STEP

Society of Trust and Estate Practitioners

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Residence and Domicile

Response to Background Paper from STEP UK Technical Committee

Introduction

1. The Background Paper addresses both the residence and the domicile rules. Our view is that different issues arise with the two sets of rules and we therefore deal with them separately.

Residence

2. Currently residence results in liability to taxation on worldwide income and gains subject to the various exceptions made for non-domiciliaries. Residence is therefore the principal connecting factor in determining liability to these taxes. We support the continuing use of residence as the primary connecting factor, principally for two reasons:

   a. It is capable of being a simple and objective test.

   b. It is widely used by other countries.

3. We say above that residence is capable of providing a simple and objective test. Currently it does not do this. There are two principal reasons:

a. The law is profoundly uncertain as it rests on cases going back over the last 100 years in which the Courts do not define residence but simply decide whether the fact-finding Commissioners were entitled to find as they did. This legally uncertainty was compounded in 1993 when the widely welcomed abolition of the available accommodation rule did not, as a matter of strict construction, achieve its intention.

b. As a result almost all cases are governed by IR20. This is a most helpful publication, but inevitably it results in uncertainty in some cases and, where this occurs only limited recourse can be had to the Courts for an objective determination of what it means.

4. In light of these factors we advocate the enactment of a statutory, objective test of residence. The test we favour is that currently used by the United States for persons who are neither citizens nor green card holders. This test is well known and was indeed advocated in the 1988 consultative document. Under this test an individual would be allowed 180 days per year in the UK before becoming resident, but this 180 days is made up of all the days in the current year, one third of the days in the preceding year and one sixth of the days in the year before that.

5. If this suggestion is adopted it is implicit that the concept of ordinary residence as distinct from residence should be abolished. We would in any event favour this, as the meaning of ordinary residence is quite unclear. To give one example of the confusion, case-law indicates an individual cannot be ordinarily resident without being resident whereas some legislation, for example TCGA 1992, is drafted on the opposite assumption.

6. We accept that abolition of ordinary residence may accelerate the impact of certain anti avoidance legislation such as TA 1988 s 739 on immigrants. In practice

theimpact of this may be limited in view of the remittance basis for non domiciliaries and (in the case of s 739) the motive defence.

7. Abolition of ordinary residence would also impact employees seconded to the UK, many of whom claim to be not ordinarily resident and so secure the remittance basis in respect of foreign duties. We believe consideration should be given to some sort of intermediate basis for all seconded employees for the first four years of residence.

8. A further result of adopting our suggestion in para 4 is that days of arrival and departure would count as days of presence in the UK. We believe this treatment is more appropriate in the current era of great personal mobility, particularly if, as we propose, it is coupled with a higher day-count threshold before residence is reached.

9. We would support the retention of split year treatment for arrivals and permanent departures, and believe this should be reinstated for CGT so as to apply both to that tax and to income tax.

Domicile – who is affected?

10. The Background Paper focuses on one category of non domiciliary, namely the foreign employee who works in the UK for a limited period, usually for an international employer. In our view this category, although significant, is not of fundamental importance in the present context. There are three reasons:

a. By their nature, many of the individuals concerned will have only modest investment portfolios or other assets when they are in the UK, such as are able to benefit from the remittance basis.

b. The remittance basis does not attach to earnings from UK employment, which, ipso facto, are likely to be the main income source of such individuals. It is

possible to create wholly foreign earnings subject to remittance rules bythe use of split contracts, but of their nature, such arrangements are possible only in respect of duties performed wholly abroad.

c. A significant proportion of the employees concerned are US citizens, who are subject to US tax on world income in any event.

11. Those of us who have contributed to this Paper have, since the Government announced its review, given much thought as to who are the most significant categories of non domiciliary. We have come up with two:

12. International entrepreneurs. These are people who own and manage their own businesses, either directly or through companies. The range of their activities is extraordinarily wide, but at one end of the spectrum are sport and media stars (and all their managers and support businesses) and at the other international technology and financial businesses. The common characteristic that all these businesses share is that the owner and the business can be located anywhere. They do not choose the UK and more particularly London for its climate or indeed its transport system. We believe they chose it because of the English language and, equally important, because the non UK income and assets of the owner and the business can lawfully be excluded from UK tax and excluded from disclosure to the UK tax authorities.

13. International investors. These are people who have inherited wealth or have retired having made it themselves. Their assets, therefore, are passive investments. Such people are often international in their outlook and in some cases they have been forced out of their home country by political turmoil. As with the entrepreneurs, these people need not chose the UK and, in our experience the main or one of the main reasons for them doing so is the favourable tax regime. These individuals are often mobile in outlook and so have homes in several places. The UK, and more particularly London may be their main base on account of the favourable tax regime.

