Treatment of loans secured on foreign income or gains by remittance basis users

Introduction

1 The purpose of this note is to highlight a change in HMRC's approach to the treatment of loans made to remittance basis users where assets of the borrower are held by the lender. The note is to assist taxpayers and their professional advisers in considering the technical and practical issues in each client's specific context.

2 This note was first published in December 2021. It has been updated for HMRC's comments (see paragraph 25), to add two supplementary questions and HMRC answers (see paragraph 14 and the Appendix) and to reference new examples added to HMRC's Residence, Domicile and Remittance Basis Manual (see paragraph 13).

Background

3 This note applies to present or former remittance basis users who have otherwise unremitted foreign income and gains. It refers to such a remittance basis user as "the RBU" and to the unremitted foreign income and gains as "FIGs".

4 The facts this note covers are in point where the RBU has incurred a debt either in the UK or abroad and the money borrowed or property deriving from it is brought to the UK or used in the UK in such a way as would constitute remittance. Using the terminology in the legislation the debt is here referred to as "the Relevant Debt" (see ITA 2007 s 809L(7)). This note is also in point where the borrowing or use is by a trust, company or family member that is a relevant person in relation to the RBU.

5 The law – ITA 2007 s809L(3) - is that FIGs are treated as remitted if either:

(a) The FIGs are "used outside the United Kingdom (directly or indirectly) in respect of a Relevant Debt"; or
(b) "Anything deriving (wholly or in part and directly or indirectly from [the FIGs] is used [in respect of the Relevant Debt]".

6 The paradigm case of use in respect of the Relevant Debt is repayment of principal or payment of interest.

HMRC's original view

7 When the present remittance basis legislation was being enacted in 2008, there was discussion as to whether FIGs are used in respect of the Relevant Debt if they form part of the security package for it or otherwise serve as collateral. HMRC's published practice was to treat FIGs as not so used, at least so long as principal and interest were paid in a timely manner. There are several technical arguments to support this interpretation. The implicit rationale was that if the FIGs were to be treated as so used, the Relevant Debt would potentially be taxed twice, once by reference to FIGs provided by way of collateral or security and once by reference to the FIGs used in repayment (assuming the two were not the same).

HMRC's change of view in 2014

8 In August 2014 HMRC abandoned this practice and adopted the position that FIGs used as collateral or security for a Relevant Debt were to be treated as remitted. This revised practice was published on 4 August 2014 in What's New – latest news from HMRC – see archived page. It was admitted the result would be that the same Relevant Debt could result in two or more lots of FIGs being taxed.

9 The revised guidance published as a result of the 2014 change made it clear that there was a cap on the amount of FIGs comprised in the collateral or security that could be treated as remitted. This equalled the Relevant Debt or (if less) such of it as was brought to the UK (see now withdrawn version of RDRM 35270 – archived page).

10 Discussions with HMRC in 2015 disclosed uncertainty as to what legal arrangements needed to be in place for the FIGs to be treated as used in respect of the Relevant Debt. Was a formal pledge or blocking of the FIGs required or was it sufficient that the lender could have recourse to the FIGs under an 'all monies'[1] clause. If the latter was correct, the RBU would potentially find all FIGs held by the lending institution could count as used in respect of the Relevant Debt.

11 In practice this latter issue was often of academic significance only in view of the cap on what could count as remitted.

HMRC'S latest change of position

12 Between 17 December 2020 and 21 July 2021[2] changes to HMRC's Residence, Domicile and Remittance Basis Manual indicated, HMRC had again revised their position. HMRC now contend that all FIGs used in respect of the Relevant Debt are to be treated as remitted if 100% of the borrowed money is brought to the UK. But if not all the borrowed money is brought to the UK, the cap still applies, the cap – ITA 2007 s809P(10) - being what is brought to the UK.

