McKie&Co

RUDGE REVENUE REVIEW

ISSUE I

We enclose our latest Review which is composed of two articles.

The first, “Perfidious Albion” returns to the subject of foreign taxation credit on the new Remittance Basis Charge. The publication of the Finance Bill revealed that the Government has tried to avoid giving credit for foreign tax suffered on income which is subject to the charge and the article explains why that attempt will probably be unsuccessful.

“Squeezing the Rich until the Pips Depart” takes a step back from the detail of the new remittance regime to look at the principles governing the taxation of non-domicillaries.

You will also see that our Bulletins have been renamed, “The Rudge Revenue Review”. We gradually moved our operations from the City to this beautiful village in Somerset between 2003 and 2005. The transfer was seamless and we think we can say that over the last three years our clients have noticed no change in our service, other than that it is given by happier and more relaxed professionals and support staff. It is always a pleasure to welcome our clients and contacts to Rudge. You can see a picture of our office on our website on http://www.mckieandco.com/about.html

Actually, we have a new website in development. We hope we shall be able to direct you to that new website when we send to you our next Review.

Sharon McKie **Simon McKie**

"PERFIDIOUS ALBION"

Avoiding our international obligations

Budget Note 107 announced that the mechanism for imposing the £30,000 Remittance Basis Charge on long term resident non-UK domicillaries would be different from the one used in the draft legislation which had been published on the 18th January 2008. The Budget 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 the article "Diminished Returns" which appeared in our Budget Review in March it was 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. In the article it 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."

The Finance Bill has now been published and it is clear that we were 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 Remittance Basis 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 we shall demonstrate, represent a disgraceful attempt by the Government to obtain the benefits of our tax treaties whilst denying effective relief for foreign tax. That attempt will be unsuccessful because it will, as we 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 Income Tax Act 2007 Part XIV. That chapter includes New s.809G[1] which imposes the Remittance Basis Charge.

Under the proposed New s.809B, an individual who claims the Remittance Basis 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 eighteen, must nominate the income or chargeable gains to which s.809G(2) is to apply. Section 809G(2)

[1] The statutory references prefixed by "New" are to the statutes cited as they would be amended by Finance Bill 2008 Schedule 7 if it were enacted.

charges Income Tax on the nominated income and/or Capital Gains Tax on the nominated chargeable gains as if the Remittance Basis 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 Capital Gains Tax 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 a 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 Capital Gains Tax 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 Capital Gains Tax 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 by reason 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 which 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:-

---

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

"… 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 the purpose of Parliament in enacting the legislation not the motivation of the draftsman in drafting it. We 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 which 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 Capital Gains Tax. 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 which 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 Remittance Basis Charge that symmetry which is of the essence of double tax relief arrangements.

An attempt at artificial tax collection

There is 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 which the law allows (*Taxation* "*The Dave Channel*" 2nd 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.

Example One

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

Mr Trufflehunter claims the remittance basis in 2008/2009 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 Capital Gains Tax liability for the year is £1,768 (((£10,000 - £2,320) @ 20%) + (£2,320 @ 10%)).

The total amount of Income Tax and Capital Gains Tax that would have been paid by Mr Trufflehunter 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.

McKie&Co

Example Two

The following example applies a literal construction of New s.809G(4) to the example concerning Mr Tumnus given in the original article "Diminished Returns". The relevant information from that example is repeated here for those reader's who cannot refer to our original article.

Mr Tumnus has been resident and ordinarily resident in the UK for the last ten 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. That 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).

At least, that is the result of a literal construction of New s.809G.

McKie&Co

"SQUEEZING THE PIPS UNTIL THE RICH DEPART"

This was written in response to an article written by Mike Truman and published in *Taxation* magazine on the 20th February 2008.

Schadenfreude

In an article on the 20th February 2008 ("*So Long, Farewell*") Mike Truman concluded that:-

> "Some non-domiciles have expressed the fear that this [the remittance basis changes announced in the Pre-Budget Report] may just be the start of a process which will lead to a removal of all their tax privileges; all I can say is that I hope their fears are realised."

Mike seems to have based this rather unsympathetic view on two independent arguments;

First, on an economic argument, that the number of non-domicillaries who will leave the United Kingdom due to the new charge has been greatly exaggerated and that the departure of those who will go will not significantly damage the UK economy.

Secondly, on a moral argument, that it is morally right that non-domicillaries should be taxed in the same way as UK domicillaries.

The economic argument: they are not valuable and they won't leave

Mike attempts to demonstrate that non-domicillaries are not particularly important to the economic welfare of the country and, even if they are, it is unlikely that many would leave if UK taxation becomes less favourable to them. Mike's judgment of the economic effect of taxing non-domicillaries on the same basis as UK domicillaries is clearly not shared by the Government.

