Avoiding our international obligations?

Simon McKie exposes the government's attempt to obtain the benefits of our tax treaties while denying effective relief for foreign tax

Budget Note 107 announced that the mechanism for imposing the £30,000 Remittance Basis Charge (the Charge) on long-term resident non-UK domiciliaries would be different from the one used in the draft legislation, which had been published on 18 January 2008. The Note announced that it would now be structured as a charge to tax on specific income and gains nominated by the taxpayer concerned. The point of the change in method was to ensure that the charge would be creditable against foreign tax suffered on unremitted income.

In my article in last month's issue (p 22), I pointed out that the logical consequence of this was that foreign tax suffered on the nominated income would, under many tax treaty provisions, be creditable against the UK tax charge. I said:

> '… the government will find it very difficult to prevent foreign tax from being credited against the charge because it will be bound by its treaty obligations.
>
> 'That is not to say that it won't make the attempt. Only when the legislation implementing the revised proposal is published, either in the Finance Bill or before, shall we know the approach the government will take.'

FINANCE BILL 2008: NON-DOMS

The Finance Bill has now been published and it is clear that I was right to be wary.

As we shall see, the effect of the Finance Bill provisions, read literally, is that no effective double taxation relief will be given for foreign tax suffered on the income nominated to be subject to the Charge. The essence of double tax treaties is that they are mutual agreements for giving relief to prevent double taxation, which allocate taxing rights between the parties on an agreed and rational basis. The Finance Bill provisions, as I shall demonstrate, represent a disgraceful attempt by the government to obtain the benefits of our tax treaties while denying effective relief for foreign tax. That attempt will be unsuccessful because it will, as I shall argue, be defeated by a purposive construction of the relevant legislation.

New Section 809G

Finance Bill 2008 Schedule 7 para 1 will, if enacted, insert a new Chapter A1 into the *Income Tax Act 2007*, Part XIV. That chapter includes New s. 809G[1], which imposes the Charge.

Under the proposed New s. 809G, an individual who claims the Charge and fulfils the conditions of having been resident in the United Kingdom for at least seven of the nine tax years preceding the year concerned and of being over the age of 18, must nominate the income or chargeable gains to which s. 809G(2) is to apply. Section 809G(2) charges income tax on the nominated income and/or capital gains tax on the nominated chargeable gains as if the Charge did not apply for the relevant tax year. It should be noticed that there is no requirement to nominate sufficient income and gains to give rise to a charge of £30,000. The only requirement is that some income or gains are nominated.

To ensure that a charge of £30,000 arises where an election for the remittance basis is made, New s. 809G(4) imposes an increase in the charge to income tax for the year of £30,000 minus the ‘relevant tax increase’.

‘The relevant tax increase’ is defined in subsection (5) *ibid* as the total amount of income tax and capital gains tax payable by the individual for the relevant tax year, minus the total amount of income tax and CGT that would be payable by the individual for the relevant tax year if the nominated income and gains had not been chargeable. Notice that there is some circularity (the Circularity) in this definition. The additional charge under New s. 809G(4) will be part of the total amount of income tax and CGT payable by the individual for the relevant tax year, and yet in order to determine the charge one has first to determine the taxpayer’s total tax charge for the year.

If one corrects the Circularity by assuming that one determines the taxpayer’s liability to income tax or CGT liability for the purposes of subsection (5) without reference to the charge under New s. 809G(4), that subsection deals appropriately with the problem of the taxpayer who nominates income and gains of a lesser amount than the amount necessary to create a £30,000 charge. Example One demonstrates that where no foreign tax has been suffered on the nominated income or gains, the provision works unexceptionably to ensure that the additional tax paid because of s. 809G is £30,000.

An anomalous result of literalist construction

As Example Two demonstrates, however, where foreign tax is creditable against the tax on the nominated income, the reduction in the tax liability caused by the foreign tax credit will always result, on a literal reading, in an equal increase under New s. 809G(4).

A purposive construction

It is now well established, however, that in construing legislation due regard must be had to the legislation’s purpose[2].

Because double tax agreements are treaties between sovereign states, they cannot themselves give rights that are enforceable by the subject, although they can be, and are, incorporated into law by statutory provisions[3].

