

TAXREP 26/03

**REVIEWING THE RESIDENCE AND DOMICILE RULES
AS THEY AFFECT THE TAXATION OF INDIVIDUALS:**

A BACKGROUND PAPER

Memorandum submitted in July 2003 by The Tax Faculty of the Institute of Chartered Accountants in England and Wales in response to a consultation paper issued in April 2003 by the Inland Revenue and HM Treasury

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REVIEWING THE RESIDENCE AND DOMICILE RULES AS THEY AFFECT THE TAXATION OF INDIVIDUALS: A BACKGROUND PAPER

INTRODUCTION

- 1 We refer to the above background paper published in April 2003 and we welcome the opportunity to contribute to this important consultation. We also appreciated the opportunity to participate in the joint meeting between the representative bodies and the Inland Revenue/Treasury in May 2003.

WHO WE ARE

- 2 The Institute is the largest accountancy body in Europe, with more than 123,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.
- 3 The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department of Trade and Industry (DTI) through the Accountancy Foundation. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy (which includes taxation).
- 4 The Tax Faculty is the focus for tax within the Institute. It is responsible for technical tax submissions on behalf of the Institute as a whole and it also provides various tax services including the monthly newsletter 'TAXline' to more than 11,000 members of the Institute who pay an additional subscription.

EXECUTIVE SUMMARY

- 5 The Government should be cautious in making any changes in this area.
- 6 The Government should seek to develop a statutory definition of residence. In order to provide certainty, this should be a factual test based upon whether or not the individual was physically present in the UK for a certain period of time. The proposed definition should be put out for separate consultation.
- 7 The Government should consider either abolishing the concept of ordinary residence or subsuming it within the definition of residence. However, the impact upon short term residents will need to be considered and specific reliefs may be needed to ensure that they are not disadvantaged.
- 8 The Government should not change the domicile rules for tax purposes unless it can be demonstrated with reasonable certainty that the changes will be beneficial to the UK. The two key considerations are the effect on the UK tax take and international competitiveness.

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GENERAL COMMENTS

Caution in making changes

9 For the reasons set out in our response below, we think that the Government should be cautious in making any changes in this area. There is a danger that changes may be made in reaction to short term issues that may result in long term consequences which are not favourable to the UK.

10 The Government should resist making policy changes which do not command widespread support. We are concerned that this consultation exercise does not follow the example set by the double taxation relief consultation. That consultation went on for almost two years, creating widespread uncertainty, and was then followed by policy changes that were highly unpopular in the business community. This resulted in considerable amounts of further consultation which led to substantive amendments being made to the rules as the Finance Bill passed through Parliament. The result was that the credibility of the Government in the international community was undermined. It is vital that the residence and domicile consultation does not follow a similar path.

Uncertainty

11 Although we appreciate on the one hand the need to consult widely on these issues before any action is taken, on the other hand we are concerned that the continuing uncertainty as to whether the Government will make policy changes in this area is in itself disadvantaging the UK. It is important that this consultation does not become prolonged and create uncertainty in the international business world.

Previous consultations

12 We are surprised that no reference is made in the paper to previous consultation work in this area. In 1988, the Government published a paper on residence and many of the issues raised then are still applicable today. The Law Commission study into the Law of Domicile published in 1987 was also an important study. In each case, proposals for change were rejected. We doubt whether the issues have changed materially since those earlier studies such that changes should now be necessary.

DETAILED COMMENTS ON THE PAPER

13 The background paper effectively discussed two separate issues. The first is in relation to the UK residence rules and the second is in relation to domicile. Whilst we accept that these two are interlinked, we believe that they need to be considered separately as the issues and rationale for any changes are quite different.

Residence

14 Residence is not defined in the Taxes Acts and the result is that whether or not an individual is resident in the UK is subject to considerable uncertainty. The existing rules are based almost entirely on case law decisions from many years ago. These decisions date from a time when international travel was not well established and they do not sit well with developments in international mobility. As a result, the Revenue

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has developed a long established practice for dealing with residence issues which is set out in IR20.

