



## AVOIDANCE INVOLVING PROFIT FRAGMENTATION ARRANGEMENTS (CL10, SCH 6)

Issued 30 August 2018

ICAEW welcomes the opportunity to comment on the [consultation on draft Finance \(No.3\) Bill 2017-19 legislation: Clause 10 Sch 6: Avoidance involving profit fragmentation arrangements](#) published by HMRC on 6 July 2018.

This response of 30 August 2018 has been prepared by the ICAEW Tax Faculty. Internationally recognised as a source of expertise, the Tax Faculty is a leading authority on taxation and is the voice of tax for ICAEW. It is responsible for making all submissions to the tax authorities on behalf of ICAEW, drawing upon the knowledge and experience of ICAEW's membership. The Tax Faculty's work is directly supported by over 130 active members, many of them well-known names in the tax world, who work across the complete spectrum of tax, both in practice and in business.

On 6 August 2018 we attended a meeting with HMRC in which we were able to put forward some key comments and concerns and discuss aspects of the draft legislation.

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## EXECUTIVE SUMMARY

1. We endorse and agree the policy objective that UK tax and national insurance are payable on profits arising from a trade or profession carried out by a UK resident and that a non UK resident is taxable on profits arising from a trade or profession carried on in the UK.
2. We are pleased to note that some of the comments in our response submitted as [ICAEWrep 67/18](#) to the consultation, [Tax avoidance involving profit fragmentation](#), have been taken into account, and in particular
  - there is no need for advance notification
  - notification can be made on the self assessment tax return
  - there is no need for any payment up front
  - reimbursement payments are ignored for tax purposes.
3. However we are still of the view that new legislation is not necessary given all the existing anti-avoidance legislation such as transfer of assets abroad (ToAA), controlled foreign company rules (CFC), disguised remuneration, close company gateway rules, trading income through third parties, and (as the ultimate backstop) the general anti abuse rule (GAAR).

## THE MEASURE

### PARA 1(3)(B) DEFINITION OF OVERSEAS PERSON

4. Defines an overseas person.

## OUR CONCERNS

5. The definition of overseas person in para 1(3)(b) potentially includes UK residents. For example, it would catch a UK resident foreign incorporated company as well as a UK resident trust established with a foreign governing law.
6. The transfer of assets abroad (ToAA) rules used to provide that a foreign incorporated but UK resident company were to be treated as a resident abroad, but the FA 2013 abolished this with effect from 6 April 2012.

## OUR RECOMMENDATION

7. UK residents should be specifically excluded. This would then tie in with ToAA definition which was amended in 2013 with effect from 2012.

## THE MEASURE

### PARA 2 - PROFIT FRAGMENTATION ARRANGEMENT CONDITIONS

8. This paragraph sets out the arrangements to which the rules apply, five conditions must be satisfied.

## OUR CONCERNS

### Use of the word 'value'

9. We understand that value is meant to just mean amount but value means more than that. For example, a mispriced contract is caught by para 2(1)(b):
  - need to notify as para 10(1) re notification requires a, b, d and e to be met; and

- para 2(1)(c) could be interpreted to not assist, so as to remove the transactions from the provisions, unless the wording is amended.

The actual intention is to catch transactions where for example a tiny overseas office is purportedly providing services well beyond their actual capabilities, this would be caught by 2(1)(c).

#### Reference just to 'services' in para 2(1)(c)

10. Currently 2(1)(c) means that the scope of the draft provisions is narrowed to services and that is not the intention, it is to apply to goods also and indeed even in scenarios where there is no service. The wording needs to be adjusted so as to catch everything that should be caught.

#### Reference 'acting at arm's length' in para 2(1)(c)

11. The phrase 'acting at arm's length' is a little "woolly", if the parties are unconnected they would be acting at arm's length almost by definition. Is this the concept HMRC is trying to capture or is it more a market value price that was required? Consideration needs to be given to the definition and what it is intended to capture.

#### Inserting the ToAA motive and EU defences

12. We are very concerned that the para 7(1) motive defence gives taxpayers virtually no protection as it would be so hard to show that any transaction came within it. The current ToAA motive and EU defences should also apply for profit fragmentation purposes. The defences should be inserted into para 2 in such a way that it would mean that there would be neither a notification requirement nor a tax charge if one of the ToAA defences applies. This should address both the EU issues and reduce the number of notifications.

## THE MEASURE

### PARA 4(5) TO 4 (7) AND PARA 5 - 'THE 80% PAYMENT TEST'

13. Sets the threshold for the amount of overseas tax paid which provided it is at least 80% of the amount that would have been paid in the UK on the same profit these measures are not triggered.

