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Personal Tax Offshore Anti-Avoidance Legislation Call for Evidence: CenTax Response

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1 About CenTax

We are researchers at the Centre for the Analysis of Taxation (CenTax), a research centre co-hosted by LSE and University of Warwick. CenTax is dedicated to improving public understanding of tax policy and helping to design a better tax system, by generating evidence that is rigorous and relevant to policymakers and the public. Further information about CenTax is available via our website.

Our work focuses on tax policy design and the measurement of tax policy outcomes. We conduct cutting-edge research on the behavioural and economic impacts of tax policy changes and have contributed substantively to debates on tax policy in the UK over recent years. We use HMRC administrative data accessed through a secure research environment that allows us to compare academic research findings with official government costings, providing insight into how policy analyses are conducted.

We sent this in response to the government's call for evidence on Personal Tax Offshore Anti-Avoidance Legislation which can be found here.

2 Question 1: What could be done to simplify this legislation?

Some of the complexities of the current legislation are a legacy of past circumstances that have now disappeared (or will do soon), as a result of recent changes to the non-dom regime and the UK's exit from the EU. These provisions are a prime target for simplification, since here the repeal of existing provisions should be achievable without incurring risks of additional avoidance.

However, beyond this low-hanging fruit, we would warn that efforts in 'simplification' that merely involve repealing or curtailing the scope of existing anti-avoidance measures could lead to re-emergence of the behaviours that these measures were originally intended to tackle. Consequently, the government should proceed with caution before accepting that such measures are genuinely no longer necessary or justified.

In our view, the best form of simplification comes from systematic reforms based on clear policy principles, which can then eliminate the kinds of arbitrary or unprincipled distinction that generate complexity in the tax system in the first place. Consequently, we would urge the government to consider the fundamental principles underlying this area of tax, as part of this review, rather than only tinkering incrementally with the existing regime.

3 Question 2: What could be done to remove inconsistencies and align this legislation?

3.1 Abolish exceptions to the attribution of certain gains realised by closely held companies

Rules for the attribution of certain gains realised by closely-held companies were introduced after the European Commission requested the amendment of the rules to preserve the EU freedom of establishment (TCGA 1992 s3(1)(c) and (d)). The justification for these exceptions is no longer present and so the provisions could be removed.

3.2 *'Level up' definition of settlor-interested trusts for Income Tax and CGT*

The definition of settlor-interested trusts for the purposes of attributing income and gains to the settlor differ for income tax and CGT purposes. In our view, this inconsistency is not justified given the economic equivalence and functional interchangeability of income and capital gains in many contexts. In particular, for those controlling a company the payment of dividends can substitute the realisation of gains through techniques such as dividend recapitalisation. In this context, having different tests increases complexity with no corresponding justification.

For income tax the definition of settlor-interest only includes settlements where payments can be made to the settlor or their spouse/civil partner (ITTOIA 2005, s.625). For CGT the definition is wider, also including the settlor's children, grandchildren, their spouses/civil partners and certain companies controlled or associated with such persons (TCGA 1992, Sch 5, s.2). We would favour 'levelling up' the Income Tax definition to match the CGT definition, which we think provides a more robust defence against

transactions between parties who – in the clear majority of cases – will substantially be acting as a single unit rather than at arms-length.

3.3 Address liquidity concerns around attribution rules for settlor-interested trusts without reducing scope of liability

We strongly support the attribution of income and gains to settlors when they retain an interest in the settlement, but we accept that the charge could pose liquidity issues when the settlor does not have immediate access to the settled funds. Consequently, the government could consider ways to impose the charge on the trustees, with liability on the settlor as a backstop (if unable to enforce against trustees or if trustees are not subject to UK tax under double tax convention). In our view, this approach should not be prevented by DTTs as the settlor (to be captured by the attribution rules) will be UK resident, which ought to provide a sufficient territorial nexus with the trust from a treaty perspective.

4 Question 3: What are your views on how the motive defence tests are applied and what areas of these tests could be improved?

