CHAPTER ONE

FOREIGN DOMICILE TAX REFORM

1.1 Policy issues in foreign domiciliary taxation

This section considers policy arguments for and against a lighter fiscal regime for foreign domiciliaries (or some similar class of footloose individuals).[1]

1.1.1 *Economic arguments*

Foreign domiciled individuals in general have a choice where to reside. If their tax burden was as great as that of a UK domiciliary fewer would choose to live in the UK, and the UK economy would lose:

(1) directly, from tax paid by the foreign domiciliaries (including VAT); and
(2) indirectly, from investment and expenditure in the UK which is more likely to be made by UK residents..

There is no shortage of low-tax or preferential tax regimes to which wealthy individuals can move. Switzerland, for instance, has a lump sum taxation regime for non-Swiss citizens specifically targeted for this

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1 For discussion on policy issues, see 'Residence and Domicile: Response to Background Paper' (STEP, 16 June 2003); 'Reviewing the Residence and Domicile Rules' (CIOT, 1 August, 2003); PBRN18 (Residence & Domicile Review), CIOT, 20 November 2007; all accessible on *www.kessler.co.uk*.

purpose.[2] Where there is tax competition, the term "customer," which HMRC have (controversially) applied to taxpayers since 2001 seems almost apt.[3] UK resident foreign domiciliaries are generally in a better position than other taxpayers to take their custom elsewhere.

Also, UK firms competing for expertise in the international labour market will find recruitment easier if the tax regime for foreign employees is lighter. Some potential employees would not chose, or could not afford, to come if the UK tried to tax them as it does its own domiciliaries.

Where the UK faces international tax competition, those making the law sometimes accept the need for pragmatism:

> Overseas investors are in theory liable to inheritance tax on their OEIC and AUT holdings, because they are regarded as being situated in the UK for tax purposes on the investors' death. Competing centres do not

2 Though this is currently politically controversial and its future is uncertain.
The OECD study "Engaging with High Net Worth Individuals on Tax Compliance" para 34 (May 2009) singles out Ireland, France, the Netherlands and the UK for what it terms "preferential regimes for specifically defined groups of taxpayers"; see *www.oecd.org/dataoecd/5/25/42798312.pdf*

3 A note on this terminology. It was about 2001 HMRC began to refer to taxpayers as "customers." A press release at the time provided: (14/06/01) "M and C Saatchi, a leading advertising agency, has been appointed by the IR to rebrand the department. Branding and design consultants, Corporate Edge, will also be working with the IR and M and C Saatchi to 'create a customer driven department.'"
In 2003 Sir Nicholas Montagu (then Chairman of the Board of Inland Revenue) said that the reason for the change was to remind Revenue staff that the needs of the consumer of public services should be considered first: see "The Customer is always right" Tax Advisor February 2003.
The terminology will probably be dropped sooner or later. No other Revenue department in the world has adopted it. It continues to give rise to derision among tax practitioners. See eg "Customer Service?" Julie Cameron, *Taxation* 10 Apr 2008, p.361 "It never ceases to amaze me that HMRC have adopted the word 'customer' to describe the taxpaying public. A customer is someone who chooses to patronise a business." Andy Wells agrees: "I will never be a "customer" of HMRC. This disregard for the English language irks just about every tax professional I come across..." *Taxation* 4 June 2009, p.549.)

> charge tax in parallel circumstances. ...[4] Removing the potential inheritance tax charge will help UK managers compete on an equal footing with overseas fund providers.[5]

In assessing the attractiveness of the UK relative to other countries several points must be borne in mind. Effective low tax is often achieved in other countries by formal or informal concession rather than by law. One paragraph summaries of other countries are bound to be misleading.