## OUR CONCERNS

14. The 80% figure is unchanged from the consultation, the UK Government and tax authorities had no desire to suggest that payment of a lesser effective rate of tax was acceptable. The figure of 80% has been used in another statutory context so there is consistency.
15. While we understand the reason why the 80% figure cannot be reduced it is a potential problem as it had been hoped that lowering the percentage would filter out notifications. Rather than lower the percentage, additional exclusions and 'carve outs' have been included in para 10(4) which may filter out unnecessary notifications.

## OUR RECOMMENDATION

16. Further exclusions / carve outs are needed. We understand consideration is being given to whether electing into transfer pricing could be an exemption from notification under the profit fragmentation rules.
17. There is also a need to look at 'legitimate' foreign earnings related benefit charges as the current definition might inadvertently catch these.

18. The list of provisions in 10(4) that exclude the profit fragmentation rules if they apply should be expanded to include foreign income where there is only a tax mismatch as a result of a remittance basis claim, the ToAA legislation and settlement provisions (see paras 36-41 below).

## THE MEASURE

### PARA 6 - THE ENJOYMENT CONDITIONS

19. These conditions consider whether the related individual and/or a person connected with them is able to enjoy the benefit of the amounts that have been transferred to the offshore entity. The arrangements often ensure that the related individual does not have legal entitlement to the amounts, but the practical outcome is that they, their family or other connected persons are able to make use of these amounts, directly or indirectly.

## OUR CONCERNS

20. The enjoyment conditions are divided into:
- para 6 (1)(a) (which broadly relates to the activities undertaken), and
  - para 6(1)(b)(i) to (vi).
21. Para 6(1)(b)(ii) to (vi) conditions appear to have been drawn from the ToAA conditions and all consider who is or could receive a benefit as a result of the arrangements (the end product). However, para (b)(i) does not act as a filter at all. Sole traders or one person companies will always be caught as they will have procured the transfer as they are the only person involved, including, for example, a contract which is erroneously mispriced.
22. We understand that HMRC is re-visiting the concept of 'value' in para 2 of the schedule and that this filter in para 6 would be re-considered in light of that amendment. In essence, the purpose of the 'procure' limb in para 6 was to act as a backstop to the benefit tests – in the sense that the taxpayer would not implement the arrangement if some benefit did not accrue to him.

## OUR RECOMMENDATION

23. The current drafting does not seem to accurately reflect HMRC's intention and para 6 (1)(b)(i) should either be omitted or redrafted.

## THE MEASURE

### PARA 7 – THE MOTIVE DEFENCE

24. Sets out how the arrangements to obtain a tax advantage are to be counteracted.

## OUR CONCERNS

25. The test is based on it being objectively reasonable to conclude that profit fragmentation arrangements were entered into to obtain a tax advantage. This is a very narrow motive test and in our view it will be of no use to taxpayers even where the situation is entirely commercial, because: (a) tax advantage is a very broad term; and (b) the motive defence will be unavailable if a tax advantage is (even in a very minor way) relevant to the decision making process.
26. Comparable legislation refers to tax avoidance, rather than advantage. ToAA refers to having more than an incidental tax avoidance motive. Even so the EU commenced infringement

proceedings against the UK on the basis that the motive defence within the ToAA rules, was insufficiently wide and, therefore, infringed EU law (being incompatible with the freedoms). An economically significant activities test, which disapplies ToAA irrespective of motive, was added to the ToAA legislation to make it compatible with EU law. Section 13, TCGA 1992, historically did not have a motive defence. In response to the EU's infringement proceedings against the UK, the following tests were added and, if met, disaply s13, TCGA 1992

- a no main purpose of CGT or corporation tax avoidance motive defence; and
  - an economically significant activities test (similar to the ToAA test, where this is met motive does not matter).
27. It is difficult to see how the proposed profit fragmentation rules could be compatible with EU law, given that:
- it is not proportionate since what is proposed will be next to impossible for people who have taken tax advice to obtain. and
  - there is no separate economically significant activities defence.

## OUR RECOMMENDATION

28. Remove the current motive defence and insert all the ToAA defences (including the specific changes to bring ToAA in line with EU law) into para 2.

## THE MEASURE

### PARA 7 – COUNTERACTION

29. Sets out how sets out how the arrangements to obtain a tax advantage are to be counteracted.

## OUR CONCERNS

30. Our interpretation of the draft legislation is that the notification has to be made by the taxpayer on the self assessment return (as per para 10), but any additional tax payable as a result of the legislation will be imposed by HMRC under para 7 by way of raising a counteraction assessment. That is, from a personal tax perspective, it is similar to the transactions in securities legislation but with an added notification requirement.
31. From our meeting with HMRC we understand the intention is
- notifications will need to be included on tax returns where required
  - the tax payable will be self-assessed by affected taxpayers also on the tax return
  - any queries by HMRC will be dealt with using the normal enquiry or discovery provisions.