Both the transfer of assets abroad (TOAA) rules and those attributing gains of offshore closely-held companies to participators (close-held companies attribution rules) have been shaped by the interaction with the EU fundamental freedoms, in particular regarding the defence against their application. Both set of rules were introduced several decades before the European Commission required their amendment to make them compatible with the EU freedoms (TOAA rules were introduced in 1936 and the close-held companies attribution rules in 1965). This strongly suggests that these rules are workable without the changes arising from the European Commission requests, and therefore removing the defences introduced in the name of EU freedoms is a strong candidate for simplification.

In light of the UK's exit from the EU (and consistent with the government's objective to take advantage of 'Brexit freedoms' to achieve simplification), we think that the government should consider the following:

4.1 TOAA rules: Abolish defences introduced to comply with EU freedoms

The defence test in the transfer of assets abroad legislation (ITA 2007, s 742A) was introduced in 2013 and it added an additional defence to the motive defence test already contained in the TOAA rules (s.737 and 739). However, the defence in s742A is considerably broader than the original motive defences, in effect only catching 'wholly artificial arrangements' (HMRC Capital Gains manual, at CG57314).

4.2 Closely-held companies attribution rules: Replace or abolish defence and increase de minimis interest

The defence test contained in TCGA, s3A(6) and (7) were also introduced at the European Commission request and should therefore be reconsidered. Although the original rules did not contain a motive defence test (as did the TOAA rules) they did exclude from the scope of the provisions any gains connected with foreign trades which considerably protecting taxpayers not involved in tax avoidance. As a consequence, the defence test contained in s3A(6) and (7) can either be removed entirely or replaced by the same motive defence tests originally contained in the TOAA (ITA 2007 s737).

In addition, the interaction with EU freedoms led to an increase in the minimum interest that the UK taxpayer must have for the rules to apply from 10% to 25% (originally it was 5% in 1992). The 25% de minimis rules is likely to be too high to make the rules effective, so we would support reducing this to 10% now that EU freedoms do not justify such an increase.

5 Question 4: Do you have any suggestions on how the government should approach personal tax offshore anti-avoidance legislation in these areas going forward?

5.1 Consult on fundamental principles of trusts taxation

One key issue that contributes to the complexity in this area is the lack of clear policy principles underlying the existing legislation. There are some fundamental questions about what 'neutrality' means in the context of trusts taxation, which we think HMRC did not fully grapple with in its last consultation on this topic (2018: Ch3). These problems are most acute in the context of discretionary trusts which effectively facilitate 'floating' (beneficial) ownership in circumstances where it is legally and/or practically impossible to identify the current and/or intended beneficiaries. We would urge the government consult on these

fundamental issues rather than only seeking to make incremental changes from the current (largely unprincipled) regime.

5.2 Beware of arguments that existing rules are unnecessary because they are only required infrequently and/or do not raise much revenue

We think that the government should be sceptical of arguments for repealing existing anti-avoidance rules that rely on the relatively small numbers of taxpayers that are currently caught by them or the small amount of revenue directly raised by the charges. This is because it is typical for anti-avoidance rules to function mainly as deterrence, so even if it is the case that relatively little revenue is directly collected under these charges currently, this could be seen as a success of the legislation (i.e. the rules have effectively deterred taxpayers from engaging in the targeted behaviours), rather than a reason why they are no longer required. We accept that in some cases (including those described above) the need for specific provisions may genuinely have been obviated as a result of developments since their original enactment. However, the mere fact that provisions are not frequently relied upon does not mean that they are not serving any useful purpose.

5.3 Invest in the quantitative evidence-base and engage with external researchers

As a key part of this consultation, we would urge the government to invest in the quantitative evidence-base relating to trusts and other offshore structures in order to inform current policy changes and facilitate subsequent policy evaluation. We think that HMRC should be ambitious and creative in its use of existing data sources and be willing to invest in the digitisation and/or linkage of these sources where needed for analysis. We would also encourage HMRC to involve external research organisations (such as CenTax) to help develop a clear strategy both for analysing existing data sources and to determine the types of data that HMRC should collect (in the course of administering the tax system) to maximise its capacity for future policy evaluation.

