FOREIGN COLLATERAL DAMAGE

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I recently came across a word which you don't see every day, and that is "de-arrested". This was used to describe the release of the jogger who inadvertently bumped into the Prime Minister recently, and was promptly arrested. On the police accepting the jogger's story that he was on his way to the gym, he was de-arrested before they got to the police station. I could not help dreaming up a similar verb to describe a change in practice which HMRC announced on 4th August 2014, and that is the verb "to de-concession". To be de-arrested means not to have been arrested at all, so that no record of the initial arrest can exist. To de-concession, as will become apparent, means to remove a concession which probably did not exist in the first place.

The change in HMRC practice relates to the tax treatment of remittance basis taxpayers ("RBTs") who take out loans secured on foreign income and gains ("FIG"). This change was unexpected, and is not accompanied by any legislative proposal. HMRC said that their new approach to such loans will be to treat the receipt of the loan proceeds in the UK as a remittance of the FIG used as collateral offshore, as well as to continue to treat as remittances any FIG used to service interest payments and repayment of principal. So, the same loan will give rise potentially to two remittances in respect of a single amount of principal. The change takes the form of a revised paragraph 33170 in the Residence, Domicile and Remittance Basis Manual ("RDRM"), as well as a note announcing the change (the "Note").

The previous practice

Under their previous practice, published in 2010, HMRC treated the remittance of the loan proceeds as not constituting a remittance, but treated any subsequent use of FIG to service or repay the loan as a remittance. However, in their previous practice, HMRC reserved the right to tax secured loan proceeds as remittances in "avoidance or non-commercial arrangements" where the loan was not substantially serviced or repaid by the RBT. That did not mean that a borrower who was in the fortunate position of being able legitimately to repay out of clean capital would be caught. It only affected artificial arrangements.

It is worth setting out the relevant extracts from the old RDRM33170:

> "Thus there are potentially two possible sources of a taxable remittance charge in respect of the relevant debt - the foreign income or gains used as collateral and the foreign income or gains used to repay the debt.
>
> In the majority of commercial situations, neither party to the relevant debt transaction expects or intends that the collateral offered as security will be taken by the lender. Instead it is planned that the loan will be serviced and the capital repaid without recourse to the security charge. In such cases using foreign income or gains to regularly service or make capital repayments in respect of the relevant debt effectively 'masks' the collateral being used. **In such cases the only taxable remittance will occur as and when the foreign income or gains are used to service or repay the loan. The payments, and thus the taxable remittances, will be spread over the loan period**."

And:

> "In some cases, usually involving avoidance or non-commercial arrangements, the relevant debt is not serviced or repaid by the borrower, or only a token amount is offered. In these circumstances the foreign income or gains offered as collateral are being utilised in respect of the relevant debt, that is, to delay or

> minimise service charges or repayments. As there is only one possible tax charge in respect of the relevant debt, that is the charge HMRC will take. The charge is taken up-front when the collateral is offered. Such arrangements are expected to be rare."

Having stated their view that both the provision of collateral out of FIG and subsequent repayment could be separate remittances, HMRC set out the wording in the first extract above. They say that in commercial situations, the use of FIG to service the debt or to repay it "masks" the collateral being used, and thus no remittance arises in relation to the provision of collateral. The word "masks" is attractive, but not very helpful in determining whether HMRC are setting out their view of the law, or whether they are offering a concession. The better view is the former. Certainly, the rest of the extract is quite clear about the treatment in precise language which does not indicate any concessional factors. The last two highlighted sentences in particular appear to encapsulate a view of the law. The language is also consistent with the previous legislative position where something further like a set-off arrangement was required beyond the provision of collateral to give rise to a remittance (see Section V below).

We then have the second extract dealing with uncommercial arrangements, where HMRC reserved the right to tax the provision of collateral as a remittance if they were unable to tax interest payments and repayment of principal. There is in fact no basis for this in the legislation: HMRC cannot pick and choose when a remittance arises in respect of a loan. This may have been one reason why HMRC thought a change in approach was needed.

I do not know if HMRC thought that they were simply following the usual extra-statutory concession practice of setting out the concession, but prohibiting its availability where someone tried to rely on it for tax avoidance purposes. If that is what they had intended, then the language in the old RDRM33170 did not support them.

The new practice

The previous position seemed to be well-settled and justifiable on a sensible reading of the legislation, (subject to the avoidance exception, which was not in the legislation). If a RBT could rely on the practice to avoid a remittance arising when collateral was provided, he would not be particularly concerned about the status of that practice. He may even have been advised that HMRC's approach was based on a correct application of the law, rather than the granting of a concession. However, in the Note, HMRC state that the old RDRM33170 treatment, published in 2010, was in fact a concession. They go on to say that there had been abuse of the concession, with large numbers of non-commercial arrangements being created where the loan payments and repayments were not made out of FIG, so that no remittance was made to the UK in respect of the loan. To counter this, all borrowers will be treated as remitting their collateral when the loan proceeds are received in the UK. The fortunate borrower who repays his loan genuinely out of clean capital will no longer escape a remittance charge if he has provided collateral out of FIG. He will be taxed on the provision of collateral when loan proceeds come into the UK.

HMRC do say in the Note that the double remittance treatment will only apply where one amount of FIG is used as collateral, and a "different" amount of FIG is used for payments under the loan. Unfortunately, that does not appear in the revised text of RDRM33170; indeed, the word "different" does not feature at all. It might be implied from the Example given in the revised text, where the loan is secured by an offshore bond, and repaid from different FIG in the form of offshore employment earnings. But that is hardly satisfactory. So, in a situation where a RBT has provided FIG as collateral and subsequently uses that collateral to repay the debt, it may be necessary under the new practice to point to RDRM33170 and the wording in the Note to escape a double charge.

