TRANSFER OF ASSETS ABROAD 2017

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1. The transfer of assets abroad provisions ("the TOAA code") in Chapter 2 Part 13 ITA 2007 have a venerable history dating back to Finance Act 936. They have been tinkered with and amended on numerous occasions. Latest indications are that there is no end of this in sight:

   a) Finance (No.2) Bill 2017 sees further amendments proposed.

   b) On 13 September 2017, further draft clauses to be introduced in Finance Bill 2018 were published.

2. The 2017 changes are discussed in this article. Further changes are proposed for the Finance Act 2018.

Brexit and the TOAA Code

3. A more general and potentially significant change to the TOAA Code in coming years is the impact of Brexit.

4. In recent years the effectiveness of the TOAA code has been undermined by the principle of EU law that while Member States have competence in the area of direct taxation, that competence must be exercised in compliance with EU law. The TOAA code falls foul of that restriction. That view was confirmed by the FTT in *Fisher v HMRC* [2014] UKFTT 804 (TC). For the properly advised taxpayer, the TOAA had become toothless.

5. Then on 23 June 2016 the UK voted to leave the European Union. Any consideration of the current state of the TOAA code must address a fundamental question: what is the impact of Brexit on the TOAA code

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going forward? What is the relevance of EU law going forward? Will we simply ignore EU law in interpreting the TOAA code in the future?

6. In addressing the impact of Brexit on the TOAA code there are two related considerations:

   a) What is the impact of EU law on the TOAA code at present?

   b) How will the European Union (Withdrawal) Bill affect that?

Impact of EU law on the TOAA code

7. Central to this question is the question of how EU law is given effect as a matter of UK law. There are two possibilities: UK law is construed in a manner which is consistent with EU law (conforming interpretation); or UK law is ignored or disapplied in favour of the EU law rights (disapplication).

8. It is obviously the case that when dealing with disapplication, one must be able to show that there is an EU law right being relied upon. Therefore, where no EU law applies you fall back on domestic construction.

9. The position is not as straight forward where there is a conforming interpretation. There the issue is the scope of application of a UK statute. There can only be one construction of the statute. There cannot be a different construction depending upon whether EU law is involved or not. There may, however, be a construction which takes the application of EU law into account.

10. That is because what is required interpretation by reference to EU law principles (but possibly also other principles of construction e.g. Human Rights Act 1998). The ultimate question is always whether the situation comes within the meaning of the statutory words, properly construed. The process of construction is informed by EU law, but the law applied is provided by Parliament. Withdrawal from the EU should not change that.

Fisher v HMRC – a conforming interpretation

11. It is worth recalling what the FTT decided in *Fisher* as to how EU law impacts on the TOAA code:

[649] Anne Fisher's freedom to establish in the UK (albeit a part of the UK given we are in this section of the decision assuming the freedoms do not apply as between the UK and Gibraltar) is so restricted in our view. She is a national of one member state (Ireland) who is dissuaded from establishing in part of another member state (the UK for the purposes of this argument) by being charged to UK tax on the profits of SJG and being charged at a higher personal tax rate.

…

[651] We are satisfied that the TOAA code restricts Anne Fisher's right of establishment. That does not of course mean the legislation is incompatible. The approach confirmed by the relevant case law, which we do not understand to be in dispute between the parties, is then to consider if the restriction is justified, and if it is, to consider further if the restriction is a proportionate means of achieving the legitimate objective pursued by the legislation. We turn now to those questions.

…

[661] It is clear from the findings of fact that SJG was a real operation with premises, staff and equipment. It was not a letter box company and there can be no question in our minds that it falls within the artificial arrangements envisaged by 'avoidance' as understood in European law terms.

…

[665] The justification put forward by HMRC of preventing tax avoidance by the movement of profits generated in the UK to Gibraltar does not amount to a valid justification in our view. As the appellants point out they are being taxed on profits generated in Gibraltar. This illustrates in our view that the provisions are not targeted at deterring the movement of profits made in the UK but that they operate to dissuade establishing in Gibraltar to take advantage of tax advantages there. It follows from Cadbury Schweppes that this behaviour does not amount to avoidance in European law terms and that the justification of fighting against tax avoidance understood in those terms does not serve to justify the TOAA legislation which is cast in far wider terms.

…

[668] HMRC argue the legislation is proportionate because it is closely targeted on situations in which the transferor has a tax avoidance motive. It does not apply to transactions undertaken purely for commercial reasons.

