1
Tax Systems and their Bases of Taxation

BACKGROUND

Every country has its own rules which determine the extent of an individual's tax liabilities. Such liabilities may be those relating to an individual's income, capital gains and/or assets.

Typically, income is subject to some form of income tax; capital gains (often but not always) to some form of capital gains tax; and assets to some form of wealth and/or inheritance tax on death and/or lifetime gifts.

It may be that not all types of income are subject to income tax and/or that not all gains are subject to some form of capital gains tax. It may also be that certain categories of asset are excluded from any inheritance tax whether on death and/or lifetime gifts.

Rates of a particular tax will inevitably vary often depending upon the quantum of income/gains and often also depending upon the status of the individual taxpayer.

No two countries' tax systems are identical and great care is thus needed, in particular, whenever a taxable event (e.g. sale of an asset; death of an individual) occurs which may be subject to tax in more than one country; where this occurs double taxation is said to arise (see Chapter 25). Almost certainly, for example, the tax rules which apply in France will be different from those applicable in the UK which in turn will no doubt be different from those of the USA.

As a consequence in seeking to ascertain the tax implications of a particular transaction it becomes necessary to identify which countries' tax systems are in point, the status of the person concerned, the type of income/assets involved and the nature of the transaction.

Two simple examples may serve to illustrate the point.

Example 1.1

Henry Marlowe lives in England with his wife Mary and their two young children Joanne and James. Henry's father has died but his aged mother continues to live alone in her own home.

Henry wishes to ensure that in the event of his death his wife, children and mother will be provided for in a tax efficient manner.

It thus becomes necessary first of all to identify which countries' tax systems are in point. Rather obviously it would appear that only that of the UK is involved as all the

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parties involved live in the UK and, prima facie, all income arises, and all assets are located, within the UK.

In principle, therefore Henry's primary issue is to ensure that on his death any UK tax liabilities which may arise are minimised. Prima facie, this would involve considering and mitigating the impact of any UK inheritance tax liability which will in principle arise on Henry's death.

However, in practice it is by no means unusual to find that the tax issues are far more complex than those of Henry's in the above Example 1.1 involving more than one country's tax regime.

Example 1.2

Raymond Brown married Claudia Schmidt and they now both work in the UK where they have done so for 20 years. They own properties in the USA, the UK and Germany and have share investments in companies located in Hong Kong, Canada and South Africa. One of their two adult children, Samantha, now lives in Italy and the other, George, lives in Cyprus.

If Raymond had a similar objective to Henry above (i.e. mitigating tax arising on his death to ensure all family members are adequately provided for) the tax issues would be far more complex. It is necessary to examine the tax implications of Raymond's death in all of the countries listed in order to ascertain the ramifications of each of the tax systems and to seek to resolve any possible double tax which may arise.

Optimal tax planning for Raymond would thus not, for example, be achieved by simply mitigating any UK inheritance tax liability if, in so doing, the tax ramifications in the USA, for example, were made substantially worse.

A truly international approach is necessary.

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CATEGORIES OF TAX

The main categories of tax (albeit not exhaustive) are those which apply to:

- income (income taxes);
- capital gains (capital gains taxes);
- inheritance (inheritance taxes);
- death (estate taxes); and
- wealth (wealth taxes).

Not all countries levy all these types of tax and, as will be seen below, sometimes the nomenclature adopted by a particular country may differ from that of another country when in fact the taxes being levied are basically the same.

For example, in some countries (e.g. the UK) the term "inheritance tax" is used to refer not only to the tax levied on an individual's death but also to the tax levied on any lifetime gifts made by such individual. In other countries, the term "inheritance tax" may be used to apply only to lifetime gifts (the term "estate tax" being used to describe the tax levied on the individual's death).

CAPITAL v. INCOME DISTINCTION

For some countries no distinction is made between income and capital gains (e.g. Belgium, Denmark, Italy, Japan, Spain and Sweden) with both being taxed at the same rates; in other countries income and capital gains are taxed at different rates (e.g. in the USA the marginal *income* tax rate is 35%; whereas *capital gains* are subject to tax at the marginal rate of 15%); indeed, some countries not only tax income and capital gains at different rates but distinguish between short- and long-term gains (e.g. short-term gains refer to gains arising within two years in the case of France; Italy three years; and the USA 12 months); and in some countries (e.g. Barbados, Gibraltar, Guernsey and the Isle of Man) capital gains are simply not taxed at all.

Which approach a country adopts may be extremely critical. In particular, where a country's tax system *does* distinguish between income and capital gains (as does the UK) it is often the case that capital transactions are usually taxed more favourably (as in the UK). This usually arises either because the rates applicable to capital gains are lower than those applicable to income and/or the bases of computation are more favourable.