14. It is impossible to specify in absolute terms the positive impact the above two categories of individual have on the UK economy. However our collective experienceindicates that directly and indirectly it is significant and may be

considerable. We would make the following points:

15. The individuals concerned contribute directly by employing UK resident individuals and purchasing UK goods and services when here.

16. In the case of the entrepreneurs, the fact that the individual owner finds it attractive to be based in the UK means that at least some part of his overall business activity is based in the UK. In some cases these activities may simply be service activities but often they may be a key part of the global business. Such activities would quite simply not be in the UK if the owner did not find it attractive to live here.

17. Because both the entrepreneur and the investors are based here, their key advisers and service-providers are more likely to be based here. We believe this has resulted in significant business for fund-managers, lawyers and others in the financial and professional sectors. Indeed one reason why these sectors of the UK economy have been so successful globally is, in our experience, the international client base on their door-step in London.

18. It is well known that the UK, and London in particular, has certain world-class economic activity, most notably in the financial and the cultural and media and media sectors. We suggest one reason why London has achieved critical mass in these areas is that the foreign owners or controllers of such businesses have a powerful fiscal incentive to base themselves in the UK.

19. Many of the individuals concerned make very substantial donations to UK charities.

20. As indicated above, quantification is difficult if not impossible. Nor, for reasons of client confidentiality, can we give specific examples. However what we can say that many of the individuals which have caused us to form the view we hold have immediately recognisable names.

The present intermediate basis

21. We summarise the present intermediate basis of taxation which non domiciliaries enjoy as follows:

22. It applies to any resident of the UK who is not domiciled here.

23. The one qualification to domicile being the criterion for eligibility for intermediate status as is that residence in 17 out of any 20 years causes intermediate status to be lost for IHT (but not for CGT or income tax).

24. The effect of intermediate status is:

    a. Foreign income and gains are not taxable unless remitted.

    b. Foreign situs assets are not subject to IHT.

25. In practice the scope of the intermediate basis is often extended:

    i. IHT on UK assets is avoided by holding them in a foreign holding company

    ii. CGT on UK assets may be avoided by holding them in a foreign company or trust

    iii. Income and gains only count as remitted if money traceable to them is remitted. Careful banking procedures enable capital to be remitted tax-free while leaving the income abroad.

    iv. The IHT consequences of deemed domicile are avoided if the assets are settled prior to the acquisition of the deemed domicile.

Should the UK have an intermediate basis?

26. Our experience suggests that our first category described in para 9, the international entrepreneurs represent the main economic justification for the remittance basis. If the fiscal incentives represented by the current regime were ended, we believe there would be a real risk of erosion of the UK's pre-eminence in key economic areas, with consequent long-term economic damage and loss of tax base. This, in our view, is the prime argument in favour of retaining an intermediate basis.

27. We recognise there are counter-arguments, most notably two referred to in the Background Paper namely:

    a. Unfairness as compared with UK resident and domiciled taxpayers.

    b. Harmful tax competition as against other countries.

28. In our view both these arguments can be overstated. Wealthy entrepreneurs, whether non domiciled or UK domiciled, normally find there is no shortage of low-tax jurisdictions or preferential tax regimes to which they can gravitate. True low tax is often achieved in other countries by formal or informal concession rather than by law, but the reality is that an individual domiciled in the UK who is prepared to move to find a favourable tax regime can normally find one. In short he is no worse off than the foreign domiciliary who moves from his original home country to the UK. Further and perhaps more compelling to those who believe in transparency, the British system is based on above board law rather than informal practice.

29. There is one additional reason in favour of an intermediate basis which applies both to entrepreneurs and to the category we refer to as international investors. This is that it avoids the necessity of individuals not in the UK permanently having to disclose details of their foreign financial arrangement to the UK tax authorities. So too, it saves the Revenue the trouble and expense of understanding those arrangements, which are often complicated and based on unfamiliar legal concepts. One has only to

think of how assets are regarded as in family rather than individual ownership in many parts of the world. Without an intermediate basis both inadvertent evasion and Revenue work would, we suspect, greatly increase.

Is foreign domicile the appropriate criterion for qualification for the intermediate basis?

30. In our view domicile has two great attractions as a measure of fiscal connection:

31. The law In contrast to the law of residence, the law of domicile is well-worked out and understood. In most cases experienced practitioners have little difficulty in determining domicile. Any new system would inevitably throw up uncertainties and injustices which would take years to resolve.

