ICAEW
REPRESENTATION 04/19

F3B17-19 CL16 & SC4: TAX AVOIDANCE INVOLVING PROFIT FRAGMENTATION

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Text of briefing submitted on 3 January 2019 to MPs by ICAEW Tax Faculty on Clause 16 & Schedule 4: Tax avoidance involving profit fragmentation in Finance (No.3) Bill 2017-19 updated on 11 December 2018.

This briefing submitted on 3 January 2019 in advance of the Finance Bill Report Stage debates was prepared by the ICAEW Tax Faculty. For further details on who we are please see Appendix 2.

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FINANCE (NO.3) BILL 2017-19: CLAUSE 16 & SCHEDULE 4: TAX AVOIDANCE INVOLVING PROFIT FRAGMENTATION

Briefing for MPs by ICAEW Tax Faculty

WHO WE ARE

1. Please see Appendix 2.

SUMMARY OF THE MEASURE

2. The anti-profit fragmentation legislation (APL) is designed to counter avoidance where UK traders and professionals arrange for their UK-taxable business profits to accrue to entities resident in territories where significantly lower tax is paid than in the UK.
3. In essence the legislation seeks to bring those profits back into the charge to UK tax.

OUR CONCERNS

4. We commented on the consultation on profit fragmentation ICAEW REP 67/18 and on the first draft of the legislation ICAEW REP 106/18 and we are pleased to note that some of our recommendations have been adopted.
5. However we are still concerned that the wording of the legislation is far wider than the stated target and the safe-harbours too difficult to access.
6. Consequently, there will be an administrative burden on compliant small businesses that deal across borders that would not exist if the legislation were more targeted.
7. The response will no doubt be that any collateral damage can be dealt with via guidance but this is now a recurring theme. At some stage it will need to be acknowledged that when law is drafted this wide it loses all meaning. When that happens, the practical effect is that the law is made through guidance and not by Parliament and it can be changed at a whim.
8. We set out below the issues with the legislation, as we see them with more technical detail in Appendix 1.

The scheme of the legislation

9. The legislation works broadly as follows:
    a) It defines a profit fragmentation scheme using 4 tests – this is the gateway (paras 13-42);
    b) The legislation then provides a safe-harbour by removing some things from the definition where:
        i. There is no “tax mismatch” (paras 43-50); or
        ii. A main purpose was not obtaining a tax advantage (paras 51-55).
    c) It then defines the counteraction steps the taxpayer must take if the legislation is still engaged (paras 56-62); and,
    d) It then deals with some issues of double tax (paras 63-78).

Demonstrating the legislation does not apply

10. The remainder of this briefing attempts to highlight our reservations with the current drafting of the APL. We consider the material points to be as follows:

a) We think that innocuous family transactions which are not the target could be caught by the legislation; and,

b) Even straight forward commercial transactions will need to be able to demonstrate that this legislation does not apply.

c) This need to demonstrate may be on a transaction by transaction basis.

d) To do this, business will need to be able to demonstrate all their prices are broadly aligned to transfer pricing rules - this is so even though the majority of these businesses are specifically carved out of transfer pricing by Parliament because they are too small.

e) Or they will need to be able to show the third party with which they deal is truly a third party – the benefit tests (see below) are very wide.

f) Or they will need to rely on the safe-harbour which is an involved calculation requiring knowledge of other jurisdictions' tax systems and which may or may not protect the taxpayer depending on the specific jurisdiction with which the taxpayer is trading.

11. While we appreciate that HMRC intend this legislation to be overseen by senior officials and with a light touch, the fact remains that it is within self-assessment and it cannot be the case that legislation is expected to be more honoured in the breach than the observance.

12. It will therefore be incumbent on compliant taxpayers to operate this legislation and the administrative burden that comes with it.

Definition of a profit fragmentation scheme - gateway

13. As stated there are 4 tests. The idea is that through the application of these tests or filters, the effect of the legislation is pared back to the intended target i.e. you have to meet these tests or come through this gateway before the legislation can apply

Test 1

14. The first test is whether there is an arrangement between the UK resident and a non-UK resident. The concept of arrangement is very wide so this could include simple sales/purchase transactions with a customer abroad or simple loans – normal daily transactions.