The terms of statutory tax law are only one aspect of tax competition. Compliance costs are important. The quality of tax administration is important. An OECD study lists six desiderata: a developed legal system, confidentiality, impartiality, proportionality, responsiveness [I am not sure what is meant by that] and competence. They add:

> Frequent changes in legislation, particularly where there has been an absence of consultation, can have an adverse impact on the taxpayers and their advisers trust in the tax system.[6]

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4 The text continues: "This very rarely generates any significant yield, because UK assets still have to exceed the inheritance tax threshold ... before any tax is due. But it is a deterrent in marketing terms". I suspect that the true reasons that the old IHT charge raised little IHT was rather different, namely that no-one (if properly advised and wishing to comply with UK tax rules) would invest more than the IHT threshold in AUTs or OEICs within the IHT regime. Undetectable non-compliance must also be reckoned with. But that does not affect the point made here.

5 Press Release 16 October 2002 (OEICs and AUTs) para 6. Another example: "The location of ownership, flagging (registration) and management activities is very 'footloose', since it can easily be transferred from one country to another. This makes it vital to have regard to the fiscal regimes in other countries if we want to maintain a successful shipping industry in the UK. The modern armoury in the battle for success invariably includes a virtually tax-exempt fiscal regime." (Independent Enquiry into a Tonnage Tax, Lord Alexander, HM Treasury 1999.) Another example is the exemption granted to performers in the 2012 Olympic Games: s.68 FA 2006.
This sort of tax competition against other countries might be thought undesirable. But this consideration assumes a level of international fiscal co-operation that does not yet exist, though from time to time it hovers as an element in tax policy.

6 "Engaging with High Net Worth Individuals on Tax Compliance" (May 2009) para 208 and 243; see *www.oecd.org/dataoecd/5/25/42798312.pdf.*

But there are others: can a tax authority subject an individual to an expensive tax investigation without any evidence to justify doing so? Certainty is very important. Perception matters as much as reality. By many of these measures, the UK scores poorly.[7]

In the 6th and earlier editions of this book, I said:

> The UK tax system is largely[8] based on the rule of law rather than informal practice and discretion.

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7 Not just in foreign domicile taxation. See, for instance, Taxation & the Competitiveness of UK Funds (KPMG, October, 2006):

> "For all fund types, the UK tax regime is viewed less favourably than those of Ireland and Luxembourg ...The negative perception of the UK tax regime is driven more by uncertainty than by any specific factor. . A key feature of [structured] products is that promoters must be as certain as possible of the tax analysis for investors over a period of five years and more, and hence the uncertainty of the UK regime in this area makes the UK an unsuitable domicile location. Accordingly, most firms look immediately overseas when establishing these products. ... The most common concern with the UK tax regime is not a specific tax measure that can be fixed by a change in legislation. Rather, it is the overall management of the UK tax regime, characterised by the pace of change and the style of consultation... The majority of participants made strong calls for certainty and stability, regarding the lack of these as a key adverse factor of the UK tax regime. ...The lack of constructive consultation has led to an increasing number of surprising changes to the regulations and a number of proposed changes that were reversed after further prolonged consultation. ... Comments on derivatives caused uncertainty by questioning the appropriateness of an accounts based regime that was introduced just two years before, and the suggestion that QIS would not benefit from the established regime for authorised funds, significantly slowed development of UK based QIS. As one participant commented:"By this stage Ireland and Guernsey were laughing."...There is also a view among participants that HMRC is focused on targeting avoidance rather than creating an environment to support industry development and growth. ...
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> "The UK tax system undergoes constant change, or threat thereof, which results in ongoing uncertainty as to the tax treatment of funds and investors on assets totalling many billions. The UK Revenue can overturn arrangements without consultation albeit of very many years standing and is not seen to be working with the industry for the benefit of UK Plc, quite the reverse. This approach is very much at odds with that in other territories."

8 But see 9.25 (Forward tax agreements).

To the extent this is true it is a feature which makes the UK an attractive choice for anyone choosing where to reside. However, it is rapidly becoming less true, due to:

(1) over-wide, over-complex, or wholly vague anti-avoidance provisions mitigated by informal practice, discretion or plain oversight.[9]
(2) an increasing use of retrospective or retroactive legislation.[10]

The economic argument is crucial but what will be the economic effect of any reform is very hard to tell.