[669] *We disagree with HMRC. Even if the objective of the legislation were articulated as the prevention of the avoidance in the European sense of the term, as can be seen from our earlier findings, it operates to catch persons who establish in Gibraltar in order to take advantage of the more favourable tax regime but who have not done so using artificial means. It is not therefore closely targeted at those situations (artificiality as described in Cadbury Schweppes) which count as avoidance in European law but captures persons such as Anne Fisher who exercise freedom of establishment rights into Gibraltar and UK nationals who exercise their freedom of establishment into other member states.*

[670] *Further, even if the fight against avoidance of UK betting duty were to be a valid justification for the provisions, the provisions are not suitable for that objective and go far beyond it as the way in which the tax charged on the appellants is calculated goes far beyond the amount of betting duty avoided.*

…

[673] *Our conclusion is that the TOAA charge does restrict Anne Fisher's freedom of establishment (and by extension her free movement of capital) and that it breaches those freedoms in a way which lacks justification. Even if the breach of those freedoms were justified it is not proportionate to any legitimate justification of fighting tax avoidance as that concept is understood in European law.*

…

[675] *It is uncontroversial that once it is found an appellant's rights under the Treaty are infringed by legislation, here the TOAA charge, then we must first see if we can interpret the legislation in such a manner which is consistent with the appellant's rights (ie find a conforming interpretation). If that is not possible then the legislation must be disapplied.*

…

[679] *The appellants' primary position is that the legislation should be disapplied but if it is not disapplied then the conforming interpretation would recast the motive defence so as to construe tax avoidance in the more restricted European law sense of artificiality so that the provision did not operate so as to catch exercises of freedom of establishment and movement of capital protected by the Treaty.*

[680] *The motive defence must, they argue, be interpreted in a manner which complies with EU law, which would be as set out in*

Cadbury Schweppes i.e. that disregards only activities which are wholly artificial.

[681] We think a conforming interpretation along the lines the appellants suggest is possible with the following caveat. In seeking a conforming interpretation which ensures the relevant freedom is not infringed, we are mindful of the need to not go further than necessary. In our view the appellants' suggested conforming interpretation therefore needs a further gloss. This is that their reinterpreted more restrictive definition of 'avoidance' in the motive defence need only be applied to those situations where the individual subject to the charge is exercising Treaty freedoms. A conforming interpretation, (using a narrow conception of avoidance) which applied irrespective of whether a person's treaty freedoms had been infringed would be going further than what was necessary to ensure compliance with s 2 of EC Act 1972. It would, for instance, apply the benefit of the more limited definition to movements to third countries. The rationale in Cadbury Schweppes of tax being paid in one member state being equivalent to tax being paid in another would not extend to saying that tax paid in a third country is equivalent to tax being paid in a member state.

12. To summarise:

a) The TOAA code restricts freedom of establishment and by extension free movement of capital (paras 649, 651 and 673);

b) That restriction is not justified (paras 661 and 665);

c) Even if there was a justification it would not in any event be proportionate (para 668 to 670).

d) The motive defence must be interpreted so that tax avoidance does not include the exercise of a treaty freedom (para 679 to 681).

13. *Fisher* involved companies as the person abroad. HMRC have in the past argued against the application of EU treaty rights to situations involving trusts.

14. On 14 September 2017 the CJEU rejected that argument in Case C-646/15 *Trustees of P Panayi A&M Settlement v HMRC*:

32 Accordingly, it appears that the legislation at issue in the main proceedings, for the purposes of that legislation, holds the trustees as a body, as a unit and not individually, to be liable to pay the *tax due on the unrealised gains in value of assets of the trust when that trust is deemed to have transferred its place of management to a Member State other than the United Kingdom. Such a transfer occurs when a majority of the trustees are no longer resident in the United Kingdom. The activity of the trustees in relation to the trust property and the management of its assets are therefore inextricably linked to the trust itself and, therefore, the trust and its trustees constitute an indivisible whole. That being the case, such a trust should be considered to be an entity which, under national law, possesses rights and obligations that enable it to act as such within the legal order concerned.*

33 As regards whether the trusts at issue in the main proceedings are profit- making, suffice it to state that it is clear from the documents submitted to the Court that those trusts have no charitable or social purpose and that they were created in order that the beneficiaries might enjoy the profits generated from the assets of those trusts.

34 It follows that an entity such as a trust which, under national law, possesses rights and obligations that enable it to act in its own right, and which actually carries on an economic activity, may rely on freedom of establishment.

What is the effect of a conforming interpretation of the motive defence?