Recommendation

15. This is a wide test and that probably cannot be helped. It is therefore important that the remaining 3 filters effectively pare back the application of the legislation.

Test 2

16. The second test is whether value flows under the arrangement from the UK resident to the non-UK resident and whether that value "derives directly or indirectly from the profits of a business…".

17. This is troublesome. The policy documentation states that the target is effectively business income which is diverted to the non-UK resident <u>before</u> it is taxed.

18. The wording deployed however is far wider. Clearly post-tax profits "derive from the profits of a business" so immediately we see that this filter is far wider than the stated intention.

19. For example, a gift from a UK business man out of his taxed profits to his son or daughter studying abroad arguably meets both the first two tests.

20. Alternatively an interest free loan from the businessman out of taxed profits to his children abroad would meet both the first two tests.

21. It is therefore important that the final two tests are effective in paring back the legislation. However we do not think they are.

22. The cumulative effect of having wide filters at each stage is that the legislation is far wider than it should be meaning collateral damage for the compliant majority.

Recommendation

23. We believe that this filter needs to be pared back to capture the intended target – something along the following lines:
as a result of the material provision, value is transferred from the resident party to the overseas party which represents untaxed profits of a business chargeable to income tax or corporation tax, be that through, inter alia, the diversion of income or payment of expenses.

Test 3

24. The third test is whether the value transferred is greater than it would be had the arrangement been between parties acting at arm's length.
25. In the case of our hypothetical businessman lending money to his adult children abroad, clearly the value transferred could be argued to be greater than it would be for a commercial loan.
26. So far this innocuous family arrangement has probably met the first three filters.

Recommendation

27. This test is probably appropriate – while an odd result is generated, the problem here stems from test 2 being too wide.

Test 4

28. The fourth and final test is whether the person who transfers value overseas or people connected to him/her must be able to enjoy or benefit from the value in some way.
29. Such a filter makes sense. It is probably a hallmark of genuine arm's length activity that the UK resident is not able to benefit from the value transferred - as the recipient will be an independent third party.
30. On the other hand, if the individual can benefit from the value transferred then that could point to a tax motivation.
31. So as a filter this is theoretically sensible. However, it only works as part of a coherent whole and if the other filters are effective. Our view is that they are too wide.
32. In the case of our businessman lending money to his adult children, as they are connected with him then he will meet this test. The problem in this case remains test 2 which is too wide and should not have allowed a post-tax loan to come within the legislation.
33. Furthermore, a benefit test only works if it is actually a benefit test in action as well as in name.
34. In the case of the APL legislation, it could be read so wide that the taxpayer can meet this test while getting no benefit at all.
35. The problem is the clause which states that:
it is reasonable to conclude that the individual (whether acting alone or with any other person) procured the transfer of value from the resident party to the overseas party in such a way as to avoid the conditions in paragraph (a) being met.
36. We think it would be more effective if it read: (our insert in square brackets):
it is reasonable to conclude that the individual (whether acting alone or with any other person) procured the transfer of value from the resident party to the overseas party in such a way as to avoid the conditions in paragraph (a) being met [but still benefitted in some form from the value].

37. If a taxpayer ensures that neither he nor anyone connected with him gets a benefit then there is unlikely to be any mischief. The problem is that if the taxpayer ensures this, he will be treated as if he did get a benefit which gives odd results.

38. While in commercial transactions this is likely to be a material issue, because test 2 is so wide, it could have relevance for trusts. It is common for settlors to exclude themselves and/or family members from benefitting and there is a whole suite of legislation in place to tax this effectively.

39. However, such an exclusion would itself bring the individual within the scope of APL. We think what the measure is trying to do is actually capture taxpayers who try and circumvent the 4 tests but still derive a benefit. Hence our suggested amendment.

Recommendation

40. As mentioned above, we believe that the cumulative effect of the 4 tests is far too wide and will capture transactions, especially between family members, where there is no tax avoidance.

