ICAS response to the HMRC consultation document ‘Reforms to the Taxation of Non-Domiciles’

11 November 2015
About ICAS

The Institute of Chartered Accountants of Scotland ("ICAS") is the oldest professional body of accountants. We represent around 20,000 members who advise and lead businesses. Around half our members are based in Scotland, the other half work in the rest of the UK and in almost 100 countries around the world. Nearly two thirds of our members work in business, whilst a third work in accountancy practices. ICAS members play leading roles in around 80% of FTSE 100 companies. ICAS is also a public interest body.

General Comments

1. ICAS welcomes the opportunity to comment on the HMRC consultation document Reforms to the Taxation of Non-Dominciles published on 30 September 2015.

2. The consultation only includes limited draft legislation which leaves details on many aspects of the proposals unclear. It would be helpful for the remaining draft legislation to be published as soon as possible.

3. Our responses to the specific questions appear below. We have also included an appendix covering a suggested alternative approach to the proposals in paragraph 3.2 of the consultation document, which has been developed by representatives of the CIOT, the Law Society, STEP and the ICAEW. We agree with them that this approach should be considered instead of the proposals in paragraph 3.2.

Questions on the proposal to legislate the deeming provision for those resident for 15 of the past 20 years

Question 1

Do stakeholders agree that the approach outlined in this document is the best way to introduce the test for deemed-domicile status?

4. It is difficult to comment on the overall approach given that details of some aspects of the proposals will only be covered in a separate consultation. Some specific points arising from the current consultation are outlined below.

5. The summer technical note suggested that an individual leaving the UK before 6 April 2017 but who would nevertheless be deemed domiciled under the new rules on 6 April 2017 would still be subject to the old rules. This does not appear to be reflected in the draft legislation in the consultation document which therefore needs to be amended.

6. The proposals state that time spent whilst an individual is under the age of 18 will count. This would mean that a child could become domiciled before they reach adulthood even though they are likely to have little choice in the matter. We believe serious consideration should be given to excluding time spent in the UK under age 18. It seems particularly unfair to take into account where a minor child spends time when they have no say in where they live. In particular the common law rules still prevail in deciding where someone is domiciled in the first place. The Government has stated it wants to attract people to the UK who can contribute to the economy. This measure will deter people coming to work here with their families. It will also deter people from sending their children to school and university here which will have a detrimental effect on the economy.

Question 2

Are there any difficult circumstances that might arise as a result of the intended approach that could be avoided with a different test?

7. Due to the proposed treatment of split years there could be issues where a year of becoming deemed domiciled coincides with a split year. IT and CGT will not apply in the non-resident part of the year but the position for IHT where there are chargeable transfers in the non-resident part of the year appears to be different.
8. HMRC has suggested that there may be transitional provisions for non-domiciled individuals who left the UK before the announcement of the changes and may not therefore be aware of the new requirement to be outside the UK for 6 years. Transitional provisions for these individuals would be helpful. However consideration should also be given to individuals who may have returned before the announcement of the changes – basing that decision on the old rules which they thought applied.

**Question 3**

The government is interested in views from stakeholders about the need for preserving the £2,000 de-minimis threshold for those non-domiciled individuals who become deemed UK domiciled.

9. Generally it seems reasonable to remove the de minimis threshold for those becoming deemed domiciled, for the reasons given in the consultation document. However the Government also notes that it wants to ensure that any new regime is proportionate in terms of the burdens it puts on individuals, particularly those on lower incomes. Some individuals, particularly those on lower incomes, may not have access to advice and may find it difficult to obtain details and report such income/gains; there is a significant risk that some could be pushed into non-compliance. There could be particular problems where the income/gain is not dividends/interest or a gain eligible for the allowances noted but is derived from another source such as an overseas property: as noted in the consultation this may not previously have been taxable in the UK and information may not be readily available. Some unrepresented taxpayers may also assume that because tax has been paid in the overseas territory none is due in the UK which could be true in some cases but will depend on the relevant tax treaty.

**Question 4**

Do stakeholders agree that the approach outlined in this document which will change the inheritance tax rules for those UK domiciliaries who are leaving the UK is straightforward and reasonable?

10. It would make sense to treat UK domiciled individuals and UK deemed domiciled individuals in the same way to avoid having two different regimes. However there will be practical problems arising from extending the IHT ‘tail’. HMRC is likely to find it hard to obtain information and to enforce payment of tax; this is already an issue with the current provisions but will be made worse by the longer time period. Where the liability can be enforced there may be double taxation issues because not all tax regimes offer unilateral relief and many treaties currently do not cover the issue.