13 Members will need to consider the implication of this change of practice when filing on behalf of RBUs. Further details of HMRC's present approach are set out in RDRM 37050 (appendix 5). HMRC have subsequently added examples 3 and 4 at RDRM35270[3] and examples 2, 3 and 4[4] at RDRM35050. Example 1

[1] The term 'all monies clause' usually means any security will cover all amounts the debtor owes to the lending institution under any arrangements (including future arrangements) regardless of how they arise.
[2] RDRM37050 Appendix 5 was added on 17 December 2020. RDRM35270 was updated on 18 May 2021 and RDRM35050 was updated on 21 July 2021.
[3] Added March 2022
[4] Added March 2022

at RDRM35050 (Freda) was amended as part of the changes on 21 July 2021 – see paragraphs 27 and 28 below.

14 STEP have put two supplementary questions on HMRC's present approach to which HMRC have responded. See the Appendix to this note.

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Possible technical views

15 The professional bodies do not advocate a particular technical view. There are alternative technical interpretations with arguments for and against in each case.

16 As stated in paragraph 7 there are several technical arguments supporting the original 2008 analysis. One technical position is that the original 2008 practice was correct avoiding as it does the risk of more than one lot of FIGs being taxed by reference to the same Relevant Debt. Others argue the point in relation to the more general issue as to when "collateral" is used with respect to the relevant debt and the counter-intuitive results that can arise from the revised HMRC interpretation. Such positions also avoid the contortion implicit in the proposition that there is no cap if 100% of the borrowed money is brought to the UK but that there is a cap if less than 100% is brought to the UK.

17 The opposite technical position is that everything HMRC are now saying is correct, including the 2020/21 change that if 100% of the borrowed money is brought to the UK, the amount taxed as remitted equals the FIGs used in respect of the Relevant Debt even if those FIGs exceed the debt.

18 An intermediate technical position is that HMRC were right in 2014, but not in 2020/21, so that there is always a cap on the taxable remittance equal to the amount brought to the UK (and not just in cases where part only of the borrowed funds are brought to the UK).

19 Unless the position is taken that HMRC's original 2008 practice is correct, a further technical issue is whether FIGs are used in respect of the Relevant Debt only if formally charged as security or pledged as collateral. One view is that this is correct. An alternate view is that any funds the lender holds are used in respect of the Relevant Debt, including subsequent investment return generated by those funds. This would be in point if the loan documentation includes an all monies clause. An intermediate position – which appears to be the stance which HMRC is taking in RDRM 37050 - is that funds are caught if their deposit with the lender is a condition of the making or continuance of the loan. An alternate intermediate view is that FIGs are used where their availability to the lender in the event of default forms part of the substantive negotiations of the security package for the loan but not where the possibility that they might be taken in repayment is simply part of the boiler-plate terms and conditions of the loan and unlikely to be relied upon by the lender in practice.

20 Paragraph 23 in Professional Conduct in Relation to Taxation Help sheet A: Submission of tax information and Tax Filings gives helpful guidance as to when additional disclosure should be considered:

> "23. Cases will arise where there is doubt as to the correct treatment of an item of income or expenditure, or the computation of a gain or allowance. In such cases a member ought to consider what additional disclosure, if any, might be necessary. For example, additional disclosure should be considered where:

- There is inherent doubt as to the correct treatment of an item, for example, expenditure on repairs which might be regarded as capital in whole or part, or the VAT liability of a particular transaction; or
- HMRC has published its interpretation or has indicated its practice on a point, but the client proposes to adopt a different view, whether or not supported by Counsel's opinion. The member should refer to the guidance on the Veltema case and the paragraph below. See also HMRC guidance."

This will be useful when (i) filing returns for 2021/22 (the current tax year) and subsequent years; or (ii) filing returns for 2020/21 (filing deadline 31 January 2022) or amending returns already submitted for 2020/21.

Historic compliance issues

21 When HMRC announced the 2014 change of practice grandfathering was allowed for those who had relied on the 2008 practice. No such grandfathering has been allowed as respects the 2020/21 change. A compliance issue therefore arises for RBUs who have relied upon HMRC's previous post-2014 practice, particularly where the time period for amending the return remains open and: (i) the remittance has been disclosed on a tax return; or (ii) no remittance was disclosed (the loan agreement giving priority to the clean capital collateral and this clean capital being equal to or in excess of the value of the remittance). Advisers will need to consider whether they agree with the latest HMRC change in position and how they should advise their clients to proceed.