Where an order in Council declares that a double tax treaty is to have effect, *ICTA* 1988, s. 788 (3) provides that:

> ‘… the arrangements shall, not withstanding anything in any enactment, have effect in relation to Income Tax and Corporation Tax in so far as they provide:-
>
> (a) for relief from Income Tax, or from Corporation Tax, in respect of income or chargeable gains …’.

Section 788(1) applies to arrangements specified ‘with a view to affording relief from double taxation’. It is quite clear, therefore, that the purpose of relief under s. 788 is to provide a relief from double taxation.

Unilateral double tax relief is conferred by *ICTA* 1988, s. 790(1), which provides that:

> ‘… relief from Income Tax and Corporation Tax in respect of income and chargeable gains shall be given in respect of tax payable under the law of any territory outside the United Kingdom by allowing that tax as a credit against Income Tax or Corporation Tax’.

The general rule of unilateral relief is stated in s. 790(3):

> ‘Unilateral relief shall be such relief as would fall to be given under Chapter 2 of this part [dealing with relief under double tax treaties] if arrangements in relation to the territory in question containing the provisions specified in subsections (4) to (10C) below were enforced by virtue of s. 788’.

The purpose of unilateral relief, therefore, is analogous to that of relief under double tax treaties; that is, to provide relief from double taxation.

It is quite clear that, if a provision such as New s. 809G(4) nullifies double tax relief by providing for a charge equal to the relief given, it would prevent effective relief for double taxation from being given under s. 788 or s. 790 and so frustrate the purposes of those sections. Is there anything to suggest that the legislatures’ purpose in enacting New s. 809G was to nullify double taxation relief in this way?

What is relevant is Parliament’s purpose in enacting the legislation, not the draftsman’s motivation in drafting it. I have no doubt that, in reality, the draftsman, under instruction from HMRC, deliberately attempted to avoid giving credit for foreign tax. The legislature’s purpose in enacting legislation, however, is to be determined primarily from the words enacted. The legislation does not refer directly to double taxation relief. If it negates such relief it does so only by reason of the interaction of its detailed computational provisions with those of double tax relief. So the legislation itself does not lead one to conclude that its purpose was to negate double tax relief. What is more, New s. 809G would still have a function (dealing with situations where the income and gains nominated give rise to a tax charge of less than £30,000) if it is construed so as not to negate double tax relief for foreign tax suffered.

Do extra-statutory materials suggest that the purpose of New s. 809G(4) is to negate double tax relief? Neither Budget Note 107 nor the explanatory notes of the Finance Bill provisions say so. At the time of writing, no ministerial statements, either in Parliament or outside it, have suggested that the provisions are designed to negate double tax relief. That is hardly surprising. It would be deeply embarrassing for the government to admit that it is attempting to avoid its international obligations in this way.

Is there available a construction of New s. 809G that does not do too great violence to the words used and yet does not defeat the purpose of *ICTA* 1988, ss. 788 and 790? Surely there is. Article 23B of the OECD model treaty, which forms the pattern on which double tax treaties are based, provides the credit method of giving relief. It provides that the contracting state of the taxpayer’s residence must allow:

> ‘As a deduction from the tax on the income

> of that resident, an amount equal to the Income Tax paid in that other State…'

and it similarly so provides in relation to CGT. So in giving relief one must first calculate the tax chargeable in the contracting state in which the taxpayer is resident without reference to double tax relief and then allow the foreign tax to be deducted from that amount. Section 790(4) provides a similar method in relation to unilateral relief.

Because, for the purposes of double tax relief, one must first calculate the UK income tax that will be payable without reference to the double tax relief and then give effective relief for foreign tax suffered, it is surely arguable, on a purposive construction, that the reference in New s. 809G(2) to:

> '… the total amount of Income Tax and Capital Gains Tax payable by the individual for the relevant tax year'

is a reference to that total amount before deduction of the foreign tax credit.

If New s. 809G were construed in that manner, it would provide in relation to double tax relief on the Charge that symmetry which is of the essence in double tax relief arrangements.

An attempt at artificial tax collection

I have little doubt that the Courts would adopt such a purposive construction. The question is, however, why the government should have made an attempt to avoid its obligations under its double taxation treaties in this way, even allowing, as it appears, that that attempt will be unsuccessful.