In addition to self-assessment data on offshore income/gains and trust income/gains, there are several additional data sources that could be used to improve the current evidence base in this area:

- IHT100 data, using OCR technology if needed to digitise information collected via paper forms. This data would be useful to assess the value of the assets held in existing relevant property trusts, which would help to forecast future revenues from 10yr charges and exit charges, as well as for evaluating the effects of past reforms affecting trusts. This would also be useful for future analysis of reforms to IHT reliefs and non-doms, as well as analysis relating to offshore avoidance.
- Trusts Registration Service data which includes personal identifiers and information for all of the parties to taxable trusts (including beneficiaries, settlors, and trustees) as well as asset-level data on trust assets. It is crucial that TRS data is collected in a way that enables it to be linked and analysed for risking and policy evaluation purposes, and not merely on a case-by-case basis for enquiries. Even if the data has not historically been collected in a suitable format for analysis, it should be possible using modern data science techniques to process key information.
- CRS data related to trust accounts. Where there is a UK resident beneficiary, information about (some) trust accounts should be included in CRS data reported to HMRC as 'indirectly held' accounts (i.e. where the account holder is a corporate entity but the controlling person is reported as a UK resident). Based on research published recently by HMRC for its analysis of undisclosed foreign income, it appears that HMRC has not yet undertaken a systematic analysis of these types of account.

In our view, the most effective uses of these data will come from their triangulation rather than siloed analysis of individual datasets or linking records on a case-by-case basis. This will likely require some investment to link previously unlinked data sources – for example using fuzzy matching techniques where the datasets lack common identifiers – but we believe that this approach would have substantial payoffs for policy evaluation in the longer run. We strongly recommend that HMRC treats improvements in the quantitative evidence-base as a key component of the current consultation process, which in our view should extend to 'evidence-gathering' in the broadest sense rather than purely consultation in the conventional (narrow) sense.

6 Question 5: Are there any other personal tax offshore anti-avoidance provisions the government should consider as part of the consultation?

6.1 Scope of reporting under the TRS

The current scope of reporting requirements under the TRS can depend on the residence of the trust, which in turn depends on where the trustees are resident. This factor lacks any principled rationale and perversely encourages the appointment of offshore professional trustees to avoid reporting. The connecting factors used for reporting purposes under the TRS should instead focus on the residence status of the settlor and beneficiaries, reflecting the underlying economic substance of the trust arrangements. In our view, if either the settlor or any of the beneficiaries is UK resident then the trust should be subject to reporting under the TRS, irrespective of whether the trust has an existing UK tax liability. In this regard, the UK could look to the example of the US, which already adopts a similar approach regarding reporting of trusts where the grantors and/or beneficiaries include a US taxable person.

6.2 Reporting requirements under TRS

The reporting requirements under the TRS are different for taxable and non-taxable trusts. For the latter, the reporting of assets only covers UK land and property, which is insufficient for the purpose of detecting potential non-compliance and applying appropriate risking, especially in relation to tax avoidance schemes involving an offshore element. We recommend that the TRS should require basic information about all of the assets held by a reportable trust (i.e. also requiring the disclosure of shares, partnerships and business interests, money, offshore land and property and other valuable chattels), sufficient to enable HMRC to estimate the approximate value of the trust assets for risking and policy evaluation purposes.

6.3 'Deemed Disposal on Departure' for CGT ('exit tax')

Many of the tax avoidance risks targeted by existing anti-avoidance rules in this area result from the residential scope of CGT. Currently, gains accrued during a period of UK residence fully escape UK CGT if they are realised whilst non-resident (subject to the TNR rules), or if the asset is transferred to a non-resident in circumstances where the disposal is an exempt or relieved from CGT. A more principled way of approaching these

risks would be to introduce a deemed disposal on departure (DDD) rule that would charge CGT on emigration or the (non-taxable) transfer of an asset to a non-resident. This approach would largely obviate the need for several existing anti-avoidance rules. A further advantage of DDD is that it could (wholly or partly) replace the existing TNR rules, which would simplify existing anti-avoidance rules since at present their interaction with the TNR rules is a major source of complexity.