During our professional lifetimes Governments of whatever political complexion have regularly examined the taxation of non-UK domicillaries and, after making initial noises about reform have, until November of last year, always backed off from making any changes. In opposition, Gordon Brown identified the remittance basis for non-domicillaries as a tax loophole. But once he got into government he spent the next ten years trying to avoid closing it until wrong-footed by the Conservative Party. He clearly didn't do so because of an ideological commitment to the welfare of the rich.

In support of his economic argument, Mike cites data which he concedes is limited.

So, for example, he cites the total number of individual non-domicillaries who pay tax on remitted income as 111,000 and he regards "the ones who might decide to leave…" as a subset of this figure. That number, of course however, does not include those who make no returns because they pay no tax having no taxable income at all. By the nature of things, that group is likely to include a large proportion of the richest non-domicillaries simply because those will be the non-domicillaries who are sufficiently rich to live off accumulated capital and to accumulate their income overseas.

Mike's economic argument seems to be predicated on the proposition that the measure of the economic loss to this country of non-domiciles moving overseas is the excess of "the extra tax that would be paid by the non-domiciles that stay against the tax lost with those who leave." The economic benefit of the residence of non-domicillaries in the UK, however, is obviously not just the tax which they pay into the UK exchequer. It is also the employment and business income which they generate, the business and financial expertise which they bring to this country, the businesses which their presence attracts to the UK, their involvement in charities and the charitable donations which they make whilst they are here. The significance of their charitable involvement in the provision of artworks for public display, for example, became obvious when lobbyists alerted the Government to the threat posed by its original proposals to heritage charities resulting in one of the Chancellor's many humiliating volte-faces.

Perhaps Mike's conclusion on this matter stems from the fact that he views what others would call serious economic damage as mere inconvenience. For example, he contemplates the relocation of one hundred family owned Greek shipping companies to Greece and the loss of £10bn of revenue from the UK with apparent equanimity. Or perhaps it is because the article does not take account of the research published by STEP on the 1st February 2008. It certainly does not refer to that research, which showed that over half of the UK's super wealthy had either decided to leave the country or were making contingency plans to do so or to sell their UK investments. The survey revealed that UK resident non-domiciled individuals pay £7.16bn, in tax, that the UK business investments of non-doms are estimated at £125bn and that non-doms spend £16.6bn in the UK every year.

So it is clear that the Government takes seriously the economic benefits of attracting non-domicillaries to the UK and the risk that changes to their taxation may result in significant numbers of them leaving. STEP's research provides evidence that, far from overestimating that net benefit and those risks, the Government has seriously underestimated them.

<u>The moral argument: equality of misery</u>

Mike's article, however, does not really rest on his economic argument. He is mainly concerned with a moral argument that it is unfair that non-domicillaries should have special tax privileges. He does not see the questions as simply one of balancing the benefits of the increased tax revenues from those who remain against the economic losses resulting from the departure of those who don't, for he sees this approach as being based on:-

> "… the assertion … that the richer you are, and the more mobile you are, the lower your average rate of tax should be."

To this supposed underlying principle he opposes two equitable principles.

> "There are two principles which are generally accepted as being fundamental to a fair tax system – horizontal equity and vertical equity. Horizontal equity says that people who are in the same position should face the same tax liability; vertical equity says that the greater your income, the greater your average rate of tax."

But if Mike's moral argument is independent of his economic argument, then his view amounts to no more than the old view that it is better for everyone to be poorer provided they are less unequal; a belief in the virtue of equality of misery. There is no virtue in equalising the taxation of domicillaries and non-domicillaries if the result is to make the general body of citizens poorer.

So it is unlikely that Mike's two principles are generally accepted at all. There is no reason why two people should be forced to pay the same price for the privilege of residing in a place, whether it is a country or a hotel room, simply because they have the same income or why one person should be forced to pay more for something simply because he has a higher income. Rather, it is appropriate that the price set by the market should be allowed to best match willing suppliers with willing buyers. In Simon's article ("*Towards a better tax system: Tax competition – liberation or a flaming liberty"* Tax Faculty May 2000) he argued that in a global economy where individuals are free to move between countries, tax becomes the price which a country places upon its amenities. Where taxpayers are internationally mobile they truly become HMRC's "customers" and not its victims. In relation to the amenities of a country or of a hotel, the market place best maximises the utility of buyers and sellers.

The principle which one hopes is generally accepted is that the Government's duty is to protect and advance the interests of the Queen and her subjects. That requires the Government to extract the largest possible advantage for the general body of citizens from allowing the privilege of residence in this country. If we accept for a moment the rather dubious proposition that an increase in Government revenue benefits the general body of citizens then taxation can be regarded as the balancing charge by which the Government maximises that benefit.

Mike suggests that the end result of ignoring his twin equitable principles is:-

> "… that the rich end up negotiating a flat amount of tax that they are prepared to pay in order that the UK can be graced by the favour of their presence, in which case you might as well go the whole hog and apply to become the twenty seventh canton of Switzerland."

