is liable to tax by virtue of a provision other than the transfer of assets rules or
- A payment on which the transferor is not subject to income tax can be treated as a capital payment for section 87 TCGA purposes.

Subsection 5(a) (which provided that the section 720 charge was to apply even if the income was taxable apart from section 720) has been deleted as a consequence of the introduction of subsection (3B). However, this does not mean that if the income is taxable other than from section 720 it cannot also be taxed under section 720. Merely deleting the confirmation that the income can be taxed in those circumstances does not necessarily mean that it cannot be taxed.

Paragraph 11(2):

This turns the income arising to the transferor under section 724 into deemed income of an amount equal to the income of the person abroad, rather than being income of the person abroad.

As a result of the income of the transferor becoming deemed income, consequential amendments are made to section 746 (by paragraph 19). These are presumably intended to ensure that reliefs, including UK double tax relief, remain available even though the amount on which the transferor is taxed is a deemed amount rather than actual income.

This is a particular issue for double tax relief. As we pointed out in our submissions on the consultation document, most treaties require the tax charged in each jurisdiction to be charged on the same income. Where tax is charged in one jurisdiction on actual income and in the other jurisdiction on an equivalent amount of deemed income, the relief would not be available.

The amendments to section 746 do not therefore quite work as they do not seem to treat the income of the person abroad as being that of the individual for the purpose of applying reliefs.

Paragraph 19 sub paragraph (b) accordingly needs to provide for subsection 746(2) to read:

“The same deductions and reliefs are allowed as would have been allowed if the income, by reference to which the amount of income treated as arising to the individual under section 721 or 728 is determined, had actually been received by the individual”.

While (with the amendment as mentioned above) section 746 would generally enable a transferor to obtain double tax relief in the UK for foreign tax paid by the person abroad:

- It would not assist if the terms of the double tax treaty require the tax to be paid by the same person as well as being paid on the same income; and

- It would not assist where the UK liability is secondary and the foreign country has the primary taxing right subject to giving credit for UK tax paid. This can be an issue with, for example, the US/UK treaty;
- It does not assist non-transferors.

Paragraph 11

This deals with the charge where a benefit is provided out of the income of the person abroad. The changes mostly flow from the change to income being deemed income of the person abroad.

Paragraph 12

This amends section 725 which deals with the situation where part of the income of a person abroad is income which is deemed to arise under the CFC legislation. In this case, the transferor's deemed income is reduced to take account of the CFC profits included in the income of the person abroad.

New sub sections (2A) and (2B) introduce further provisions that adjust the reduction where a benefit is provided out of the income of a person abroad under section 724. In these circumstances, the CFC reduction is itself reduced, i.e. the amount of income treated as arising to the transferor is increased.

The amendments made to section 728 – the capital sum provisions – are on the same lines as those made in relation to the section 721 charge. Accordingly, the income arising in the hands of the transferor is treated as an amount equal to the income of the person abroad and not the income itself.

Paragraph 14(4)

This introduces a new sub section (2A) to section 728 which prevents a double charge where the transferor is liable to income tax under a provision other than the transfer of assets provisions and “all income tax” for which he is liable has been paid.

Our comments above in relation to new subsection (3B) of section 721 apply here also.

Paragraph 16

This amends section 743 (no duplication of charges). It provides that where income is treated as the transferor's income under sections 720 or 727 and the transferor subsequently receives the income “the income received is treated as not being the individual's income for income tax purposes”.

This approach does not make it clear that actual receipt of the income would not constitute a capital payment subject to capital gains tax under section 87 TCGA. We previously submitted that this was effectively double taxation as the same amount of income would be subject to both income tax and capital gains tax. If the intention is to avoid such double taxation, then the paragraph needs to add at the end words such as:

“(2C) The income received is treated as not being a capital payment for the purposes of section 87 TCGA or section 97 or Schedule 4B TCGA”

Paragraph 19

This introduces the amendments to section 746 mentioned above in relation to reliefs and double tax agreements. As mentioned there:

- We submit the wording needs to be altered; and
- It only deals with the UK half of the equation; it does not enable the transferor to obtain credit in the other jurisdiction; and
- Section 746 does not apply where non-transferors are taxable under section 731 which, as we have previously pointed out, is unfair.