**Question 5**

Do stakeholders agree that the period a spouse needs to remain non-resident before the inheritance tax spouse election ceases to have effect should be amended to 6 years?

11. This would make sense to align the election with the other new rules. However see the response to Question 4 above on the practical issues arising from extending the IHT ‘tail’.

**Questions on the proposal to treat those who are born in the UK with a UK domicile of origin as domiciled while they are living in the UK**

**Question 6**

In what circumstances would having a short grace period for inheritance tax help to produce a fair outcome?

12. This would assist to some extent where someone born in the UK (with a UK domicile of origin) leaves shortly after birth, acquires a different domicile and does not return to the
UK for many years. When they do return they are only in the UK for a short period, possibly to deal with an elderly/sick relative, and then return to their permanent overseas life. However it does not alter the essential unfairness of the approach for someone whose connection with the UK has been so limited and who has no intention of living in the UK for any length of time. If this approach is adopted a one year period of grace seems an unreasonably short period for someone who has been out of the UK for, say, 30 years. Also the draft legislation may need to be amended to ensure it addresses the situation where the return period in the UK straddles two tax years.

13. There will also be issues for employers sending employees to the UK on temporary assignments. Employees who were born in the UK with a UK domicile of origin who have acquired a domicile of choice elsewhere and have no plans to move back to the UK permanently may be unwilling to accept an assignment to the UK because of the adverse consequences (particularly for IHT). This might partially be addressed by extending the period of grace to, say, three years where the individual is resident in the UK for full time work under an employment contract.

14. The period of grace only addresses IHT and does not address other issues arising from the ‘born in the UK’ approach which are mentioned in the responses to Questions 8 and 9 below.

Question 7

What difficulties do stakeholders envisage there could be for trustees tasked with calculating the 10 year charge in these circumstances?

15. It is unlikely that trustees in these circumstances will have adequate records to calculate the 10 year charge accurately. Going forward trustees might be expected to keep sufficient records but for the past, when there was no reason to keep records for this purpose, they are unlikely to exist. Could some form of rebasing election be considered to address this issue? Without some form of rebasing or grandfathering trustees may be pushed into non-compliance by reason of retrospection.

Question 8

Do stakeholders agree this is the most reasonable way to deliver these reforms? Are there any circumstances when applying these rules would produce unfair outcomes?

16. The approach may be reasonable in dealing with individuals who have strong connections with the UK and return regularly/spend reasonable amounts of time in the UK. However as noted above in the answer to Question 6 there will be obvious unfairness for an individual who, although born in the UK, leaves in childhood and lives permanently elsewhere. A number of options could be considered to address this. Further conditions linked to an individual having a meaningful connection with the UK could be added to the rules. An individual who acquired a non-UK domicile of dependence, after leaving the UK in childhood, could be excluded from the provisions. The ‘period of grace’ for IHT could be extended to two or three years, either in all cases, or where the individual returns to the UK for a temporary period for their employment.

Question 9

Would the rules as described leave any significant uncertainty? If so, how?

17. Domicile of origin may be hard to establish, particularly if the individual’s parents are internationally mobile. Siblings could potentially be treated differently solely because one of them happened to be born in the UK, whereas the other was born elsewhere, even though their circumstances are otherwise identical. This is likely to cause uncertainty and confusion as well as unfairness.
Appendix: an alternative to the proposal in paragraph 3.2 of the consultation document
DISCUSSION DRAFT – POSSIBLE TREATMENT OF OFFSHORE SETTLEMENTS FOR NON-DOMICILIARIES AFTER 6 APRIL 2017

Background

This paper has been prepared by representatives of the CIOT, Law Society, STEP and ICAEW who attended a meeting with HM Treasury and HM Revenue & Customs on 9 October 2015. It describes in more detail one possible way in which trusts with non-domiciled settlors / beneficiaries could be taxed after 6 April 2017.

Please note that:

• While this paper is produced by representatives of the above bodies, it is intended merely as a discussion draft. It does not constitute the formal policy of any of those bodies and has not (yet) been through the full review procedures of those bodies. As such it should not be attributed as the official view of those bodies

• This paper is intended merely as an outline of one possible method of taxing offshore trusts. More detail would be needed to flesh-out this proposal.
Executive Summary

We consider that the “dry benefits” tax charge set out in the condoc has a number of insurmountable problems. This is the unanimous view of all those participating and we are aiming to send you a separate note shortly about the many issues which arise under that proposal.