41. We recommend that the effect of the 4 tests in total is reconsidered and test 2 especially is reworked.

42. We recommend that the clause in test 4 is amended to include the additional wording along the lines above.

Tax mismatch calculation

43. Next in the scheme of the legislation is a safe-harbour which carves out certain arrangements that meet the 4 tests but where there is no tax mismatch.

44. The calculation is complex as is evident from the legislation. Broadly speaking there is a tax mismatch if the tax paid by the non-UK resident on the income diverted overseas is less than 80% of the tax that would have been paid in the UK by the UK resident.

45. However due to how the law works, it may very well be that parties other than the non-UK resident pays tax on that income. That this person may be a UK resident does not seem to be taken into account in applying this test.

46. While a safe-harbour is welcome, we generally do not think it is feasible to expect a small business to undertake this exercise for every transaction.

Recommendation

47. The explanatory notes (ENs) refer to the remittance basis and the newly introduced trust rules for non-domiciliaries. It is not clear what is envisaged but it seems to indicate that these can be factored in when calculating the tax mismatch.

48. However we struggled to see this in the legislation and we recommend that the legislation is amended to reflect the ENs if this is indeed the intention.

49. Furthermore, in addition to excluding from consideration foreign income eligible for the remittance basis, we consider that the limitations should apply to income within the scope of the settlement provisions (Income Tax (Trading and Other Income) Act 2005, Part 5, Chapter 5) and the transfer of assets abroad (TOAA) provisions (Income Tax Act 2007, Part 13 Chapter 2) as a whole.

50. We consider that the tax mismatch provisions should consider the tax payable in the round, rather than (broadly) the tax payable by the resident party being compared only to that payable by the overseas party.

Tax advantage

51. The second safe-harbour is a carve out where there is no main purpose of obtaining a tax advantage:

it is not reasonable to conclude that the main purpose, or one of the main purposes, for which the arrangements were entered into was to obtain a tax ***advantage*** (our emphasis).

52. It is tempting to read this as a tax avoidance motive test but it is not – the tax advantage threshold is so low that opening an ISA would fail this test.

53. The practical effect of using the term “tax advantage” instead of the term “tax avoidance” is that the safe-harbour is very limited.

54. Tax avoidance is a commonly used term in income tax anti-avoidance legislation. We consider that the term “tax advantage” should be replaced with “tax avoidance” to provide a proper safeguard for business.

Recommendation

55. When assessing the main purpose for which arrangements were entered into, we consider that, in paragraph 2(2)(b) of draft Schedule 4, the term “tax advantage” should be replaced with “tax avoidance”.

Counteraction

56. For the avoidance of doubt, the concept of a tax mismatch is used only for the carve-out. After that it is not relevant.

57. If the taxpayer remains within the scope of the legislation, he/she must counteract all the tax advantages that accrue from the arrangements.

58. The counteraction therefore is not equal to the tax mismatch.

59. The legislation states:
Adjustments must be made so as to counteract the tax advantages that would (ignoring this Schedule) arise from profit fragmentation arrangements.

60. It is unclear if this includes VAT and PAYE and other taxes. Some elements of the legislation seem to point towards this and some point away.

61. For example “tax advantage” is said to “include” income tax and corporation tax which would seem to imply that these taxes are what the draftsman was primarily focussed on. But equally, it is not an exhaustive definition and so other taxes must also presumably be included since the counteraction states that all tax advantages must be removed.

Recommendation

62. The legislation should be clarified to make clear what taxes are in scope.

Counteraction part 2 and double tax relief

63. The explanatory notes make it clear that the adjustments are to take place after other anti-avoidance provisions have applied. As per the ENs:
These adjustments are to be made in order to counteract any tax advantages arising from the profit fragmentation arrangements that remain after the application of other provisions. If other provisions have already applied to fully counteract the tax advantage then no further adjustments are required.

64. The legislation however does not seem to support this.

65. On the contrary, the legislation is focussed on “tax advantages” and, in the scheme of the legislation, the tax advantages in question appear to be those that accrue to the UK resident who has transferred the value.