Responses to questions 12, 13 and 14

The draft legislation does not take account of most of the points made in our original representations in reply to those questions.

The only point which we raised which has been addressed is the potential double charge where the transferor is taxable under section 624 ITTOIA (which charge would take priority) and also under section 720. Now there will be no additional charge under section 720.

However, there is still a potential double charge where the settlor is chargeable on the income arising under the settlement under section 624 ITTOIA and a non-transferor beneficiary is chargeable under the transfer of assets rules.

No account has been taken of the comments in our section (b) and indeed the potential income tax and capital gains tax double charge situation has been made worse by the amendments.

In relation to question 14 about double tax agreements, section 720/727 income has been made deemed income but the amendments to section 746 designed to preserve reliefs in this context are defective for the reasons we have mentioned above.

Part 4

Paragraph 22

This replaces the current sections 732 to 735A with new sections 732 to 735A.

It employs the defined concepts of:

- A relevant tax year (one in which income is treated as arising to an individual)
- A relevant benefit (as defined by subsection 732(4))
- A relevant income amount (as defined by subsection 732(5))

New subsection 732(2) provides that untaxed relevant benefits are carried forward until relevant income arises in a later tax year then available to match with those benefits.

Relevant benefits

New subsection 732(4)(a) provides that an individual must be ordinarily resident for a benefit to him to be relevant.

Under the draft legislation for the proposed statutory residence test (SRT) the concept of ordinary residence is to be abolished as from 6th April 2013 (save for up to 2 years for individuals who are not ordinarily resident before that date).

By paragraph 25 the provisions of Part 4 only apply as from 6th April 2013 (subject to transitional provisions for income and benefits for the 2012-2013 tax year carrying forward into the new regime).

This apparent mis-match between this draft legislation and the draft SRT legislation may not have been intended but we would suggest the two changes are cross-referenced for clarity given the phased abolition of the concept of ordinary residence.

For example, it should be made clear that:

1. Until 5th April 2013, the requirement for liability is to be ordinarily resident, and
2. For those who are not ordinarily resident as of 5th April 2013, the requirement remains ordinary residence for a further two tax years (as provided for in the statutory residence test legislation, and
3. In all other cases, liability is by reference to residence

Relevant income amount

This is defined (subsection 732(5)) by reference to income arising to persons abroad.

As mentioned in our comments on paragraph 19 above, the proposed changes to section 746 (double taxation relief) do not extend to non-transferors.

New section 734 broadly replicates the current provisions on reducing an income tax charge where chargeable gains are treated as accruing to the individual concerned in the same or later relevant tax year.

Calculation of relevant income amount

New section 733 broadly follows the step approach of the current legislation but employing the three defined concepts mentioned above.

The order of matching is more clearly set out than in the current legislation. This is welcomed.

For example it adopts a similar approach as used by section 87 TCGA in:

- The order of matching of benefits and relevant income by tax year
- Pro-rating where relevant income is less than relevant benefits in a tax year

Order of matching

New sections 734A, 735 and 735A contain further details concerning how relevant income is reduced by matching to relevant income under new section 733.

These rules in essence match relevant foreign income before other income where the individual concerned is resident, non-domiciled and pays UK tax on the remittance basis and adopt the opposite approach for other individuals.

It is not clear what the objective of this ordering approach is – unless it is to maximise tax - and does appear in our view appear to be unnecessarily complicated.

Commencement and transitional provisions

The transitional provisions are limited insofar that only balances of 2012-2013 relevant benefits and relevant income as at 5th April 2013 are rolled-over into the new regime.

This still leaves uncertainty as to how relevant income and capital benefits arising before 6th April 2012 will be treated under the new regime. If, as appears to be the case, they would continue to be dealt with under the current legislation, there will be in many cases two parallel sets of calculations having to be run side by side until and unless relevant income arising before 6th April 2012 is exhausted.