The current law

This of course presupposes that the new treatment is justifiable under the law. The relevant statutory provision is Section 809L of the Income Tax Act 2007 ("ITA"). This section gives us the meaning of remittance. It requires various conditions to be met for a remittance to arise. The conditions applicable to the present subject-matter are Conditions A and B, which must both be satisfied. I only refer below to the relevant parts of each Condition.

Condition A requires simply that any money is brought to the UK by or on behalf of the RBT.

Condition B requires that FIG are used outside the UK (directly or indirectly) in respect of the relevant debt viz. the loan.

The remittance of loan proceeds clearly satisfies Condition A, as all that is required is the receipt of money in the UK. The fact that there is a repayment obligation is immaterial. The critical question is whether the provision of FIG as collateral constitutes ***use*** outside the UK of that FIG in respect of the loan.

It is difficult to see how the mere provision of collateral is the use of FIG. "Use" connotes the application of the FIG in a manner which results in a reduction of the borrower's indebtedness. Repayments of principal clearly fall within Condition B, as do interest payments made out of FIG. In both cases, the borrower's financial exposure to the lender is reduced by the use or application of FIG to make the payment. It is something of a stretch to say that collateral which remains untouched by the lender is "used" at all. Of course, if there were a default and the lender enforced his security by realising the collateral, that would amount to use of the borrower's FIG, but only at that point in time.

The previous law

That certainly seems to have been the position under the previous legislation on remittances. Section 833(1) of the Income Tax (Trading and Other Income) Act 2005 (“ITTOIA”) brought into the remittance category any FIG ***applied*** by the RBT towards the satisfaction of a debt. That clearly referred to actual payments, and it seems to me that an equally good word in the old legislation for “applied” might have been “used”. In fact, Section 833(1) stated that where foreign income is applied in satisfaction of a debt, a remittance occurs when it is “so used”.

There was a specific category of remittance provided by Section 834 ITTOIA. That applied where a borrower provided a pot of FIG to a lender which could be used to reduce or pay off the debt by set-off or otherwise. It was effectively a way of amortising the loan. In those circumstances, the provision of the FIG to the lender and its retention for set-off purposes was specifically treated as a remittance. Section 834(1) deemed the borrower to be “using” foreign income to satisfy a debt in this scenario.

Both Section 833(1) and 834 types of remittance strongly indicated that the mere provision of collateral could not have been a remittance under the old law. Now, HMRC could quite justifiably say that the old law is irrelevant as the legislation now in the ITA 2007 is a new code for dealing with the remittance basis, and only those relevant bits of ITTOIA which have survived should be taken into account: both Sections 833 and 834 were repealed. But it is still pertinent to ask why the position regarding receipts of loan proceeds was not made much clearer, given the clear contrary position under the old law. It is particularly unsatisfactory that Condition B can, on HMRC’s view, apply both to loan proceeds where collateral is provided, and to the repayment of the loan out of FIG. Indeed, there is nothing in the legislation to say that a double charge cannot arise where the same FIG is used both as collateral, and subsequently to repay the loan. It might, therefore, be said that the use of the word "different" in the Note, as I have discussed above in Section III, is itself a concession.

If there was intended to be a significant shift from the old law, then the draftsman failed to achieve that in Section 809L ITA.

The proper approach

It seems to me that the proper approach should be as follows:

- The receipt of loan proceeds should not constitute a remittance. It makes no difference whether the loan is secured or not. In the case of an unsecured loan, clearly Condition B is not satisfied as nothing is used offshore on any basis. In the case of a secured loan, the provision of FIG as collateral does not constitute use;
- To the extent that loans are serviced or repaid out of FIG, then that fairly falls within Condition B, and remittances arise at that point in time; the same applies to arrangements like set-off where the loan is effectively amortised;
- If a RBT is able to arrange his affairs so that he is able to repay the loan out of offshore funds which are not FIG, then that means no remittances arise at that stage. He has managed his affairs in an unobjectionable manner: the remittance rules are prescriptive. He has simply followed them, and managed not to make a remittance to the UK;
- There is nothing in the legislation specifically to deal with egregious arrangements. If HMRC want something to this effect, then they need to legislate (assuming they regard the GAAR as insufficient). It is quite unacceptable to impose a potential double tax charge on RBTs on statutory wording which points to a contrary meaning.

Conclusion

HMRC's previous practice made sense as a matter of law and did not, therefore, need to be concessional. The only grey area was the discretion they gave to themselves to tax uncommercial arrangements by imposing a charge at the time of receipt of loan proceeds. By choosing now to tax all loan proceeds where FIG have been given as collateral, they have simply magnified the error. What is urgently required is legislation to put beyond doubt that loan proceeds are not taxable, and then to include any appropriate specific avoidance provision to deal with HMRC's concern. But the latter needs to be crafted in a way that does not catch the bona fide RBT who is able to repay a loan out of clean capital. All that he has done is to remit clean capital to the UK. His position is comparable to the RBT who brings clean capital into the UK without having to borrow anything.

The net result is that the new practice needs to be treated with caution. HMRC's statements in the Note regarding existing loans and transitional arrangements appear to carry the force of law, but they do not. There are also questions regarding HMRC's conduct to be answered, and yet again we have the issue of how much reliance can be placed by a taxpayer on what is in the Manuals. But the unusual substantive position is that HMRC implemented two steps, which they viewed as the grant of a concession, and then its recent removal. Both steps are, in my view, based on a misapplication of the law, since the content of the apparent concession was in fact good law. Therefore, the old practice has been "deconcessioned".

Two wrongs don't make a right. Where does this leave the affected taxpayer? There are a number of reasons why I do not think he is bound to follow HMRC's revised view and, on a more practical basis, to comply with HMRC's notification requirements for existing loans.