15. The most significant aspect of the reasoning in *Fisher* is how it applies a conforming interpretation. If correct, the Tribunal's conclusion means that the UK legislation, properly construed does not apply because the motive defence is available. This in turn means that the protection against charge flows from *UK law*. The charge does not apply because the exemption in section 737 and/or 739 ITA 2007 is available.

16. All which flows from that then applies. In particular, it would seem to follow from this being an interpretation of those sections that the same interpretation follows whether one is dealing with the transferor charge or the transferee charge (where the EU law arguments are less clear).

17. It would also seem to follow that express legislation will be needed to withdraw the motive defence which was available by reason of an EU complaint interpretation. Leaving the EU will not be enough.

18. It also means that care should be had as to the potential for post-Brexit associated operations which do not qualify for the motive defence (section 741 and 742 ITA 2007).

The European Union (Withdrawal) Bill

19. Even if this were not the case it is worth noting that the effect of the European Union (Withdrawal) Bill will be to retain the status quo after 'exit day'. Clause 5(1) to (3) provides:

(1) The principle of the supremacy of EU law does not apply to any enactment or rule of law passed or made on or after exit day.

(2) Accordingly, the principle of the supremacy of EU law continues to apply on or after exit day so far as relevant to the interpretation, disapplication or quashing of any enactment or rule of law passed or made before exit day.

(3) Subsection (1) does not prevent the principle of the supremacy of EU law from applying to a modification made on or after exit day of any enactment or rule of law passed or made before exit day if the application of the principle is consistent with the intention of the modification.

20. An important limitation on this is to be found in para 3, Schedule 1:

3(1) There is no right of action in domestic law on or after exit day based on a failure to comply with any of the general principles of EU law.

(2) No court or tribunal or other public authority may, on or after exit day—

(a) disapply or quash any enactment or other rule of law, or

(b) quash any conduct or otherwise decide that it is unlawful, because it is incompatible with any of the general principles of EU law.

21. Again this means that express legislation will be required in order to address the TOAA's EU compatibility issues.

Finance No.2 Bill 2017 Changes

22. The Finance Bill will bring in a number of changes to the TOAA code with effect from 5 April 2017. These changes fall into two parts: those which follow from the new deemed domicile rules; and new valuation rules.

Changes Flowing from Deemed Domicile Rules

23. A particularly significant aspect of that change is that (broadly) liability for foreign income of certain non-UK domiciliaries is no longer dealt with under the transferor charge but is now charged under the transferee/benefit charge. Conversely, there is no longer a risk of sums within a trust structure being remitted.

The transferor charge

Limitation on attribution of income arising to a person abroad

24. The rule that the income treated as arising under section 721(1) ITA 2007 (the income treated as arising to the transferor) is equal to the amount of the income of the person abroad is modified.

25. The old rule continues to apply where the transferor is (i) domiciled in the UK in the tax year or (ii) treated as being so domiciled by reason of his place of birth and domicile of origin. Where, however, the transferor is not domiciled or is deemed domiciled by reason of residence, then protected foreign source income is excluded from the charge (section 721(3B), (3BA) ITA 2007).

26. This is a significant change. Whereas previously the transferor could be liable to tax on such income on a remittance basis (under section 726 ITA 2007), it will now be the case that the transferor charge will not apply to such income at all.

27. This will permit the trustees to remit such protected foreign-source income without a charge on the transferor/settlor.

Protected foreign source income

28. Protected foreign source income is defined in section 721A ITA 2007. It must be income which would be relevant foreign income if it were the individual's. The income must arise within a trust structure, and:

29. a) The 'person abroad" must be either:

    i) Non-UK resident trustees of a settlement; or

    ii) A company in which non-UK trustees of a settlement are a participator;

    iii) A company at the end of a chain of companies each of which is a participator in the other where non-UK resident trustees are participators in the company at the top of the chain.

    b) Where the person abroad is a company the power to enjoy must arise as a result from the trustees being participators in the relevant company.

    c) The settlor must not have been domiciled or deemed domiciled when the settlement was created.

Tainting

30. Income will cease to be protected foreign income if the settlement becomes tainted.

31. Tainting occurs if *at a time when the transferor is domiciled or deemed domiciled in the UK* property or income is provided directly or indirectly for the purposes of the settlement (and this includes the addition of value to property comprised in the settlement) by

    a) the transferor; or

    b) any other settlement of which the transferor is a settlor; or

    c) any other settlement of the transferor is a beneficiary.

