In a news analysis, contributing editor Lee A. Sheppard explores how European nations deal with the question of domicile and residence for tax purposes.

Date: Jun. 23, 2005

Let's talk about what really matters to our worldwide readers. Football.

Yes, football matters even to American readers. America will win the World Cup eventually, and that is an idea that sticks in many a craw, because the American public won't care. They will merely assume that winning the World Cup is yet another entitlement of American exceptionalism. Aren't Americans supposed to win everything?

There's no reason it can't happen. America has a big population, and most males are now considered too small for American-style football. There are many Italian and Latin American immigrants to teach football. Moreover, the United States has to qualify out of CONCACAF, playing against Central American countries and Mexico. CONCACAF is a boot camp, more than just figuratively; the American team travels with its own water supply.

Moreover, American kids beat Argentine kids the other day, which is a big deal because Argentina usually wins the world youth championship. But America's World Cup victory is not going to happen in 2006. So who will win?

Take comfort, Italian readers. The winners will have Italian passports.

Take comfort, Spanish readers. The winners will speak Spanish.

Cold comfort for English readers: The winners will play for clubs founded by Englishmen.

Any comfort for French readers? The winners will be avid meat-eaters.

Argentina is going to win the 2006 World Cup. No hand of God will be needed. Imagine a team with South American ball-handling skills in attack and Italian tenacity in defense. This is a combination that club managers in Milan have been using successfully for some time, but Argentina has that ideal mixture in a single national group. Indeed, they play like a really good club team. Then add a new Maradona (Carlos Tevez of Corinthians) and a smaller Maldini (Gabriel Heinze of Manchester United) to the equation.

We invite letters from readers with their predictions. Readers who disagree are advised to watch a tape of the 2004 Olympic final or the recent Argentina-Brazil World Cup qualifier before writing. (Your correspondent's editor, can of gasoline in one hand and matches in the other, wanted a comparison between Tevez and Wayne Rooney. We won't go there, except to note that the recent selling price of Rooney was roughly four times that of Tevez.)

Which brings us to our English correspondent, who cheerfully admits that his head is stuck in 1966. (For the uninitiated, 1966 was the last time England won a World Cup, and the first and last time sending defenders forward worked.) Trevor Johnson argued that foreign resident nondomiciliaries in Britain enjoy an unfair tax advantage over British resident domiciliaries, such as himself, in that their income from foreign investments is not taxed if it is not brought into Britain. (See Tax Notes Int'l, Feb. 28, 2005, p. 771.)

Our Italian correspondent, Adelchi Rossi, countered that Italian resident nondomiciliaries in Britain were being taxed on that income in Italy, under an information exchange agreement between Italy and Britain. Rossi's point is that British resident domiciliaries should not feel hard done by if tax is being paid on the income somewhere in Europe. (See Tax Notes Int'l, June 6, 2005, p. 907.)

Is there more to this? Absolutely.

Johnson is correct that the British law of domicile is stupid. That policy does not, contrary to the assertions of many other commentators, appear to be a loophole in the sense of being a problem that was negligently overlooked. The policy appears to be a deliberate self-inflicted wound.

Successive British governments, including the present Labour government, have appeared to believe, rightly or wrongly, that having rich foreigners living in Britain and not paying tax on much of their investment income is somehow good for the general economic welfare. Britain has been characterized as "a superb tax haven" in these pages because of its longstanding policy of not
taxing investment income that is not brought into the country. (See Tax Notes Int'l, Dec. 18, 2000, p. 2831.)

Indeed, the current Labour government railed against that policy before coming into power eight years ago, then quietly changed course. This is, after all, a country that has lax or nonexistent securities regulation and tolerates tax/banking havens within sight of the shoreline, which even middle-class people use. Those policies have produced a rentier society with preindustrial wealth distribution levels. But Britain has higher growth than other EU members.

The British policy is akin to the widespread preferential treatment of nonresident investors, which international practice and EU law tolerate and can even be said to encourage. Johnson is correct that preferential treatment of foreign investors is permitted under EU law. American law prefers nonresident investors as well, which is why American hedge funds masquerade as nonresidents.