In the UK, for example, before the recent changes introduced in FA 2008 although the marginal (i.e. highest) rates of income and capital gains taxes were the same, i.e. 40%, the bases of computation were very different with the more favourable treatment being accorded to capital gains (this was primarily due to the application of taper relief which exempted a percentage of any indexed capital gain from capital gains tax; taper relief did not apply in computing income tax liabilities; see Chapter 8). Following FA 2008 changes, the marginal rate of income tax remains at 40% but the rate of capital gains tax is 18% (see Chapter 8).

It is because of this difference in treatment that in some countries investment returns are often structured to provide the investor with capital gains not income benefits in order to produce an overall lower tax liability. To combat such approaches it is not unusual to find tax legislation which is designed to deem any, de facto, capital gain as an income benefit thus nullifying any tax advantage of structuring for capital as opposed to income treatment (e.g. the UK tax system's treatment of non-distributor offshore fund "profits" and the "profits" of offshore single premium bonds; see Chapter 18).

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WORLDWIDE v. TERRITORIAL TAX SYSTEMS

(a) Income and Capital Gains Taxes

Most countries' tax systems can be conveniently, albeit loosely, categorised as either a *worldwide*- or a *territorial*-based system of taxation (although within a particular country the method of levying tax on individuals may be different from that applying to companies or other forms of taxpayer).

Worldwide Basis

Under the worldwide system of taxation, generally speaking, *residents* of a country are taxed on their worldwide income and capital gains. In other words, irrespective of where any income or gains arise (whether within the country of residence or elsewhere) they will be subject to tax as appropriate by the country in which the individual entitled to the income or gains is resident.

The UK has adopted a worldwide-based system as has, for example, Australia, Germany, Italy, Japan and the USA.

Territorial Basis

Under the territorial system of taxation *residents* are taxed only on income and capital gains arising within that country's borders; income and capital gains arising outside thereof are not subject to tax.

Countries adopting this approach include Bolivia, Ecuador, Ghana, Israel, Malaysia, Panama, Singapore, Venezuela and Zambia.

Territorial Basis plus Remittances

Some countries which adopt the territorial system, however, extend the tax base of *residents* to include overseas income and/or capital gains but only if such income or gains are remitted (i.e. brought back) to the country of residence.

Countries adopting this approach include Ghana, Israel, Malaysia, Mauritius, Singapore and Thailand.

While there are, of course, variants of the above three tax systems, in principle, most countries' tax systems fall into one of the three categories.

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Residency

Irrespective of the variant of tax system adopted it is usual for the taxes levied on any income and gains to be levied on *residents* (basically, individuals who live in the country) of the particular country (see Chapter 4 for a more detailed consideration of the term "resident").

However, there are one or two notable exceptions which, while adopting a "residence"-based tax system, also utilise additional criteria.

Citizenship Test

The adoption of a citizenship criterion to determine the taxability of income and gains, while very unusual, is in fact utilised by some countries including the USA.

The USA adopts a worldwide basis of taxation, as does the UK, but unlike the UK and most other countries, the USA extends its tax system to tax the income and gains of its *citizens wherever they are resident.* Thus, while in many cases an individual can avoid a particular country's tax system by no longer residing in that country, a *citizen*

of the USA does *not* escape US income and capital gains taxes simply by losing US residency by, for example, moving to live elsewhere (e.g. in the UK or Bermuda).

Thus, a citizen of the USA who does not live in the USA (i.e. is not resident therein) but resides in, say, the UK is still in principle liable to USA income and capital gains taxes on worldwide income and gains (as well as in this case being liable to UK income and capital gains taxes).

Other countries which also tax on the basis of citizenship include Ecuador, Liberia and South Korea.

Levying tax on the basis of citizenship is, however, very unusual. By far the most common system is for a country to simply levy its income and capital gains taxes only on its residents (as applies in the UK).

Source Basis

Whether a country's tax system is a worldwide- or territorial-based system typically a country will also levy its taxes on *non-residents* but only with respect to income and/or capital gains arising within the country's borders. In other words, if the source of the income arises within the country or the capital gain arises on an asset situated within the country then that country will tax the non-resident (see Chapters 6 and 22).

For example, invariably any real estate income (e.g. rents) arising from real estate in any country will be subject to income tax in that country (i.e. where the real estate is located) even if the owner of the real estate is not a resident of the country.