1.1.2 *Fairness*

The other main consideration is fairness or (more analytically) horizontal equity, the view that people who are relevantly equal should pay the same amount of tax. Of course this begs the question of whether UK resident UK domiciliaries and UK resident foreign domiciliaries are relevantly equal. To regard the two as completely equivalent is facile. It seems fair that those whose links with the UK are significantly less should pay less tax on foreign income or gains. This is especially so bearing in mind that "residence" does not require a very close connection to the UK – merely passing the 183 or 91 day tests or (under HMRC 6) having vaguer and more remote connections. Further, a foreign domiciliary may not have had a fair opportunity to arrange his affairs with UK tax in mind; for instance creating settlements from which he was excluded.

Another consideration is the impracticality (both for taxpayers and HMRC) of untangling ownership of assets, especially in family ownership arrangements which are common in third world countries.

1.2 Approaches to reform of foreign domiciliary taxation

It is helpful to distinguish different ways of altering the tax system for foreign domiciliaries:

9 Examples include the POA rules (2004); restrictions on CGT losses (2007); the ITA remittance rules (2008).
10 Examples include the IHT reforms (2006); the ITA remittance rules (2008).

(1) Alter the definition of domicile for general purposes and so restrict the class who qualify for foreign domicile tax treatment.
(2) Alter the definition of foreign domicile for some or all tax purposes.
(3) Alter tax laws applying to all foreign domiciliaries.
(4) Identify subclasses of foreign domiciliaries with close UK links so as to tax them more heavily.

One can of course achieve the same end result by more than one technique.

There is a lot to be said for approach (4). The domicile concept is not ideally framed to identify the "footloose" individuals, whose UK links are less, and for whom a lighter tax regime is appropriate. The adhesive quality of a domicile of origin, and the restrictive rules for the acquisition of a domicile of choice, allow some fortunate individuals to enjoy foreign domicile tax treatment, despite very close UK links and only tenuous, historical and fortuitous links to their domicile of origin. To the extent that they do so the tax system fails both on the economic and the fairness criteria.

The IHT code has to an extent recognised this with its deemed domicile rule. The TAA provisions also recognise this (restricted to ordinarily residents).

In considering this objection to domicile, however, one should bear in mind that no perfect criteria exists: the question is not whether domicile always produces the right answer, but whether one can do significantly better with other concepts.

1.3 History of reform of foreign domicile taxation

1.3.1 *1974-2002*

The 1974 Finance Bill included a provision (clause 18) that an individual ordinarily resident in the UK for five out of the preceding six years of assessment should be regarded as domiciled here for IT and CGT purposes. This was withdrawn from the Bill.[11]

In 1987 the Law Commission published recommendations for minor

11 For an account of the lobbying behind this, see "Inside The Treasury", Joel Barnett, Andrew Deutsch, 1982, p.28–9.

reforms of the general law of domicile but despite initial acceptance by the Government, there was no change in the law. In 1996 the proposals were formally abandoned.[12]

The 1988 Consultative Document (Residence in the UK) made radical proposals. The remittance basis would be abolished. Those resident here for less than seven out of 14 years (and, perhaps, who are also not UK domiciled) would qualify for a new "intermediate basis" of taxation. This would require disclosure of worldwide income in order to tax it at an effective rate of 2% or less. This almost unworkable proposal was sensibly abandoned.

In the first edition of this work (2001) I said:

> It seems more likely than not that, apart from tinkering changes, the present regime will continue for the foreseeable future. But "the major distinguishing feature of the British tax system is its instability".[13] There is also the possibility of EU pressure for reform.[14] If what has been a backwater acquires political prominence, perhaps due to no more than a campaign by a single newspaper, there will certainly be major changes.