## OUR RECOMMENDATION

32. Our view is that the draft legislation is unclear and that HMRC should consider amendments to make the position clear.
33. We understand that the draft has been modelled on the GAAR legislation, Part 5, Finance Act 2013 (FA 2013). In the GAAR legislation s 209, FA 2013 is the counteraction paragraph. The GAAR counteraction provisions are significantly more detailed than those in para 7.
34. In addition, the GAAR legislation and this profit fragmentation legislation are very different. From the drafting of the GAAR legislation, it seems that while strictly it might be said that the taxpayer is expected to put through any adjustment for the GAAR on their return, either (i) it is expected that the planning just will not be entered into so as not to fall foul of the GAAR, or

if (ii) the planning is entered into, HMRC will be doing the counteracting as the taxpayer will be arguing that the GAAR does not apply.

35. We would be interested to know whether HMRC has any statistics to show whether any taxpayer has ever made a GAAR counteraction adjustment on their tax return and if these statistics exist, what they show.
36. This profit fragmentation legislation is quite different to the GAAR as we understand that it is expected that it will be in point and the legislation should make it clear that the tax charge should be self assessed (as for example it is clear for ToAA).

## THE MEASURE

### PARA 8 – DOUBLE TAXATION

37. This paragraph provides for a procedure to ensure that the amounts involved are not taxed more than once. The taxpayer may enter a claim and consequential amendments may be made.

## OUR CONCERNS

38. The para 8 provision covers profits within the new legislation that are charged under another UK legislative provision, for example s 731, Income Tax Act 2007. Broadly, it is only the higher of the different taxes that will apply in such circumstances with relief given for the lower amount of tax paid.
39. We accept that the provisions are widely drafted (and welcome this)
  - para 8(1)(b) provides for situations when the same person or different people suffer any UK tax
  - para 8(5) allows adjustments regardless of the time between the two tax charges.
40. However, we are concerned that there will be practical issues. The double taxation provisions will only assist taxpayers if they are aware that the same income is effectively being taxed twice. This is a particular problem where different people suffer the tax. For the relief to be claimed the taxpayer needs to be aware of the later tax charge on potentially a different taxpayer potentially many years hence.
41. We assume that 8(3) is included where there are different individuals being taxed on the same income and it is necessary to determine how the tax charge is allocated between them such that there is no double taxation. Taxpayers will want to know how HMRC sees this working in reality and it should be covered in guidance.

## THE MEASURE

### PARA 10 – NOTIFICATION OF ARRANGEMENTS

42. Specifies that notification should be made on the self assessment tax return, what is required for the notification and when a notification does not need to be made.

## OUR CONCERNS AND RECOMMENDATIONS

43. As discussed above and below we feel that a number of additional exemptions from making the notification should be added.
  - Electing into transfer pricing could be an exemption from notification under the profit fragmentation rules
  - There is also a need to look at 'legitimate' foreign earnings related benefit charges. The current definition might inadvertently catch these and an exemption may be required.

- Consider a specific exemption for remittance basis users so they do not have to notify just because the remittance basis defers paying tax on foreign earnings and, therefore, results in a tax mismatch.
  - Specific exclusions should remove from the profit fragmentation provisions any income which is added to a trust pool – including the long-standing s731, ITA 2007 provisions, as mentioned, and the new trust pools introduced by Finance (No 2) Act 2017 and Finance Act 2018. That is, both relevant income and protected foreign source income would be excluded from the profit fragmentation provisions.
44. Consideration should be given to the wording at para 10(4)(a) so that the exclusion only applies if transfer pricing work is actually done.
45. Where one of the exclusions from notification applies it should be made clear that this also means that the tax charge cannot apply such that there is no need to consider the tax mismatch calculation.

## THE MEASURE

### PARA 12 – OTHER DEFINED TERMS

46. Sets out a list of defined terms.

### OUR CONCERNS AND RECOMMENDATIONS

47. All definitions should be tied back to existing definitions in the legislation (such as the transfer pricing legislation) wherever possible, rather than creating new definitions which can only lead to confusion.