Mike obviously regards this suggestion as in some way absurd and as a general approach to taxation it is. The reason for that, however, is not because such an approach would be unfair but because it would be impractical. Pricing strategies which have too many variations are administratively more expensive than the additional revenues which they raise. Equally, pricing strategies which are too inflexible fail to maximise income either because they depress demand or fail to charge enough for what is on offer. Individually negotiated prices only make sense for particularly large or valuable customers. HMRC, of course, used to set individual prices for particularly valuable taxpayers, in the form of "forward tax agreements." Unfortunately in *Fayed & Others v Advocate General for Scotland and CIR* CS 2004 77 TC 273 it was held to be acting ultra vires in doing so.

It will only be in small numbers of cases that it would be worthwhile concluding individual agreements. That situation is common to most large suppliers whatever they are supplying. But it often makes commercial sense to identify a group of "customers", the common characteristics of which suit a particular pricing structure. The remittance basis rules are an example of exactly that. They identify a group of individuals who may be expected to move jurisdictions quite easily and recognises that if the UK's tax pricing structure does not recognise that mobility it will lose those "customers" to foreign competitors. The remittance rules, however, have always been a blunt instrument. Mike very sensibly points out that American expatriates on five year secondments will have weaker ties to this country than those who have been resident in the United Kingdom for a long time. He feels that the tax system should recognise the difference on grounds of fairness which are difficult to follow but there is a perfectly sensible, commercial justification for doing so. The longer a person remains here the more likely it is that he will be settled here and therefore the more likely that he will be willing to pay a higher price for the privilege of continuing to reside here. That is precisely the approach which the Government has adopted in applying the Remittance Basis Charge to those who have been resident here for seven of the preceding nine fiscal years.

A poorly designed pricing structure

So providing a special tax price on residence for a group of individuals defined by reference to the absence of a strong connecting factor with the UK (such as domicile) is not only rational but it correctly fulfils the function of Government in maximising the general benefit of the Queen's subjects. It has to be said, however, that the actual system by which that is achieved, which has been developed by historical accident, is in many ways a highly irrational one.

First of all, one might argue that the concept of domicile itself is a poor identifier of mobility. There are many individuals with non-domiciled status who are highly unlikely to move from the United Kingdom. A test based on citizenship and long term residence might provide a closer correlation with the benefits which this country has to offer and might better identify the internationally mobile. Perhaps, though, the real problem lies with HMRC's policing of claims to non-domicile status.

Secondly, the remittance basis encourages non-domicillaries to hold their wealth outside the United Kingdom rather than in it, thus providing a disincentive to the creation of UK jobs and businesses.

Thirdly, although the best pricing strategies are simple and transparent the changes contained in the Finance Bill 2008 Schedule 7 create a regime which is complex and opaque. If a customer doesn't know what he has to pay for something or suspects that there are hidden costs he will deduct a risk discount from the price which he is willing to pay for it. It would be much more sensible simply to provide a maximum limit on the Income Tax and Capital Gains Tax liabilities of non-domicillaries rather as is done in the Isle of Man in relation to all taxpayers.

Fourthly, the system proposed by the Government is also remarkably inflexible in creating a single point from which one moves from no charge at all to a quite significant charge. It would surely make more sense to impose a small maximum tax liability on non-domicillaries after they have been resident for a relatively short period (say, three years) which increases year by year.

A rational tax pricing system

So, a more rational tax system for those with a weak connection with the UK, would simply restrict the maximum tax liability of non-domicillaries (or perhaps foreign citizens) to a modest amount (say, £5,000) and, after they have been resident for a short minimum period (say, three years,) provide that that liability would increase in smallish increments (say, £5,000) for each additional year of residence. Such a system would recognise the fact that the longer a person lives in a country the less likely it becomes that he will more elsewhere.

Such a system would impose a price on UK residence for those without a strong connecting factor to the UK which was clear, simple, predictable and was strongly correlated to the elasticity of demand for the privilege of residence here.

The need for accurate forecasts

The price which the Government sets on residence is important and should be based on proper evidence. If it is set too low, we shall sell the privilege of residence in this country too cheaply. If we set it too high, we shall choke off demand and fail to maximise the benefits to the UK. So the price set should have been based on a proper assessment of likely market demand. In fact, although the Government started consulting on possible changes to the domicile rules in 2002 the consultation document entitled "Paying a Fairer Share: a consultation on residence and domicile" published in December 2007 revealed that the Government had made no reliable estimates of the effects of its proposals at all. Indeed, one suspects that the level of the remittance basis charge was set simply on the basis that it was slightly more than that proposed by the Conservative Party.

How was it for you?

How disappointing this "reform" has been. After six years of consultation we have a hastily cobbled together system which fails virtually every test for rational tax reform, introduced in response to little more than the childish whine of "it isn't fair." Was it too much to ask for a rational and simple system based on relevant evidence? It appears that it was.