1.3.2 *The 2003 background paper on residence and domicile*

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12 Law Com. No. 168: The Law of Domicile accessible *www.scotlawcom.gov.uk/downloads/rep107.pdf.* According to Hansard HC, 16 Jan 1996 Col 487:
"The Government have decided not to take forward these reforms on the basis that, although they are desirable in themselves, they do not contain sufficient practical benefit to outweigh the risks of proceeding with them and to justify disturbing the present long established body of case law on this subject."
This was the right reason for the right decision. However, the true reason for the decision may well have been pressure of the foreign domicile lobby: see "Rules for Determining Domicile", Law Reform Commission of Hong Kong (2005) para 4.28 accessible *www.hkreform.gov.hk*.

13 This was noted in *Taxation and Democracy*, Sven Steinmo, Yale University Press, 1993, p.44 but the instability has markedly increased since then.

14 For instance the EU required the UK to end its former discrimination against Irish source income; see the 6th edition of this work, para.9.51.

In 2002 a newspaper campaign emerged[15] which pressed the Government into action, or at least into the appearance of action. The Budget of April 2003 delivered a "background paper" called "Reviewing the Residence and Domicile Rules as they affect Taxation".[16] This was a facile document[17] but it may be unfair to criticise its (unnamed) authors. Their instructions may have been to be uncontroversial; by saying nothing, there was nothing in the document to which anyone of any political view could object.

Nothing then happened for five years except the often repeated statement that:

> The review of the residence and domicile rules ... is ongoing.[18]

It is clear that the review of foreign domicile tax did not follow the normal course of consultation, decision and implementation. In the absence of a frank explanation of what went on, it is tempting to speculate. The most likely explanation is that the Blair Government wanted to do nothing, but prevaricated to avoid an announcement which would have lead to a furore

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15 See for instance, *The Sunday Times*, 1 March 2002; *The Guardian*, 11 and 12 April 2002.

16 See *www.hmrc.gov.uk/budget2003/residence_domicile.pdf.*

17 It contained an outline of the present law (a rehash of IR20) and one paragraph summaries of the law of 29 other countries (of insufficient detail to be of any use and generally said to be misleading). The paper did not consider any proposals or their possible impact. It (consciously?) ignored every earlier discussion of reform: the Royal Commissions of 1920 and 1955, the 1936 Codification Committee, the 1974 Finance Bill, the 1987 Law Commission Report and the 1988 Consultation Paper.
For an account of the decline in quality of Government white and green papers, see "British Government in Crisis", Sir Christopher Forster, Hart Publishing, 2005 at p.134.

18 Para.5.120 Budget Report 2007 (21 March 2007); para. 5.104 Budget Report 2006 (22 March 2006); para. 5.103 Pre-Budget Report 2005 (5 December 2005); para. 5.116 Budget Report 2005 (16 March 2005); para.5.101 Pre-Budget Report 2004 (2 December 2004); para.5.103 Budget Report 2004 (17 March 2004); para.5.108 Pre-Budget Report 2003 (10 December 2003); all accessible on HM Treasury Website. Also see *Hansard* 16 October 2006 Col 1067W. The last outing of the tired statement was Hansard 12 July 2007 Col 1605 by which time almost no-one believed it, but by then it was possibly true.

from those in favour of reform.[19] A change of power led to an unannounced U-turn from that unannounced policy.

1.4 Assessment of the 2008 reforms

The 2003 background paper on domicile recited the principles that taxation of foreign domiciliaries:

[1] should be fair;
[2] should support the competitiveness of the UK economy; and
[3] should be clear and easy to operate.[20]

It seems reasonable to assess the 2008 reforms by these criteria.

1.4.1 *Clear and easy to operate*

It will be evident to anyone who reads this book that by this criteria the rules are an abject failure. The rules are unclear, often difficult and frequently impossible to operate. In these respects they are unquestionably worse than the pre-2008 rules. Government policy normally requires an impact assessment.[21] None was carried out in relation to any of the 2008 reforms. Many features of the reforms could not have survived if it had been.