## OTHER MATTERS

### CONCERNS ABOUT NON DOMICILIARIES AND THE INTERACTION WITH THE TOAA PROVISIONS

48. From discussions with HMRC we do not think that the legislation is designed to catch foreign domiciliaries where there is a tax mismatch just because the remittance basis claim defers the payment of foreign tax. The current provisions could though mean there is a notification requirement and we have suggested a specific notification exemption in these cases.
49. Moving on to ToAA, our understanding is that ToAA takes precedence but the draft legislation does not contain clauses to give ToAA priority. It appears that a transaction could fall foul of the tax mismatch provisions in paras 4 and 5, so while the carve outs in ToAA meant there was no charge on the transferor in the tax year under ToAA, there would be a charge under the wider profit fragmentation rules. The ToAA transferor charge catches benefits to spouses but the profit fragmentation rules are broader as they apply where connected persons can benefit from the income paid overseas, eg, adult children, siblings and parents. If there is a profit fragmentation charge, there should be a provision to take the income out of the tax pools in ToAA and the Income Tax (Trading and Other Income) Act 2005 (ITTOIA 2005) settlements' legislation. Trying to apply the para 8 double taxation provisions would be difficult on a practical level.
50. The remittance basis adds further problems which may not have been considered and the trust protections painstakingly introduced in F(No 2)A 2017 might be undermined. By way of further background, the changes that took effect from April 2017 and April 2018 were policy decisions that were subject to a long consultation process after changes were originally announced in summer 2015 (though subsequently adapted and broadened). We are concerned that the current draft profit fragmentation rules could create ongoing immediate tax charges in some circumstances, which contradicts the policy decision to allow a tax



deferral mechanism under the long-standing s731, ITA 2007 provisions and new trust pooling rules for protected foreign source income added to ITTOIA 2005 and ITA 2007.

51. Protected foreign source income (PFSI) should be excluded from this legislation. In theory it should not be caught as there would be no tax mismatch; if the existing legislation says no tax is payable then there can be no mismatch. The principle of the legislation is to charge UK tax where it is due. However, we are very concerned that where the para 2 conditions were met the current drafting for para 4 and 5 would not achieve this given how the tax mismatch works and the timing of when the mismatch must be measured. Specific issues are F(No 2)A 2017 changes to ToAA (putting all foreign domiciliaries into s731, ITA 2007 for PFSI) and the FA 2018 changes to ITTOIA (introducing the new benefits charge into ITTOIA 2005 with a PFSI tax pool). If nothing was taken from a trust structure there would be no tax charge so looking at the current legislation it seemed that if the para 2 gateway conditions were met such that the charge could apply, there would be a mismatch since the trust protections allowed foreign domiciliaries to defer tax (possibly indefinitely) but the profit fragmentation provisions would look to charge tax.
52. The close company gateway in the disguised remuneration legislation ([ICAEW REP 113/17](#)) ran into similar issues because non domiciliaries were considered too late in the day and no structural way could be found to remedy the issue completely. It is important that a similar issue does not happen here.

## OUR RECOMMENDATION

### Individuals

53. As stated in paragraph 43, we suggest including a specific exemption for remittance basis users so they do not have to notify just because the remittance basis defers paying tax on foreign earnings and so results in a tax mismatch.

### Trust provisions

54. If the para 2 conditions are perfected this should not be an issue as generally condition para 2(1)(c) should remove the charge. Any profit on a foreign letting business or from a foreign trading business should be on commercial terms (if it is not then it would be something that the government would want to catch with the legislation). The practical problem is that there would be the need for notification, which would be onerous.
55. Extra exemption should be included in para 10(4) to deal specifically with non domiciliaries and trusts (so ToAA and ITTOIA 2005 settlements' legislation) as well as situations where s731 would apply in relation to trusts established by UK resident domiciliaries which should simply be excluded.
56. A simple way to resolve this problem is to add ToAA and the settlement provisions to para 10(4). Specifically, the new exclusions could be drafted to remove from the profit fragmentation provisions any income which is added to a trust pool – including the long-standing s731 provisions and the new trust pools introduced by F(No 2)A 2017 and Finance Act 2018. See paragraph 43 above.

## DISCOVERY

### OUR CONCERNS

57. We are concerned that this legislation will always fall into the new 12 year offshore time limit rules regardless of how much care is taken (the new rules making no distinction between taking care and carelessness) with calculations etc and how much is disclosed on the tax return. The restriction to the 12 year extension where there is reporting under the Common Reporting Standard (or any other automatic exchange of information) will be of no assistance



in this type of circumstance as the information relevant to the profit fragmentation legislation will not be reported.

58. This prospect of a 12 year window for discovery might discourage some affected taxpayers from notifying on the basis that they do not think any tax is payable and disclosure does not give them any protection.

## **OUR RECOMMENDATION**

59. Where the profit fragmentation provisions apply and notification has been made the new offshore time limit rules of 12 years should not apply in discovery cases, so just the four or six year time limits would apply depending on whether care has been taken or not.

## 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 <https://goo.gl/x6UjJ5>).