- 15 IR 20 seeks to clarify the Revenue's policy on residence and by and large we would say has been successful in providing some certainty and consistency into what is, as noted above, a very uncertain test. We would also add that the Revenue's approach to determining residence as set out in IR20 is usually helpful and pragmatic and, taken overall, is probably more generous than the court cases which underlie the position. However, some amplification of the detail in IR20 would be welcome.
 - 16 However, residence is a key determinant in liability to UK tax. If we apply our 'ten tenets' (see appendix, against which we think the UK tax system should be judged, the residence rules are unsatisfactory. The existing rules clearly fail both the statutory and certainty tenets. Additionally it is not satisfactory to have such an important determinant of liability to UK tax largely determined by Revenue practice which has little statutory backing.
 - 17 We think that the Government should seek to develop a statutory definition of residence. In order to provide certainty, this should be a factual test based upon whether or not the individual was physically present in the UK for a certain period of time. Such a system could continue to take account of substantial habitual residence and one suitable model might be the US system based upon physical presence in the year with earlier years taken into account on a sliding scale.
 - 18 The proposed definition should be put out for separate consultation. A transitional period will be needed to ensure that legitimate expectations of individuals under the current system are preserved.
- Ordinary residence*
- 19 The term ordinary residence is not well understood and its tax implications are not always appreciated. In a similar way to the residence rules, the test of whether or not a person is ordinarily resident in the UK is far from certain. Again, the position is largely down to Revenue practice as set out in IR 20.
 - 20 Ordinary residence is not a term that fits well with the need for tax rules to be certain and clear. It is also not an internationally understood concept such as residence. With the exception of Ireland (whose rules are in any event based on UK law), the closest equivalent is perhaps the concept of distinguishing between long and short-term residents in other countries.
 - 21 If a statutory definition of residence is adopted, then in the interests of certainty and consistency, consideration should be given to either abolishing the concept of ordinary residence or subsuming it within the definition of residence. It is important to stress that ordinary residence is helpful in easing the burden of UK taxation for those who are not in the UK for long periods of time. To that extent, the definition provides an economic and policy purpose and this should not be lost. On that basis, one possibility is to convert the definition into one based upon short-term residence and to consider providing specific reliefs for short-term visitors.

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22 The downside of such changes is that the existing boundary will merely have changed, but a clearer definition should help to identify the boundary more precisely than do the existing rules.

23 Again, if the definition of ordinary residence is changed, then a transitional period may be required to preserve existing expectations.

Domicile

24 The issue of whether the UK should change the impact of the domicile rules on UK taxation liabilities raises different considerations.

25 Non-domiciled individuals are subject to the remittance basis of taxation for income and gains. Like residence, domicile is not defined in the Taxes Act. It is a legal concept in that it determines the way that international law applies to private individuals.

26 The existing domicile rules for taxation purposes have been in operation for many years and by and large are well understood. The policy purpose behind them was, we believe, that it was felt unfair to tax foreign visitors on income arisen in their home country that they left there so that it did not affect their standard of living in the UK.

27 Given the comments made above, we do not think changes should be made to the existing rules unless it can be demonstrated with reasonable certainty that the changes will be beneficial to the UK. The two key considerations are the UK tax take and international competitiveness.

Effect on the UK tax take

28 Before any changes are considered in this area, it is vital that a clear economic case is made for change and that an estimate made of the likely impact upon the tax take as a result of behavioural changes.

29 Whilst we appreciate that such exercises are fraught with difficulty, it is vital that this exercise is undertaken as the impact on the UK tax take could be either positive or negative. The effect will depend upon the number of internationally mobile non-domiciled but resident individuals who decide to cease to be resident in the UK. Will the effect of the reduction in income from such individuals be less than the increased tax take from those who remain? If it is greater, then the tax take will be reduced and the only effect of the change is an increased tax burden for all other UK taxpayers. There is a risk that any changes could reduce rather than increase the tax take and therefore counterproductive.

International competitiveness

30 The Government also needs to consider the effect of any change upon the UK's international competitiveness. The existing rules are one factor in encouraging internationally mobile individuals to come to, and live and work in, the UK. Whilst it is not the only factor in ensuring that the UK remains an attractive place to live and work, it is nevertheless an important factor.

31 If internationally mobile individuals are able to move in response to changing circumstances, then it might make economic sense to encourage such people to come

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to the UK rather than discourage them. Accordingly, one way to reform the system whilst at the same time encouraging non-domiciled people might be to provide an outright exemption for non-domiciled taxpayers from UK tax for foreign source income and abolish the remittance basis. It would of course be vital to ensure that this relief was properly targeted and did not provide scope for abuse from long term residents who have no intention of leaving the UK.

Possible options for change

32 There appear to be three possible options for change:

- to decouple domicile from tax and impose a different test entirely;
- to abolish the remittance basis; or
- to introduce a concept of deemed domicile.

Decoupling domicile from tax

33 We believe that the existing rules based upon domicile identify reasonably successfully those with a long term connection with the UK. Domicile is capable of providing an objective criteria which requires the taxpayer to argue his case. We are not sure what would be put in its place which would provide greater clarity and certainty other than a residence type test. Such a test is likely to be inappropriate and to introduce as many problems as it solves.