In its place this paper proposes a modified version of the existing non-transferor charge (s731 ITA and s87 TCGA) as the basis for taxing non-resident trusts set up by all non-doms. The essential elements of this are as follows:

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<tr>
<th>Proposal</th>
<th>Outline of legislative changes</th>
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<tr>
<td>• No (or only minor) changes for UK domiciled settlors (including “returning doms”)</td>
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<td>• We consider it essential that there should be a single coherent regime applicable to all settlors and beneficiaries of trusts set up by a non-domiciled settlor.</td>
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<td>• UK source income continues to be taxed on settlor (if settlor-interested). A subsequent actual payment of the taxed income should not be taxable.</td>
<td>s624 ITTOIA and s721 ITA restricted to UK source income and aligned more closely</td>
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<td>• No changes to the current tax treatment of a life tenant of an IIP trust</td>
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<td>• All other income and gains (e.g. foreign source) to be matched with benefits / capital payments. Remittance basis may apply to foreign benefits. Deemed domiciled beneficiaries (including the settlor) taxed on worldwide benefits. Income genuinely paid away or used to pay expenses ceases to be relevant income.</td>
<td>s731 ITA and s87 TCGA largely unchanged. Amend s735 so that remittance rules only apply if benefit received in or remitted to the UK, not if the relevant income is remitted to the UK.</td>
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<td>• Potentially combine s731 and s87 into a single code. This might involve loss of motive defence for non-transferor charge although we would only support the loss of the motive defence as a quid-pro-quo for the other changes suggested below.</td>
<td>Alternatively, s731 ITA repealed and s87 TCGA expanded to cover both income and gains. Possibly amend s736 to s742 ITA accordingly.</td>
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<td>• Switching off imputation of income to settlor prior to deemed domicile could be made dependent on the settlor being a remittance basis user. This would have advantage that trustees could remit income to the UK in their own hands for investment.</td>
<td>Amendments to s809B ff. Potentially amend s809M so that a trust is not a relevant person in relation to trust income1. Appropriate amendments to s624 ITTOIA and s721 ITA.</td>
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<td>• Transitional provisions for existing trusts as at 6 April 2017 and those where settlor/beneficiaries newly arrive in the UK for the first time.</td>
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Policy objectives and constraints

While preparing this paper it has become apparent that the policy objectives that the government wishes to achieve in relation to offshore trusts – and particularly the priority between competing objectives - are not entirely clear. We think it is helpful, therefore, to set out our understanding of those objectives (as we discern them from conversations with

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1 It could remain a relevant person in relation to income/gains of the settlor.
HMRC and Treasury and from the consultation documents which have been issued). This should help to clarify any misunderstandings at an early stage. We believe that the policy objectives (in approximate order of priority) are as follows:

1. The new non-residents trusts regime for non-doms should deliberately act as something of a counter-balance to the major changes to the taxation of non-doms announced in July whereby under the so-called deemed domicile proposals non-doms will be taxed on their worldwide personal income and gains after 15 years. It should enable non-dom settlors and beneficiaries to remain in the UK without extensive reporting and compliance obligations on what are often international trusts with little connection to the UK provided that, and for as long as, they do not receive benefits from such trusts.

2. The new regime should not be unduly favourable or have significant yield implications but it has to be recognized that any change will inevitably bring winners and losers and in many ways yield from trusts will be unpredictable. In some respects the regime for trusts suggested below could bring significant yield for UK PLC not least in that it simplifies the current over complex regime and encourages trusts to invest in the UK.

3. The proposals should not leave scope for avoidance – but recognizing in that statement that “avoidance” does not include taking advantage of a relief clearly afforded by Parliament. Consequently, recognizing the above two objectives, the straightforward use of offshore trusts to give a better position than would have been the case had assets been owned personally, does not amount to avoidance for these purposes.

4. The regime should be as coherent as possible – that is to say that the income tax and capital gains tax aspects of it should hang together and not be subject (as they are at present) to radically different codes. Within that objective, the regime should be as simple as possible, but recognizing that this is a tertiary objective which may need to be compromised in favour of the objectives listed above. It also needs to be borne in mind that trusts come in many shapes and forms and, when coupled with the range of permutations thrown up by the residence, domicile and deemed domicile of settlor and beneficiaries, this inevitably creates a complex position.

5. The position for UK resident AND domiciled settlors should remain largely as it is now. The proposals below are aimed at trusts set up by foreign domiciled settlors. As a general principle we do not think there should be different tax regimes operating before or after the 15 year cut off or between UK and foreign domiciled beneficiaries (other than UK domiciled settlors). Further, there should be a single regime which applies to all trusts created by settlors who were non-domiciled and not deemed domiciled at the time. The availability of alternative regimes is likely to lead to unacceptable complexity and difficulties in application. Of course there may be differences in impact because of the remittance basis but the same regimes should operate.