32. Domicile, and in particular the domicile of choice concept, does imply commitment to the country in question. Absence of such commitment is, we believe, as good a reason as any for granting intermediate status.

33. It has been suggested, most notably in the 1988 consultation, that intermediate treatment would end after a given number of years in the UK, either by imposing deemed domicile or by discarding domicile and relying solely on a year count. In our view, such proposals are open to a fundamental economic objection namely (a)they would encourage key entrepreneurs to leave before their time is up and (b) they would discourage others from coming here at all. In short we do not believe there would be tax gain and could be significant tax loss.

34. It may be suggested that imposing a cut-off is already in place for IHT, in the form of deemed domicile, and that this has never had the adverse effects noted above. The latter is true, but the reason is not the existence of the concept of deemed domicile, but that its impact can be and is generally circumvented by the timely transfer of assets into trust. It has always been accepted that such trusts are fully effective in preserving excluded property status even if the settlor is a beneficiary.

35. That said, we would accept that some individuals who are treated as non domiciled have been here a very long time and in some cases may have lived here all their lives. In our experience, many people in this category would be found to be UK domiciled if the Revenue were more proactive in challenging assertions of intention. Nonetheless it does have to be recognised that the onus in such cases is on the Revenue and that this does make the task harder than it should be. We would support a change in the law whereby the onus burden of proving that a UK resident has retained a foreign domicile was, for tax purposes, on the taxpayer, either ab initio or after he had been resident here for more than a given number of years. In our view it should also be confirmed that in all domicile cases the standard is the civil standard.

36. We would strongly prefer such a change to a simple cut-off based on a given number of years of UK residence. But if such cut-off is judged necessary either in the interests of fairness or to avoid tax competition, making the IHT 17 out of 20 year rule of general application would be the least damaging option. However if such change was to be fully effective, there should be a transitional period of at least two years. Circumvention by settlor-interested settlements may be felt inappropriate. If such is the case, we would urge strongly that gift with reservation concepts not be used as they are uncertain and widely criticised. The same tests of whether a settlement is settlor-interested should be used as currently apply to income tax and CGT.

37. Assuming domicile is retained as a connecting factor, we would stress the desirability of ensuring consistency in Revenue practice. A single unit to give domicile rulings for both income and capital taxes would be appropriate. It should also be confirmed that a taxpayer can make a DOM 1 application at any time.

Are the present computational rules appropriate?

38. We believe that, subject to the point made in the previous paragraph 24 that the IHT rules determining the results of intermediate status are clear and should not be

altered.

39. With regard to income tax and CGT it is tempting to conclude that the rules are complex and artificial and so should be recast. An alternative most often cited as that any monies received in the UK should be deemed to be income or gains save insofar as the taxpayer can show remittances exceed all his actual foreign income and gains.

40. Our view, however, is that with five the exceptions noted below the present income tax and CGT rules should not be altered. Our reasons are as follows:

    (1) Case-law over many years has rendered the present rules certain in most areas and capable of being well-understood.

    (2) Any move to an equivalence measure would (a) involve delving into the foreign financial affairs of non domiciliaries (see paragraph 17 above) and (b) be a negative signal, risking the results outlined in paragraph 14.

41. The main exception we would make is the source-ceasing rule. This has long been abolished elsewhere in the tax code, and has not applied to employment earnings since 1989. A second exception is that remittance in specie should be taxable. Our view is that these changes abolition would be simple to achieve and would not have negative impact of the sort referred to above.

42. The other big issue we would give consideration to is the remittance basis for earnings. There is currently no remittance basis for sole traders and, if any part of the remittance basis creates resentments, it is two employees working side-by-side under different tax regimes. As noted above, employees are, in our view, the least important category of non domiciliaries economically. Further, there is a certain rationale in keeping foreign investment income and gains free of tax, given that such investments

may represent pre-immigration capital, and taxing all earnings during UK residence. For this reason it may be felt appropriate to abolish the remittance basis for the foreign earnings of non domiciliaries either generally or at least where the taxpayer has associated UK and foreign employments. For the avoidance of doubt we confirm we favour an intermediate basis for the first four years of residence (paragraph 7 above).

43. Our other three exceptions are minor. Two concern CGT and are the rules which (a) disallow losses on the foreign situs assets of non domiciliaries and (b) require currency gains to be brought into account if remitted. Our view is that losses should be allowed if remitted (at least against foreign gains) and that foreign bank accounts and debt instruments should not be chargeable assets. Finally we would suggest the existing statutory rules as to loans and constructive remittances are confusing and need rethinking.

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