1.4.2 *Competitiveness of the UK economy*

A thorough investigation of the economic effect of the 2008 reforms would need a team with expertise in tax and economics. No investigation of this kind has been made.

On one side of the account is the gain of more tax paid by foreign domiciliaries. On the other is tax and investment lost from individuals

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19 See *The Rise of Political Lying*, Peter Oborne, 2005, The Free Press.

20 The paper might have cited Adam Smith's *The Wealth of Nations* (1776) Book 5 chapter 2, accessible *www.adamsmith.org/smith/won-intro.htm*.
The paper did not point out (though Adam Smith did) that these objectives are to a substantial extent irreconcilable.

21 *www.berr.gov.uk/files/file44544.pdf*

who leave the UK, and those who (because of the reforms) decide not to come. It is certainly a serious loss to the economy that the new rules in many cases prevent investment in the UK and prevent use of UK services.

In the 2008/09 edition of this book my initial assessment was as follows:

> Overall it seems to me implausible that the reforms will make a positive contribution to the UK economy. One can test the matter this way. If a wealthy individual, a beneficiary of offshore trusts created by himself or his family, asked for advice on the desirability of choosing the UK as a residence, what would one say? Even now the individual could still do worse; and if enough advance planning and restructuring is possible, the problems may be ameliorated, at an administrative cost. Thus tax may still not prevent an individual from coming to the UK if he wants to sufficiently. Also, the old cliché about the tax tail and the commercial dog still holds good. But all this is a far cry from the pre-2008 position, where one would simply respond that the UK was clearly a desirable place to reside.

This view is now supported by a KPMG survey of 80 foreign domiciliaries finding that 24% are planning to leave the UK in the next two years as a result of the changes in 2008, with an additional 24% hoping that the rules will be changed and looking to review their position in the medium term. More than nine out of ten said that the changes had damaged the UK's competitiveness.[22] The greater loss may not be those leaving but those who do not come, a loss more or less impossible to measure statistically but no less real for that.

1.4.3 *Fairness*

One item of the 2008 reforms – the £30k remittance basis charge – takes the approach advocated above of distinguishing between different foreign domiciliaries and taxing those more heavily with greater UK connections, the connecting factor here being an 8/10 year residence test. One cannot categorise that as unfair.

Of much greater importance is the other package of reforms which affect all foreign domiciliaries not just long-term residents.

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22 March 2009, accessible *www.kpmg.co.uk/news/docs/NomDoms_FinanceAct2008_Access3.pdf*

The new ITA remittance basis is not wholly unfair, except for the wilder reaches of the relevant person definition.

The new CGT rules for trusts can work unfairly but complete fairness is impossible to achieve in this area.

The transitional rules are another matter. The rules are retroactive in that their impact in individuals depends on income and gains arising before 2008, and unfair in that they impose tax on those income/gains in a manner that no-one before 2008 would have anticipated. These rules are unquestionably and grievously unfair.

All in all, the reform cannot score many marks for fairness.

1.4.4 *Process of implementation*

The manner in which the new law was introduced deserves to be recorded.

On 18 January 2008, 26 pages of draft clauses were published whose unwritten message to wealthy non-residents was broadly: *do not come to the UK if possible; if you must, do not under any circumstances invest any money here*. The clauses were officially described as work in progress, but this was unfit for publication.

HMRC presumably agreed. On 27 March the Finance Bill was published, containing 54 pages of legislation. The FB clauses bore almost no resemblance to the January draft. One consequence is that the professional time and clients' money spend considering the old clauses was almost entirely wasted. That certainly cost many £millions. Another consequence was that the profession had nine frantic days to scramble around before the end of the tax year. Because of the absence of sensible transitional reliefs, large amounts of tax depended on decisions and actions taken in those days. Sensible consideration of difficult and important matters was rendered impossible.