On to the ECJ

Johnson equates the preferential treatment of rich foreigners with nationality discrimination, and argues that he might have a cause of action under the Treaty of Rome (EC Treaty). He then speculates that his case might be a loser in the European Court of Justice. Johnson probably doesn't have a cause of action at all, but we will assume for purposes of argument that he does.

Johnson's discrimination case would be a loser, but not for the reasons he cites. Rossi's argument that tax is being paid somewhere in Europe on the foreign investment income of foreign resident nondomiciliaries would carry the day under Manninen (C-319/02), 2004 WTD 174-17 or Doc 2004-17814 [PDF]. In that case, governments had unsuccessfully resisted giving imputation credit for corporate taxes paid to other countries.

In Manninen, the ECJ struck down Finland's imputation method dividend relief scheme as discriminatory. Finland made dividend relief available for dividends paid by domestic corporations but not for dividends paid by foreign corporations. The individual taxpayer held shares in a Swedish corporation and was fully taxable on his dividends because the Nordic multilateral treaty did not resolve the problem.

The question was whether Finland's denial of a credit for Swedish corporate tax was a denial of the freedom of movement of capital under article 56. Relying on Verkooijen (C-35/98) and Commission v. French Republic (C-270/83), the ECJ had no trouble finding a treaty violation. The court rejected the arguments of the Finnish, French, and British governments that the cohesion of the tax system required denial of the credit for dividends paid by foreign corporations, regardless of the reduction in Finnish revenue and any possible difficulties in figuring out how much corporate tax the Swedish company paid.

Under Manninen, a tax paid somewhere in Europe is good enough. Indeed, there could be no discussion of a foreign resident nondomiciliary's British tax situation without some discussion of whether the income in question was subject to tax somewhere else in the EU. Manninen requires that EU member governments respect each other's choices in taxation. What if the rich foreigners don't tell how much they earned? The ECJ is unconcerned with administrative difficulties.

Although ECJ jurisprudence ignores offsetting benefits when the question is whether to tax, it asks whether the income has been taxed somewhere when the question is a tax credit or recognition of another country's assertion of jurisdiction. So when Johnson complains that as a British resident, he is deterred from investing in foreign companies because he does not get a credit for foreign corporate tax paid by them, there may have been an article 56 violation. But Manninen tells us that the credit issue is simply the flip side of the foreign resident nondomiciliaries issue. Under Manninen, every foreign tax on the same item of income deserves recognition.

Presumptuous

The Economist, a magazine that never met a tax on investment income that it didn't oppose, succinctly characterized the British test of domicile:

In most countries, a foreign resident's "domicile" (home country) status is determined by objective criteria. In Britain, it's largely up to the foreigner. So a Greek ship owner who has lived in Britain for years but says that he intends to move back to Athens when circumstances permit is treated differently from one who says he intends to settle in Britain. (The Economist, Jan. 9, 2003.)

Why hasn't anything been done to prevent Britain from continuing to be what the magazine characterized as "a tax haven for rich foreigners"? Successive governments have fretted that the highly mobile rich folks will leave, causing tailors to starve and, possibly, prices of residential real estate to fall. Ireland has the same policy toward foreign investment income of resident nondomiciliaries, as well as similar tests of domicile.

Certainly if Britain really wanted to tax the foreign residents claiming to be nondomiciliaries, the government could have instituted irrebuttable legal presumptions -- such as a person is a domiciliary if he is stupid enough to buy a first-division football team.
The problem stems from rich people being capable of having more than one residence for tax purposes. Other countries, however, don't seem to have the British (and Irish) problem with tax residence, because they don't take the individual's word for it. Those countries use irrefutable presumptions of residence for purposes of taxation of an individual's worldwide income. If an individual has two tax residences, then a tiebreaker rule in a treaty is invoked.

In America, the messy question of domicile is pertinent for estate tax. (See Tax Notes Int'l, Dec. 17, 2001, p. 1146.) The question of income tax residence does not depend on the individual's intent. Under the substantial presence test of Internal Revenue Code section 7701(b)(1)(A)(ii), an individual is a resident if he or she is physically present in the United States for 31 days during the current year and 183 days during the current and two preceding years. For purposes of determining the 183-day count, only one-third of the days present in the year before the current year are counted, and only one-sixth of the days present in the year before that are counted. Time spent in transit, in the United States for medical treatment, or under an exemption for government employees or students is also not counted.