34 The determination of domicile depends upon a consideration of all of the facts, in particular the expressed intentions of the taxpayer in question. In cases of dispute the position will be determined by the courts. The test is therefore uncertain, although arguably less so than with residence as there is a reasonable amount of case law and the principles for determining domicile are reasonably well understood.

35 One way to reduce the uncertainty for tax purposes could be to provide advance rulings which could be binding for a set number of years (provided that there was not a material change in circumstances during that time).

Abolition of the remittance basis

36 See our comments made above. No changes should be made to the remittance basis without a full economic analysis of the effect which identifies that the change will be beneficial to UK plc.

Deemed domicile

37 The Government could consider a 'long stop' test to deem a person to be domiciled in the UK for tax purposes as a result of long-term residence in this country. However, the test should be exactly that: a long stop test which is only triggered after a long period in the UK. In the 1988 consultation exercise, we considered that the introduction of a test similar to the existing inheritance tax deemed domicile rule might be appropriate. In other words, residence in the UK in 17 out of the last 20 years would trigger a deemed domicile status for income and capital gains tax purposes. We see no reason to change our view.

Our conclusion

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38 Any decision is ultimately a policy question for the Government to decide. However, in the light of the comments made above we do not think that a convincing case has yet been made to change the domicile rules as they apply for UK tax purposes.

Inheritance tax

39 Domicile also determines liability to UK inheritance tax. We are disappointed that in highlighting the possibility of changes to the rules of determining domicile, no reference has been made to the implications of the change for the purposes of calculating inheritance tax (IHT). The effect of a change in the domicile rules for inheritance tax purposes will need to be considered before it is decided to proceed with any changes to the rules.

The EU dimension

40 We are concerned that the existing rules on domicile might be overtaken by events at the EU level. The law of domicile is an area which is becoming of interest to the EU Commission. We note that a study was presented in November 2002 to the Commission on the practical problems of will drafting and devolution of estates (http://europa.eu.int/comm/justice_home/doc_centre/civil/studies/doc/report_conflicts_uk.pdf). The study also seeks to develop possible solutions for legislation by the European Union.

41 Whilst we appreciate that the study was concerned with cross border inheritances, the study envisages possible changes to EU Member states' rules on domicile/habitual residence. If the Commission seeks to develop these proposals into a draft Directive, then they could have consequences for the UK direct tax rules.

42 Consequently, we caution against changing the UK tax rules if it is likely that they will have to be changed again in the relatively near future.

COMMENTS ON SPECIFIC CHAPTERS

Chapter 2 Examples

Example 1

43 This example does not appear realistic. Domicile is not determined solely by residence. Under the existing law of domicile, Bill would inevitably have established an objective pattern of life that would demonstrate an intention to remain in the UK permanently or indefinitely.

Example 2

44 We do not dispute the example but question what the example is meant to show as the two cases are very different.

Examples 3 & 4

45 The question of whether days of arrival and departure should be included or ignored will always produce different results at the margins. A policy is required in order to provide certainty and inevitably this will cause problems at the boundary, as demonstrated in these examples.

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Example 5

46 Intention is arguably uncertain and possibly subjective. A statutory definition of residence should put Jan and Kate on the same footing,

Example 6

47 As in Example 1, we would have expected Mona's domicile position to be queried and challenged.

Example 7

48 This example merely illustrates the application of the remittance basis. Anecdotal evidence would suggest that it is unlikely to be realistic.

Example 8

49 This illustrates the beneficial effect on behaviour on attracting highly skilled workers to the UK. However, in our view Quentin is likely to have acquired a domicile of choice in the UK on arrival.

Example 9

50 This example illustrates the capricious impact of existing rules. A statutory definition of residence should provide certainty but merely result in the boundary being drawn elsewhere.

Example 10

51 The benefit of permitting such rules from a policy point of view is that they encourage the bringing of funds to the UK for either investment or spending. If the rules were to be changed, this would simply encourage such money to be invested or spent abroad. It is at least arguable that this should be encouraged, with the result that the UK should grant an outright exemption from foreign source income and gains for non-UK domiciled individuals.

Chapter 3 International experience

52 The comparisons with other major countries are interesting and helpful but they do not tell the whole story. Like the UK, many of the countries will have developed practices with regard to applying the residence rules etc which may not bear much resemblance to the statutory rules. It is important to review the position as it applies in practice rather than by way of a theoretical exercise.

Chapter 4 Key principles

Fairness

53 Whilst fairness in taxation is a laudable objective, in practice it is not easy to either define or achieve. In the case of possible changes to the domicile rules, the desire for fairness needs to be balanced against the possibility that changes designed to increase the tax burden on non-domiciled individuals will merely result in an increased burden for non-domiciled taxpayers.