22 Taxpayers and their advisers will also need to consider whether a discovery assessment could be competent as respects a return filed in accordance with the 2014 practice where the enquiry window has closed. Advisers will, in particular, need to consider carefully the terms of Taxes Management Act 1970 s29(2) in relation to years up to and including 2019/20.

23 In other cases public law remedies may be available where the RBU has relied to their detriment on HMRC's practice and might be able to claim "legitimate expectation".

Knock-on implications of historic remittances

24 There may be knock-on implications where taxpayers and their advisers accept that, as a result of HMRC's change of practice, a remittance has previously been made. The general rule – ITA 2007 s 809P(12) – is that where FIGs have been remitted once, they cannot be remitted again. Taxpayers and their advisers will need to consider carefully whether this rule only applies where the first remittance has been taxed, or whether it applies irrespective of whether the first remittance has actually suffered tax. If the latter position is taken, it should be accompanied by white space disclosure and explanation to the client.

HMRC comments on this note

25 *Thank you for providing a copy of the joint bodies note. We note the views of the joint bodies. The note characterises the updates made to the Residence Domicile and Remittance Basis manual (RDRM) as a change in HMRC's position. HMRC has applied a consistent approach to the remittance basis treatment of foreign income or gains used as loan security since publication of the HMRC notices on 4 August 2014 and 15 October 2015. The updates to the RDRM made in December 2020 and July 2021 were to clarify and correct existing guidance and were not made because HMRC had changed its position.*

26 Readers of this note may wish to consider HMRC's comments in the context of the changes to the guidance including the pre and post 21 July version of example 1 of RDRM35050 reproduced below.

Extract from the pre and post 21 July 2021 version of RDRM35050

27 RDRM35050 Example 1 – **archived 21 July 2021**

Freda, a remittance basis user takes out an interest-free loan for £100,000; with allegedly no requirement for repayment until an indeterminate future date. She uses the loan to purchase a plot of land in the UK, so the loan is a relevant debt.

Freda offers as collateral for the loan a French painting, currently in her Parisian apartment. She purchased this painting in an earlier tax year in which she was also a UK resident remittance basis user, using £160,000 of her untaxed relevant foreign income from that year. The painting is still worth £160,000.

Freda has used her foreign income as collateral, in respect of a relevant debt. The amount so used is 'capped' at the amount of the debt, which is £100,000 in this case.

The reason for this is obvious if you consider what would happen in the very unlikely event that the lender immediately 'seized' the collateral in the painting to repay the £100,000 debt in full. The lender would realise £160,000 from the painting; the lender would retain £100,000 to satisfy the debt owed and return £60,000 to Freda (ignoring accrued interest, penalties and service charges). So only £100,000 of the collateral is used in respect of the debt.

28 RDRM35050 Example 1 – **current version (as at April 2022)**

Freda, a remittance basis user takes out an interest-free loan for £100,000; with allegedly no requirement for repayment until an indeterminate future date. She uses the loan to purchase a plot of land in the UK, so the loan is a relevant debt.

Freda offers as collateral for the loan a French painting, currently in her Parisian apartment. She purchased this painting in an earlier tax year in which she was also a UK resident remittance basis user, using £160,000 of her untaxed relevant foreign income from that year. The painting is still worth £160,000.

Freda has used her foreign income as collateral, in respect of a relevant debt. The amount so used is the untaxed relevant foreign income that was used to acquire the painting - £160,000 in this case.

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Appendix

<u>Question 1: Non-resident individual with existing “relevant debt” secured over non-UK portfolio becomes UK resident – is there a remittance of income/gains arising within the portfolio after the individual becomes UK resident?</u>

A is non-UK resident and domiciled (and has never been resident or domiciled in the UK). In 2015, he purchases a house in the UK for £1 million. This is funded as to £400,000 by A from his own resources and as to the remaining £600,000 by a loan from his bank in Malaysia which is secured by a charge over A’s investment portfolio held with the bank which, at the time the security is granted is worth £1.5 million.