Exceptions to tainting

Transactions other than loans

32. There are a number of important exceptions to the tainting rules:

33. For transactions other than loans, the following are ignored:

a) Property or income provided by a transaction entered into at arm's length.

b) Property or income provided without any intention on the provider to confer a gratuitous benefit.

c) Property or income provided in pursuance of a liability incurred by any person before 6 April 2017.

d) Property provided to meet the excess of taxation and administration expenses over trust income or if greater the amount by which such expenses may be paid out of trust income.

Loans

34. For loans, the position is more nuanced. In the first instance the following are ignored:

a) The principal of a loan to the trustees of a settlement on arms' length terms.

b) Payment of interest to the trustees of a settlement under a loan made by them on arm's length terms.

c) Repayment of principal of a loan by the trustees of a settlement.

35. For these purposes a loan if on arm's length terms if:

a) Interest is payable at least annually; and

b) Interest is the official rate (under section 178 FA 1989 for the purposes of Chapter 7, Part 3 ITEPA 2003) or greater for a loan to the trustees and no more than the official rate for loans by the trustees.

36. The principal of a loan to the trustees will be treated as having been provided if:

a) Interest is capitalised;

b) Interest is not paid in accordance with the terms of the loan; or

c) The loan is varied so as to cease to be on arm's length terms.

Fixing things for settlors becoming domiciled after 5 April 2017

37. There will in general be a tainting if:

a) A settlor becomes deemed domiciled on 6 April 2017;

b) There has been a loan to the settlement by:

i) The settlor; or

ii) Trustees of a settlement connected with the settlor;

c) The loan is not on arm's length terms; and

d) The loan is repayable on demand.

38. That tainting can be reversed if *before 6 April 2018* either the principal and all interest under the loan is repaid; or alternatively the loan can be varied *before 6 April 2018* so that it is on arm's length terms but:

a) interest must paid *before 6 April 2018* for the period from 6 April 2017 as if the loan had been on those arm's length terms as from that date; *and*

b) interest must continue to be payable from 6 April 2018 on those terms.

Transitionally protected income

40. Undistributed income in a settlement which arose before 2017/18 but which would have come within the meaning or protected foreign-source income (disregarding the tainting provisions) will be transitionally protected income. Section 832 ITTOIA 2005 (relevant foreign income charged on the remittance basis) will not apply where transitionally protected income is remitted to the UK after 2017/18. This takes such income out of the remittance basis and aligns it with the treatment of protected foreign-source income.

The capital receipt charge

41. Identical changes are enacted in relation to the charge under section 728 ITA 2007 on a transferor in receipt of a capital sum.

The charge on benefits received

42. The charge on benefits received has been extended as set out below:

Charge on foreign domiciled settlors

43. The quid pro quo for the treatment of protected foreign source income is that the transferors who can benefit from that treatment (i.e. transferors who are neither deemed to be domiciled in the UK nor treated as such by reason of UK birth and domicile of origin) are now brought within the scope of the charge on benefits received.

44. This means that it will no longer be possible to provide benefits in the UK to such a transferor out of clean trust capital. Although there is a remittance basis, the benefit will be treated as deriving from the foreign deemed income (section 735(4) ITTOIA 2005).

Benefits to closely related beneficiaries

45. The second change is a charge on a UK resident transferor where a benefit is received by certain beneficiaries which would be matched with protected foreign source income. The recipient must be closely related, defined to mean a spouse, civil partner or minor child. The charge applies if the recipient is not UK resident or is a remittance basis taxpayer who does not remit the benefit to the UK. So much of the benefit as is not charged on the recipient is treated as income arising to the settlor. If the settlor is a remittance basis taxpayer, the income is treated as relevant foreign income of the settlor.

Valuation Rules

46. Sections 742B to 742E ITA 2007 provide fixed rules for the valuation of benefits provided by way of loan, by way of movable property and provision of interest in land.

47 The benefit of loan is the official rate of interest less what is paid in that year.

48. The benefit of making property available without transferring the property in it is based on the capital cost (the greater of market value or what was paid for it) and official rate interest less what is actually paid.

49. (Note: a chattel lease will not amount to a transfer in the property of the chattel (*HMRC v Apollo Fuels* [2016] EWCA Civ 157).

50. The value of land is for each tax year in which the benefit is provided the amount by which its rental value exceeds what is paid in the tax year. Questions may arise in this regard. What is meant by "making land available for use"? Does it cover the situation where the trustees hold the reversion to a 99 year lease? If so, how is the benefit valued? What happens if the beneficiary sells his 99 year lease in year 2?