6. We would also note that the remittance basis has always contained an inherent contradiction within it. The remittance basis has always acted as an incentive to non-doms to remain in the UK, but at the same time it has acted as a disincentive for them to bring funds into the UK (to the detriment of creating economic activity in the UK). While respecting that the government has made a policy decision not to alter the fundamentals of the remittance basis as part of this package of measures, it is our view that if the proposals can meet the above objectives (particularly in terms of yield) then to the extent to which they may permit funds to be brought into the UK (thereby being attractive to non-doms and good for the UK economy) this should be considered as a positive feature, even though it may spoil the “purity” of the remittance basis.

Set in the context of the above objectives, we put forward the following proposals.
Proposals

A. Proposals to apply only to “settlements”

In the same way that other offshore structures, such as insurance bonds and offshore mutual funds, have their own separate regime, we would propose that offshore “settlements” should be subject to their own single regime as described below.

The following proposals therefore apply only to “settlements” – that is trusts, trust-like equivalents\(^2\), and (see further below) companies owned by trusts.

The Transfer of Assets code would be kept as a residual category for stand-alone companies and other non-trust structures.

B. UK domiciled settlers

Where the settlor is UK resident and either actually domiciled or a “returning dom”\(^3\) then the present rules should remain. Some limited aspects of the following proposals might be adopted to ensure consistency.

The following therefore applies only to non-UK domiciled settlers\(^4\).

C. Same rules to apply before and after “year 15”

In our view there are significant difficulties with a very different regime applying before and after “year 15”. For instance there would be scope for planning either side of that anniversary. There would be further issues if a settlor subsequently lost deemed domicile through 6 years of non-residence.

We therefore propose that the same rules, but with modified effect, should apply throughout.

The following proposals ensure a consistent regime applies to settlements without the trustees having to keep track of the deemed domicile status of the settlor. However, although the regime is consistent the effects vary – in particular after “year 15” the settlor will be incapable of being an RBU and would therefore be taxed (see F below) on worldwide benefits.

D. UK source income

UK source income is taxed broadly\(^5\) as at present, i.e:

- on the Settlor if the settlor is UK resident and the trust is settlor-interested
- otherwise on the life-tenant if there is one;
- potentially - depending upon the exact situation - on the trustees themselves
- otherwise on the recipient if it is distributed as income.

If none of the above apply the UK source income is taxed under the matching rules described at F below.

Once income is taxed under the above, it is not taxed again if it is subsequently distributed\(^6\).

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\(^2\) For instance Foundations to the extent to which they are akin to trusts

\(^3\) i.e. under the new proposals he had a UK domicile of origin; was born in the UK; and is now UK resident.

\(^4\) We suggest that the deemed domicile status of the settlor should be irrelevant: in practice deemed domiciled settlers are unlikely to create new settlements due to the inheritance tax entry-charge.

\(^5\) We think it would be helpful to clarify the following order of priority and to eliminate the possibility of double-charging (e.g. trust is settlor-interested, but income is actually distributed to another UK resident)

\(^6\) Income which arises at the “bottom” of a structure and which is taxed in accordance with these rules should not create a new source of income or chargeable gains if it is paid up through the structure.
E. Non-UK source income

Non-UK source income should be taxed:

• on the Settlor if UK resident and either:
  • the Settlor, the Settlor's spouse or the Settlor's minor children have an IIP in that income; or
  • it is otherwise distributed as income to any of them;
• on the recipient (or person entitled) if it is distributed as income to any other person or that other person has an IIP in that income;
• otherwise under the matching rules described at F below.

Any credits attached to such income should be available to the taxpayer in the same way as at present. Once attributed to a taxpayer under any of the above, the income would no longer be available to be matched and would not be taxed again if it is subsequently distributed.

Income attributed to a person in accordance with the above would be taxed according to the residence, domicile and RBU status of that person.

F. Matching rules for other income

Any income not taxed in accordance with the above would be matched either under s731 ITA or a modified form of those provisions as described in H below.

This would apply to income that has been retained in the trust (whether formally accumulated or simply rolled-up) and which has not been distributed or used to pay expenses.

The matching would apply to beneficiaries wherever resident.

If the beneficiary was UK resident this would give rise to a tax charge but – as is currently the case for capital gains – the deemed income would be treated as having the same source as the benefit with which it had been matched. Consequently:

• benefits received in the UK would therefore automatically be taxed;
• benefits received anywhere in the world by a deemed domiciled recipient would also be taxed;
• benefits received outside the UK would potentially be subject to the remittance basis if the recipient is an RBU.

s731 should ideally be put onto a LIFO basis. This would, in practice, address many of the problems of lack of records.