In recent years, HMRC officials have taken it upon themselves to wage a moral crusade against artificial tax avoidance. That has never seemed an appropriate activity for officials whose duty is to administer the law. The campaign has been particularly unseemly in view of HMRC's blatant pursuit of artificial tax collection. Dave Hartnett, acting chairman of HMRC, has said recently that his department should strive to collect the maximum amount of tax the law allows (Taxation 'The Dave Channel' 2 April 2008). This underhand attempt to avoid giving credit for foreign tax is surely a new low point in the government's determination to maximise its tax revenues without regard to the effect of doing so on the integrity of the tax system.

Simon McKie is a designated member of McKie & Co (Advisory Services) LLP, a specialist consultancy advising on the taxation of private clients

1. The references prefixed by 'New' are to the statutes cited as they would be amended by Finance Bill 2008, Schedule 7 if it were enacted.
2. *Barclays Mercantile Business Finance Ltd v Mawson (Inspector of Taxes)* [2004] UK HL 51
3. *Collco Dealings Limited v CIR HL* 1961 39 TC 509

Example One

Mr Trufflehunter has been a UK resident for many years but is domiciled in Narnia. He funds his living expenses from capital. His income consists of £1m of Narnian bank interest, which he keeps in Narnia, remitting none of it to the UK. Narnia does not charge tax on Narnian interest arising to non-residents.

Mr Trufflehunter claims the remittance basis in 2008/09 and in his claim nominates £10,000 of Narnian interest. So £10,000 of interest is chargeable under New s. 809G(2). The effect of the remittance basis election is that the personal allowance is not available to Mr Trufflehunter (New s. 809F). Thus Mr Trufflehunter's income tax and CGT liability for the year is £1,768 (((£10,000 – £2,320) @ 20%) + (£2,320 @ 10%)).

The total amount of income tax and CGT that Mr Trufflehunter would have paid for the relevant tax year had the nominated income not been charged under New s. 809G(2) was £0. So the relevant tax increase under New s. 809G(4) is £30,000 – (£1,768 – £0) = £28,232. The total charge under New s. 809G for the year is therefore £1,768 under subsection (2) *ibid* and £28,232 under subsection (4) *ibid*, making £30,000 in total.

Example Two

The following example applies a literal construction of New s. 809G(4) to the example concerning Mr Tumnus given in my article in the April issue (p 22). I repeat the relevant information from that example here for those readers who cannot refer to my original article.

Mr Tumnus has been resident and ordinarily resident in the UK for the last 10 fiscal years, but he is domiciled in Narnia. He funds his living expenses from capital and does not remit any income or capital gains. His income for 2008/2009 and the foreign tax creditable against UK tax under relevant double tax treaties or under ICTA 1988 s. 790(4) is as follows:

Item	Income £	Rate of creditable foreign taxation liability
UK rent	6,000	0
Narnian rent	10,000	10
Calormene rent	100,000	45
Narnia dividends	100,000	10
Archenland dividends	400,000	15
Narnian bank interest	100,000	0
Archenland bank interest	300,000	0
	£1,016,000	

Mr Tumnus makes the remittance basis election under New s. 809B and nominates £90,000 of the Calormene rent. Ignoring New s. 809G(4) (so as to exclude the Circularity) but applying New s. 809G(2), Mr Tumnus' tax liability would be as follows if one ignores double tax relief:

	£
Rental income	6,000
Income from Calormene property	90,000
Total income	96,000
Basic rate tax at 20% on 36,000	7,200
Higher rate tax at 40% on 60,000	24,000
	31,200

Thus, if it were not for double tax relief, the nominated Calormene income would have borne tax of £30,000 (((£36,000 – £6,000) @ 20%) + ((£96,000 – £36,000) @ 40%)). Double tax relief is available on the Calormene tax suffered, however, which is restricted to the amount UK tax imposed on that income, reducing the UK tax liability on the Calormene rent to nil. Because of the double tax relief, therefore, no additional UK tax is suffered by virtue of the nomination of the Calormene income. The result of that is that the relevant tax increase under New s. 809G(5) is nil, with the result that an additional tax charge of £30,000 (£30,000 – £0) is imposed under New s. 809G(4).