On the date of publication the Treasury announced that the Finance Bill was incomplete and amendments covering almost every aspect of the

rules[23] would be made in the course of progress of the Finance Bill.[24] Thirty pages of amendments duly emerged in mid June – far too late in the Finance Bill timetable to give them any serious consideration. Forty eight more Report Stage amendments were published on 26 June. The report stage and third reading (after which no further amendments could be made) were held on 1 and 2 July 2008. John Avery Jones notes that "Report Stage amendments are usually a disaster."[25]

As a result, the final legislation poses problems which will occupy practitioners and HMRC for many years, but it is also noteworthy that during the first three months of 2008/09 taxpayers could not know what laws governed transactions which they might wish to carry out, or what record keeping would be required of them.

The House of Lords Economic Affairs Committee comment in measured language:

> Our private sector witnesses would not have used words like "a real shambles" if they did not feel strongly about this. ...
> 176. We recommend that, if they have not already done so, HMT and HMRC should carry out a full review of the reasons why there were so many difficulties in the development of this policy initiative. They should ensure that the lessons are learned so that these problems do not emerge in other initiatives.

No such review has been carried out and there is no sign that the lessons have been learned.

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23 Explanatory notes to Schedule 7, para 36 (mixed funds); para 47 (s.87 charge); para 52 (non-resident trusts); para 74 (Schedule 4C); para 91 (TAA provisions; para 106 (works of art); para 107 (employment related securities).

24 In the 2008/09 edition I said:
"This is a new development in tax legislation. While from time to time inadequately drafted clauses have always been found in Finance Bills, this is as far as I am aware the first time that the Government has had to announce that fact at the time of publication of the Finance Bill."
It seems however to be a trend as there are similar examples in the FA 2009.

25 See "Taxing Foreign Income from Pitt to the Tax Law Rewrite—The Decline of the Remittance Basis", John Avery Jones in *Studies in the History of Tax Law*, Hart Publishing, 2004 accessible on *www.kessler.co.uk*.

> 177. We also recommend that if another policy initiative gets to the point where the legislation cannot be finalised for inclusion in the Finance Bill, that initiative should not be included in the Bill, or, if feasible, the part which is not finalised should not be included. We cannot support the approach of the Finance Bill's still being subject too much amendment at the time it is published, particularly when the proposals come into effect from the beginning of the tax year, as in this case. [26]

The former editor of *Taxation* is more blunt – and no-one who studies this book will disagree:

> The standard of strategic policy making at the Treasury has been unacceptably poor in recent years, but this must surely have been one of its lowest ebbs ever.[27]

1.4.5 *The future*

Alistair Darling said in his budget speech 2008:

> There will be no further changes to this regime [for foreign domiciliaries] for the rest of this Parliament or the next.[28]

No-one seriously believed that[29] and in the 2008/09 edition of this work I said:

> The statement is constitutionally wrong, as Parliament cannot bind its

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26 Select Committee on Economic Affairs, 2nd Report of Session 2007–08, The Finance Bill 2008 *www.publications.parliament.uk/pa/ld200708/ldselect/ldeconaf/117/117i.pdf.*

27 *Taxation* 12 June 2008 Vol 161 No. 4160 p.627 (Malcolm Gunn).

28 *www.hm-treasury.gov.uk/budget/budget_08/bud_bud08_speech.cfm*.

29 The House of Lords Economic Affairs Committee said:
"227. In his Budget Statement, the Chancellor promised that the rules in this area would not be substantially revised for the rest of this or the next Parliament. We do not take this to mean that there will not be legislation in coming Finance Bills to address defects in the current legislation. We think it inevitable that, given the evident pressure under which this legislation was produced, there will be such defects." 2nd Report of Session 2007–08, The Finance Bill 2008
www.publications.parliament.uk/pa/ld200708/ldselect/ldeconaf/117/117i.pdf.

> successor. But leaving aside (if one can) constitutional fundamentals, it would be rash to rely on it. On the contrary, I predict that further tinkering (at least) is likely as the effect of the present rules gradually becomes evident.

The FA 2009 has done just that, and more tinkering is already promised in the FA 2010. The current position is highly unstable and it is not likely that the law is likely to remain in its present form.