G. Capital gains treatment as at present

The capital gains position of trusts would be largely as at present.

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7 i.e. in present terminology, it would cease to be “relevant income”.
8 Given D above, this will principally be foreign income. It applies to (undistributed) UK income only where the settlor is deceased, non-resident or the trust is not settlor-interested.
9 Any perceived avoidance can be tackled as it could now by a combination of more rigorous enforcement against “conduit” arrangements and greater use of the GAAR. A specific GAAR example could be put to the GAAR panel for approval if desired.
10 Under our proposals at H, it would inevitably be put onto the same basis as s87, but we consider that it should be in any event.
H. Possible assimilation of s731 and s87

The matching proposals described at F and G above could be dealt with under the existing s731 and s87 mechanisms in a modified form.

However, we think that there is scope within the proposal to go further. Although this is not a necessary part of our proposals we think that there is a good case for amalgamating s731 and s87 into a single regime. The regime would broadly match income first (subject to income tax); OIGs (subject to income tax) second; and capital gains third(subject to capital gains tax + supplementary charge as appropriate).

A single matching code would be a significant improvement in many regards. It would remove many of the difficulties that there are at present – for instance around offshore income gains; around the fact that s731 matches on a FIFO basis but s87 on a LIFO basis; and the difficulties with s733 matching. It would also give less scope for interstices between the two codes.

Thought would need to be given to whether full alignment of s87 and s731 is possible and, in particular, to companies owned by trusts.

The price for amalgamation might be the loss of the motive defence for non-transferor trust cases\textsuperscript{11}. We should only support the removal of the motive defence as part of an assimilation of s731 & s87 in the form outlined in this section H and the proposals at section F.

\textsuperscript{11} As mentioned above, the Transfer of Assets regime would remain as a residual category for non-trust cases.
Additional Proposals

The following additional proposals should also be adopted although they are not part of our core proposal.

I. Transitional rules

There should be transitional rules for trusts created before 6 April 2017 and for those arriving in the UK for the first time. This would address the main difficulty, as identified in the condoc, of lack of records.

J. No anti-forestalling rules

There should be no anti-forestalling rules. It is of the essence of the period until 6 April 2017 that non-doms should have a sensible chance to re-organise their affairs.

K. Schedules 4B and 4C should be removed

This should be accompanied by (panel approved) GAAR guidance saying that any arrangements designed along flip-flop lines would be considered to be caught by the GAAR.

L. Carried interest

The overriding policy, as stated in the condoc, of only taxing benefits should be followed through consistently. In particular, carried interest held by trusts should not face double-taxation as it may do under the recent proposals.

Comments

While we have aimed to formulate proposals that meet the perceived objectives in a balanced way, we recognise that some of our proposals above have pros and cons. We attempt to summarise some possible concerns in this section.

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<th>Pros</th>
<th>Cons</th>
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<td>C</td>
<td>Our proposals result in a consistent regime both before and after “year 15” and have major advantages in allowing the trustees to remit foreign-source income into the UK (in their own hands) for investment without thereby causing a remittance for the settlor (see F below).</td>
<td>We recognise that, in allowing foreign source income to roll-up within trusts prior to “year 15”, there might be concern that non-doms might come to view trusts as a cheaper alternative to paying the RBC from year 8 to 15.</td>
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<td>We think that having a very different regime before and after “year 15” would cause significant anomalies.</td>
<td>We think that this concern is overstated (because in not paying the RBC, worldwide benefits would then be matched).</td>
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<tr>
<td>F</td>
<td>Our proposals for income represent a</td>
<td>We recognise that under our matching stage 12.</td>
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major simplification of the current system where we currently have a combination of imputation (to settlor); tracing (to see whether remittance) and matching codes. In particular, this would enable the trustees to bring trust (or underlying corporate) income\textsuperscript{13} into the UK in their own hands for investment without (as is presently the case) thereby causing a remittance for the settlor or beneficiary. We think that this would have significant advantages both for trustees and for the UK economy.

proposals benefits will give rise to deemed foreign income, even if the relevant income is UK source. However, given D above, this will only apply to UK source income in a limited range of cases (see footnote 8). Furthermore, the deeming as foreign income will be irrelevant for beneficiaries after "year 15" anyway. As such we think that a good case can be made for a single pool – which we note is currently the case for CGT under s87 TCGA.

The switching-off of the motive defence in non-transferor cases is, in our view, a possible quid-pro-quo for this (see H above)

\textsuperscript{13} Note that this would apply just to trust (or underlying corporate) income. It would not apply to the settlor’s own income (which he might have settled into the trust) as the trust would still be a relevant person in relation to the settlor’s income.