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Example 1.3

A German resident who owns UK real estate will be subject to UK income tax on any rental income arising from the real estate even though the individual is not a resident of the UK (such individual may also be subject to German tax on the income as a resident of Germany).

Example 1.4

Henry Bone is a resident of the Cayman Islands and has invested in US equities. Henry will be liable to US taxation on any dividend income arising on his investment.

In the case of the UK, although UK source income of a non-UK resident is liable to UK income tax, certain types of UK source income in such cases may not in fact be so liable (see discussion of "exempt" income in Chapter 22).

Although non-residents of a country are invariably subject to some form of tax in that country on income arising within that country the position with respect to capital gains may vary. Thus, some countries *do* levy their capital gains tax on disposals of assets situated within their country by non-residents while other countries do not.

In the case of the UK, for example, a non-UK resident is *not* subject to capital gains tax on the disposal of UK situs assets (unless the asset(s) form part of a UK-based trade or business).

Example 1.5

Joe America Junior, a US resident, has sold a number of his UK equity investments. Even though the assets sold are UK situs no UK capital gains tax charge arises on the sales.

(b) Inheritance Tax

Most countries levy some form of tax on the death of an individual. In addition, many countries will levy some form of tax on gifts made by an individual during their lifetime.

Terminology varies widely between countries as do the bases and underlying methodology upon which such taxes are levied.

As to terminology, common terms include *death tax, inheritance tax, estate tax/duty* and *gift tax*.

Unlike income and capital gains taxes which generally apply to *residents* of a country, taxes levied on death and/or lifetime gifts are often based upon an individual's *domicile or nationality* status. However, residence is also used by a number of countries to determine liability.

The person liable for such tax (i.e. death tax; gift tax, etc.) also varies among countries. Sometimes (as in the UK) on death the amount of the individual's death estate (assets owned at date of death less liabilities) is ascertained and tax is then levied on the estate, i.e. the tax payable on death is in fact paid out of the deceased's death estate before any assets of the estate can be transferred to the deceased's beneficiaries under the deceased's will.

However, it is not unusual for some countries to levy their tax arising on death, not on the death estate itself (as in the UK), but on those individuals who actually inherit a part of the deceased's estate, i.e. the heirs (see below).

Sometimes a country may impose a tax on death *and* a different tax which applies to lifetime gifts. This is the case with the USA which imposes both an *estate tax*, applying only on death *and* a separate tax on lifetime gifts, namely, a *gift tax*; two separate taxes. In the UK the same tax, i.e. inheritance tax, applies both on death and to lifetime gifts (see Chapter 9).

Examples of differences among countries concerning death and related taxes include:

- *in the UK* the liability on death is that of the deceased's estate and the extent of the liability depends upon the *deceased's domicile status at the date of death*;
- *in Spain* the liability is that of the heirs with the liability depending upon the *principal residence* status of the *heirs*;
- *in South Africa* the liability is that of the deceased's estate and depends upon the *ordinary residence* status of the *deceased*; and
- *in Germany* liability is dependent upon the *domicile status* of the deceased and the heirs and is a liability of the heirs, the amount of liability depending upon the relationship of the heir to the deceased.

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Trailing Tax Imposition

The term "trailing tax" usually refers to the levying of a country's taxes on an individual even when, prima facie, the individual is no longer within that country's tax regime for tax purposes.

In the UK, for example, a UK domiciled individual is liable to inheritance tax on worldwide assets. However, even where such individual loses the UK domicile status (e.g. by acquiring a non-UK domicile of choice; see Chapter 3) the individual still remains within the charge to UK inheritance tax on worldwide assets for a further period of three years (see Chapter 3).

Similarly, a Dutch national is still within the Dutch death tax net for a further 10 years after losing Dutch residency; a German national continues to be caught in the German death tax net for a further five years; and a US citizen or "long-term" permanent resident who has renounced either status but is caught under the trailing income/capital gains tax rules is automatically also deemed to still be within the death/gift tax net for a 10-year period.

The concept of trailing taxes is often overlooked when considering an individual's tax affairs. It is most likely to apply where the individual has moved from one country to another (possibly with the sole or main objective of mitigating taxes).

SUMMARY

It is important to recognise that each country's tax system may vary significantly from that of other countries.

The rules applicable in the UK are thus not necessarily reflected elsewhere.

Typically, the taxes levied by a country will include some form of income tax on income; capital gains tax on capital gains; and death tax and/or gift tax arising on death and/or lifetime gifts.

Nomenclature adopted often varies among countries and the same term may be used in a different sense in different countries.

Optimal tax planning may involve a consideration of the impact of different countries' tax systems and in particular their interaction if double taxation is to be avoided.

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