There is no restriction on A dealing with the portfolio or making withdrawals although, if the value of the portfolio falls below £900,000, he is required to top up the security so that it has a value of at least £1 million, failing which the bank can call in the loan. Subject to this, the charge is, however, in respect of all assets comprised in the account which holds the portfolio from time to time.

As the loan proceeds have been used in the UK, the loan is a “relevant debt”. On the basis of HMRC’s interpretation, the portfolio has been “used” in respect of the relevant debt as it has been given a security for the loan. There is however no taxable remittance at the time the loan is put in place as A is non-UK resident.

The question is whether any income or gains which arise within the portfolio after A becomes UK resident (and assuming that he is taxed on the remittance basis) would be treated as remitted as a result of the security arrangements.

In our view, although the post-residence income and gains will form part of the security for the loan (as the charge is over the entire contents of the portfolio account from time to time), they cannot be said to have been “used” in respect of the relevant debt. There are two reasons for this:

1. As long as £900,000 remains in the portfolio, A is free to withdraw the income and gains at any time. As there is no requirement for him to leave the income/gains in the account, they have not been “used” by A in respect of the debt.

2. The entire portfolio is (according to HMRC) “used” in respect of the relevant debt when it is first given as security. If nothing has been added to the portfolio by A, it is difficult to see how any part of the portfolio can be “used” in respect of the relevant debt a second time. As the post-residence income and gains are part of the existing portfolio (rather than resulting from any addition), there is nothing new which is being “used” in respect of the relevant debt.

The contrary argument of course is that there are now assets in the portfolio which either are, or are derived from, the post-residence income and gains and which have been “used” in respect of the relevant debt as they form part of the security of the loan. However, for the reasons set out above, we do not believe that this is the right analysis.

<u>HMRC response</u>

In this scenario the loan is secured by a charge "in respect of all assets comprised in the account which holds the portfolio from time to time''.

The £900,000/ £100,000 requirement is an additional layer of security for the loan, but the charge is over all the assets in the investment portfolio.

Foreign income or gains arising in the portfolio after the individual becomes UK resident will be 'used' in respect of a relevant debt because they form part of the security for the loan and there will be a taxable remittance

Question 2: Order of priority where the amount remitted is limited to the amount of the loan which is used in the UK.

B purchases a property in the UK for £750,000. She takes out a loan outside the UK of £500,000. Of this, she uses £400,000 to assist with the purchase of the property. B uses the remaining £100,000 to purchase a painting which she keeps at her house in Switzerland. B is a UK resident, remittance basis user.

The £500,000 loan is secured over two separate investment accounts which B holds with the lending bank in Switzerland. The first account derives from B's non-UK capital gains and, at the time the loan is put in place, holds assets worth £600,000. The investments in the second account derive from B's overseas income and is worth £200,000. The terms of the agreement between the bank and B provide that the bank must enforce its security over the capital gains account and, only if there is a shortfall, can it recover any excess from the income account.

Does HMRC agree that, as the capital gains account contains more than £400,000, the remittance should be treated as comprising entirely capital gains or would HMRC take the view that, despite the priority provisions, there is a proportionate remittance of capital gains and income (i.e. £300,000 of gains and £100,000 of income)?

HMRC response

The order in which the bank will enforce its security is not relevant to the remittance position and should not determine the foreign gain/ foreign income split of the capped remittance. The entirety of the funds in B's non-UK capital gains account and B's overseas income account have been used in respect of the relevant debt.

£400,000 of the £500,000 loan has been brought to the UK. The amount of the remittance is capped at £400,000 and the mixed fund ordering rules are applied to the determine the make up of the capped remittance

£600,000 foreign gain and £200,000 foreign income has been used in respect of the relevant debt. If the income and the gains are for the same tax year applying the mixed fund ordering rules results in a capped remittance of £200,000 foreign income and £200,000 foreign gain.