Competitiveness

54 As mentioned above, the UK tax system needs to be competitive with other jurisdictions (see the tenth tenet). The UK must not make any changes which hinder the UK's competitive position in attracting inward investment and making a positive

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contribution to the UK economy. In recent years, the proposed changes to the double taxation relief rules would have done serious damage the UK economy with some multinationals proposing to leave (or not come to) the UK. However, it is not easy for a company to become non-resident; it is much more straightforward for the internationally mobile. Many such people will relocate given changes in circumstances which are unfavourable to them: the tax burden will clearly be a major factor although not the only one.

Clarity and enforceability

55 The existing residence rules lack clarity although they provide flexibility to take account of individual circumstances. If the rules are clarified, then the price will be a loss of some flexibility.

56 It is important that the UK can enforce its tax rules. The UK has a history and culture of honesty and compliance with tax laws which many other countries do not have. However, taxpayer compliance is assisted if the rules are simple and not unduly burdensome.

Specific questions posed in paragraph 4.14

57 **Whether the current rules:**

- *successfully identify those with a long-term connection to the UK who have an obligation to help support the UK exchequer on the basis of their world-wide income;*

58 The UK rules are reasonably successful, Domicile is a reasonable basis upon which to identify this connection but see our comments above.

- *successfully identify those with a temporary connection to the UK, and ensure an appropriate contribution to the UK exchequer from those individuals;*

59 See above comments on residence and ordinary residence. The UK rules are reasonably successful in this regard.

- *provide objective criteria for determining when a long-term or temporary connection is severed, suspended or restored;*

60 Domicile is capable of providing an objective criteria which requires the taxpayer to argue his case but it is uncertain and can be costly if a case goes to appeal. If the principle of domicile was to be replaced or redefined, we are not sure what would be put in its place which would provide greater clarity and certainty other than a residence type test which is likely to be inappropriate and to introduce as many problems as it solves.

- *establish an appropriate divide between long-term and temporary connections to the UK;*

61 Again, domicile is capable of achieving an appropriate divide.

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• play an appropriate role, alongside other policy instruments, in supporting the internationalisation of labour markets, and ensuring the competitiveness of UK firms in the international market for skills, entrepreneurship and expertise;

62 For the reasons mentioned above, it is essential that no changes are made which might undermine the UK's competitive position. The current UK tax system largely achieves these objectives and therefore the rules should not be changed unless and until it can be shown that the changes will be for the overall benefit of UK plc. The current rules appear to have created a reasonably favourable position to UK plc and we would not want to see these removed, only for the Government to have to introduce some further incentives to help ensure that the UK remains competitive. There is also the danger that continuing uncertainty will damage the UK's position regardless of whether or not the rules are changed.

• ensure that any difference in treatment between UK locals and visitors, and long and short term residents have a clear economic rationale;

63 It is essential that such differences have a clear economic rationale and in the absence of an economic study we believe that the case for change has not yet been made.

• take into account the equivalent arrangements in other countries;

64 Again, this is an essential requirement. This requires an understanding of both the local law and practice.

** are transparent, provide clear and unambiguous outcomes, and minimise the compliance burden on individuals and their employers;*

65 We agree with these as basic principles. As noted above, there is a case for formulating a statutory definition of residence and possibly reforming the rule of ordinary residence. These need to be kept as simple and as straightforward as possible. As already noted, we are not convinced of the need to change the existing rules on domicile.

• present minimal opportunities for exploitation or avoidance.

66 It is entirely reasonable that the tax system should minimise opportunities for exploitation and avoidance. However, it is arguable that the current system provides net gains for UK plc because the rules bring in more tax receipts than they might otherwise. What the Government needs to do is to encourage the Inland Revenue to seek to challenge more taxpayers who are, arguably, domiciled in the UK.

FJH
31 July 2003

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Appendix

THE TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

1. **Statutory:** tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.
2. **Certain:** in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.
3. **Simple:** the tax rules should aim to be simple, understandable and clear in their objectives.
4. **Easy to collect and to calculate:** a person's tax liability should be easy to calculate and straightforward and cheap to collect.
5. **Properly targeted:** when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.
6. **Constant:** changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.
7. **Subject to proper consultation:** other than in exceptional circumstance, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.
8. **Regularly reviewed:** the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.
9. **Fair and reasonable:** the revenue authorities have a duty to exercise their powers reasonably. There should be right of appeal to an independent tribunal against all their decision.
10. **Competitive:** tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.