66. It does not seem to allow the action of other provisions to be factored in – in many cases these other provisions will cause a tax liability for another UK resident but not the UK resident who transfers the value.

67. As such, the counteraction will have to happen notwithstanding that overall there has been no tax advantage.

68. And the counteraction:
must relate to the expenses, income, profits or losses of the resident party for the tax period in which value is transferred as a result of the material provision.

69. So the counteraction seems to be required in some cases irrespective of whether other anti-avoidance provisions have applied. And it then falls to the double tax relieving provision to attempt to remove any incidence of double tax.

70. The problem is that the double tax relieving mechanism only works if:
the result is a double payment of tax calculated by reference to the same income or profits.

71. The APL is new legislation in an area which is subject to long standing tax law. Not all the other anti-avoidance legislation works quite as neatly as envisaged by the APL double tax relief provision – the charge is not always exactly by reference to the same income or profits. Or if it is, it is not always so easy to demonstrate that from an administrative perspective.

72. Nor does it always operate at the same time – sometimes the charge can crystallise years afterwards.

73. The consequence is there may be scenarios where economic double taxation occurs under the law as drafted.

74. Furthermore the relief is not available to the person paying the further tax due under the "other" anti-avoidance legislation – the relief is for the person counteracted under the APL.

75. As these may be entirely different persons this may pose issues in practice.

Recommendation

76. We recommend that the double tax provision is widened beyond being by "reference to the same income or profits".

77. Further thought should be given to how the double tax provisions will work with other anti-avoidance such as s731 ITA which charge different people and at different times.

78. Paragraph 8(5) should be widened so that HMRC can make consequential adjustments for UK tax purposes for all of the entities involved where their income is subject to UK taxation whether directly or indirectly and regardless of the time delay when that is caused by the existing legislation.

Law expressed in explanatory notes

79. As noted above, the Explanatory Notes suggest things which do not seem to be supported by the legislation.

Recommendation

80. The legislation should be amended to reflect the intention as detailed in the explanatory notes.

FURTHER INFORMATION

As part of our Royal Charter, we have a duty to inform policy in the public interest.

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APPENDIX 1

TECHNICAL DETAIL

Law expressed in explanatory notes

81. The first draft of the APL did not take account of the specific policies and tax regimes relevant to non-UK domiciled individuals and associated trusts. The original draft provisions, if enacted, would have overridden both long-standing and only recently introduced regimes in these areas. We are pleased to note that efforts have been made to address this issue. However, rather than limiting the scope of the legislation in the primary legislation, an explanation of when the APL provisions may and may not apply are included in the explanatory notes to the APL.

82. We are concerned that a statement of the intent in the explanatory notes is insufficient to limit the application of the APL provisions in unintended circumstances, where the wording of the statute would clearly result in the APL provisions applying.

83. This point was considered by Lord Steyn in the case of *Westminster City Council v National Asylum Support Service* [2002] UKHL 38. In summary, he found that explanatory notes are admissible aids to construction to the extent that they "*cast light on the objective setting or contextual scene of the statute, and the mischief at which it is aimed*." Lord Steyn noted that, while in some cases clearly expressed assurances of meaning or statement of circumstances in which a power will or will not be exercised might be admitted in proceedings, the aims of the government which may be revealed by explanatory notes cannot be attributed to Parliament: "*the object [of explanatory notes] is to see what is the intention expressed by the words enacted*.]

84. While it is helpful that steps have been taken to address the concerns we raised previously, we are concerned that seeking to limit the scope of the APL using explanatory notes does not provide adequate certainty for taxpayers. We consider that the tax mismatch provisions in paragraph 5, to which these explanatory notes relate, should be amended to encompass the refinements included in the explanatory notes.

Tax mismatch calculation

85. The explanatory notes relate to paragraph 5, which is relevant to calculating whether or not there is a "tax mismatch", which is a requirement for the APL to apply. They seek to exclude from the APL both foreign income that is unconnected to a UK business, where the remittance basis applies, and protected foreign source income arising to a trust, as defined by the provisions enacted by Finance Act 2017. We consider that, in addition to non-business foreign remittance basis income, all income within the scope of the TOAA and/or settlement provisions should be excluded from the tax mismatch calculations.