But under section 7701(b)(3)(B), a substantially present individual can still argue for nonresident treatment on the ground that he or she has a closer connection to another country, has a tax home there, and has spent less than 183 days in the United States during the current year. Factors establishing a closer connection include the location of the individual's permanent home, family, personal effects, social and political organizations, voting registration, and driver's license. (For discussion, see 2005 TNT 34-45 or Doc 2005-3450 [PDF]; see also Tax Notes Int'l, Sept. 27, 2004, p. 1221.)

European countries' rules about residence and domicile are aimed at preventing their own nationals from expatriating to avoid tax, what with their reliance on the center of vital interests rule of OECD model treaties. That makes it difficult for a citizen to escape his country's tax jurisdiction. The problem at hand is the opposite -- itinerant rich noncitizens, who may not be spending 183 days during the year in any one country. For that, many countries get into what is essentially a domicile inquiry, but one that is less reliant on the individual's intentions. By contrast, the British problem seems to be that the inquiry starts with the individual's intentions.

In France, the law looks for any one of several alternative conditions to be satisfied. An individual is a resident if France is his foyer fiscal; that is, the place where he or his family normally lives. Alternatively, the law asks whether the individual has his principal residence in France. An individual is considered a resident if he spends more than 183 days of the current year in France. Days in transit and days spent shopping in France are included. An individual is considered a resident if he performs professional activity in France, unless his French activity is secondary to the same activity performed elsewhere. An individual is also considered a resident if his center of economic interests is in France.

French treaties have a tiebreaker rule that asks where the individual's foyer permanent d'habitation, defined as the place where personal ties are strongest, is. French auditors have been known to poke around individuals' residences to figure out where they are spending most of their time. They have also challenged rich French people's claims that they have become British residents to escape tax on French investment income while taking the position that they are not domiciled in Britain. (See Tax Notes Int'l, Nov. 26, 2001, p. 844.)

Italy has the same rule residence for individuals present in the country for more than 183 days of the year in question, which need not be a continuous period. Alternatively, Italy asks about the center of the individual's personal and economic interests. That, as Rossi explained, is the OECD center of vital interests rule, which appears as a tiebreaker rule in article 4 of OECD model treaties.

Spain doesn't fool around either. Spain has a tight 183-day presumption that holds that sporadic absences from Spain are counted toward the 183 days unless the individual can prove tax residence in another country. Proof requires that the other country's tax administrator certify that the individual in question is taxable on his worldwide income in that country. Like France, Spain considers an individual to be a resident if he stays more than 183 days in the country the current year. For that, only one-third of the days present in the year before the current year are counted, and one-sixth of the days present in the year before that are counted. Time spent in transit, in the United States for medical treatment, or under an exemption for government employees or students is also not counted.

The OECD commentary on article 4 explains that residence as the basis for jurisdiction to tax an individual on a worldwide basis is not confined to domiciliaries -- Britain's central mistake here. Tiebreaker rules are ordering rules, so permanent home controls when the individual's only basis for residence in the other country is a 183-day stay. If, like our itinerant rich here, the individual has permanent homes in both countries, then the ordering rules ask where his center of vital interests is. This is the messy factual inquiry about family, social relationships, business, and management of investments. Here the commentary has a bias toward the individual's country of origin.

How does that help determine where our itinerant rich should pay tax? Commentators in Britain have observed that in most cases, foreign resident nondomiciliaries -- that'd be Greek shipping magnates -- retain their domicile in their country of origin, so that the latter country would have first claim on worldwide tax jurisdiction under accepted tiebreaker rules. But adoption of the 183-day rule, as an initial basis for assertion of jurisdiction, would be a good start. (See Tax Notes Int'l, Sept. 1, 2003, p. 791.)

Well, gee, if we're circling back to the question of where our itinerant rich individual has his primary attachments, what would we
have accomplished? Won't our Greek shipping magnates still be residents of Greece? In Britain and Ireland, the argument starts there. Starting the argument with domicile is like having the goalkeeper as the first line of defense rather than the last. Instituting a 183-day rule and similar presumptions is like having midfield defense -- a concept seldom practiced in English football, except at Chelsea. You may still get beaten in the end, but you've decreased your chances of being taken advantage of.