86. In terms of calculating the tax mismatch, we understand from our discussions with HMRC that the intention is for the calculation to take account of the tax position as a whole. However, the drafting of the tax mismatch provisions only considers the tax payable by the resident party who made the transfer and the overseas party (the overseas person or entity) who benefited from it. We consider that the overall tax payable should be considered, and the legislation should be clarified in order to do so.

87. For example, let us assume that a UK resident individual wholly owns a UK resident and UK incorporated company, which he funded by way of subscribing for shares in the company. The UK company transfers value to an overseas company in a way which satisfies the requirements for the APL to apply. The individual is a shareholder in the overseas company so he can benefit from the income arising overseas, which meets the conditions for s720 ITA 2007 (TOAA) to apply to charge him on the income arising to the overseas company (we assume here that the relevant TOAA conditions are met). He is a participator in the UK company (the "resident party"), so his enjoyment (potential or actual) means that the conditions for the APL to apply are met.

88. The income which is received by the person abroad is within the scope of taxation, as the individual is subject to income tax at personal income tax rates (which, at the current tax rates, would have actually increased the total tax payable). However, the drafting of the tax mismatch provisions do not appear to enable the tax payable by the individual to be taken into account when calculating the tax mismatch. This means that both the individual and the UK company would pay tax on the same income, and the UK company would then claim a repayment to take account of the tax paid by the individual. This is overly complex.

Overseas person or entity

89. One of the conditions which must be met in order for the APL to apply is that an “overseas person or entity” is involved in the profit fragmentation arrangements. This includes a person or entity who meets either of the below conditions:

    a) a person abroad as defined by s718 ITA 2007. This is a broad definition, which encompasses both non-UK residents and non-UK domiciliaries.

    b) “*a company, partnership, trust or other entity or arrangements established or having effect under the law of a country or territory outside the United Kingdom (regardless of whether it has legal personality as a body corporate*”.

90. The effect of this drafting is that, for example, UK tax resident but non-UK incorporated companies are within the definition of overseas person under the new APL provisions, even though the company in question would be within the scope of the UK taxation system. This definition therefore adds complexity to situations where income is already within the scope of UK taxation.

91. The same definition previously applied for the purposes of s718 ITA 2007, but part b was removed with effect from 6 April 2012 by Finance Act 2013. The government consultation which outlined this change commented that “*the overall scope of operation of the [TOAA] regime…will not change as a result of these reforms and the amended legislation will continue to provide a robust defence against abuse*.”[1]

92. Part b of the “overseas person or entity” definition therefore appears, prima facie, to be superfluous. However, having discussed this point with HMRC, we understand that the intention is to put beyond doubt that certain types of foreign entity which are not easily categorised for UK legal purposes fall within the definition of overseas person or entity for APL purposes. We have suggested a revised definition in order to achieve this objective in the main body of this letter.

[1] Paragraph 3.14 of the HMRC consultation published on 30 July 2012, entitled “Reform of two anti-avoidance provisions: (i) the attribution of gains to members of closely controlled non-resident companies, and (ii) the transfer of assets abroad”.

APPENDIX 2

ICAEW TAX FACULTY – WHO WE ARE

ICAEW Tax Faculty is internationally recognised as a source of expertise and is a leading authority on taxation. It is responsible for making submissions to tax authorities on behalf of ICAEW and does this with support from over 130 volunteers, many of whom are well-known names in the tax world. ICAEW Tax Faculty's Ten Tenets for a Better Tax System are summarised in Appendix 2.

ICAEW is a world-leading professional body established under a Royal Charter to serve the public interest. In pursuit of its vision of a world of strong economies, ICAEW works with governments, regulators and businesses and it leads, connects, supports and regulates more than 150,000 chartered accountant members in over 160 countries. ICAEW members work in all types of private and public organisations, including public practice firms, and are trained to provide clarity and rigour and apply the highest professional, technical and ethical standards.

APPENDIX 3

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).