DOMICILE AND THE CAPITAL TAXES TREATIES

Harriet Brown[1]

1. Domicile is particularly pertinent in the context of capital tax treaties, not only because it will determine when they apply but also because certain capital tax treaties prevent the application of the inheritance tax deemed domicile rules and allow potentially beneficial tax treatment of individuals domiciled in a relevant country by the disapplication of the deemed domicile rules. Deemed domicile, the concept whereby a person who while not domiciled in the UK is deemed to be domiciled here for inheritance tax purposes by virtue of an extended period of residence, is familiar to many. What is less familiar, however, is the interaction between the deemed domicile rules and certain double tax treaties covering capital taxes, namely those between the UK and France, Italy, India and Pakistan.

2. *The deemed domicile rule*

2.1. The deemed domicile rule is set out in the Inheritance Tax Act 1984 ("**IHTA**"), section 267. This provides:

> *(1) A person not domiciled in the United Kingdom at any time (in this section referred to as "the relevant time") shall be treated for the purposes of this Act as domiciled in the United Kingdom (and not elsewhere) at the relevant time if—*
>
> *(a) he was domiciled in the United Kingdom within the three years immediately preceding the relevant time, or*
>
> *(b) he was resident in the United Kingdom in not less than seventeen of the twenty years of assessment ending with the year of assessment in which the relevant time falls …*

1 Harriet Brown, Tax Chambers, 15 Old Square, Lincoln's Inn, London, WC2A 3UE. Tel: (020) 7242 2744

> *(4) For the purposes of this section the question whether a person was resident in the United Kingdom in any year of assessment shall be determined as for the purposes of income tax.*

Thus a person can be deemed domiciled for inheritance tax purposes in one of two ways:

2.1.1. he can have been UK domiciled within the three years preceding the relevant time. The relevant time is not, other than as defined in section 267(1), a defined term and should be taken to mean the time at which it is necessary to determine the domicile of an individual for inheritance tax purposes; and

2.1.2. a person can be deemed domiciled in the UK under section 267 where he has been resident in the UK (for income tax purposes) for not less than seventeen of the preceding twenty years of assessment, the final year for which this period is calculated being the year of assessment in which the relevant time falls.

2.2. HMRC explain their understanding of the deemed domicile rule in the Inheritance Tax Manual, paragraph IHTM13024. This states:

Even if a person is domiciled outside the UK under general law, two special rules apply to those who have emigrated from the UK or to those who have been resident here for many years IHTA84/S267. If either rule applies then, in most cases, we treat them as domiciled within the UK for the purposes of IHT, i.e. domicile includes deemed domicile. For all other purposes, e.g. succession, the general law applies.

The "three year" rule - IHTA84/S267 (1)(a): For the rule to apply they must have been domiciled in the UK both on or after 10 December 1974 and within three calendar years before the relevant event, e.g. gift, death.

The "17 out of 20" rule - IHTA84/S267 (1)(b): For the rule to apply they must have been resident (for Income Tax purposes) in the UK on or after 10 December 1974 and in not less than 17 out of the 20 years of assessment, i.e. 6 April - 5 April, ending with the year of assessment in which the relevant event falls …

2.3. HMRC note that it is only "in most cases" that a person is treated as domiciled in the UK for inheritance tax purposes if they come within section 267. One exception which will be "most cases" is where a double tax treaty has precedence over the provisions of IHTA in this respect. IHTA, section 267(2) explains when double tax treaties will take precedence, providing:

> *(2) Subsection (1) above [the deemed domicile rule] shall not apply for the purposes of section 6(2) or (3) or 48(4) above and shall not affect the interpretation of any such provision as is mentioned in section 158(6) above.*

In the context of double tax treaties it is section 158(6) which is of paramount importance, because it determines which double tax treaties will override the deemed domicile rule.

2.4. IHTA, section 158(6) provides:

> *(6) Where arrangements with the government of any territory outside the United Kingdom are specified under any Order in Council which—*
>
> *(a) was made, or has effect as made, under section 54 of the Finance (No 2) Act 1945 or section 2 of the Finance Act (Northern Ireland) 1946, and*
>
> *(b) had effect immediately before the passing of this Act,*
>
> *the Order shall, notwithstanding the repeal of that section by the Finance Act 1975 remain in force and have effect as if any provision made by those arrangements in relation to estate duty extended to capital transfer tax chargeable by virtue of section 4 above; but the Order may be amended or revoked by an Order in Council made under this section*

To unravel this provision it is necessary to look at a number of other provisions (some of which are no longer extant), but its operation is relatively straightforward. The ultimate effect of section 158(6) is that a number of double tax treaties passed prior to IHTA (not those based on the 1982 OECD Model, which do not contain a situs code) override the deemed domicile rule, which will not apply where a treaty within section 158(6) applies. The implications of this for long-term residents of the UK who have retained a domicile in one of the relevant treaty countries are potentially highly beneficial.

2.5. The treaties which are subject to IHTA, section 158(6) are those with France, India, Italy and Pakistan. They come into force by virtue of the Double Taxation Relief (Estate Duty) (France) Order 1963 (the "**French Treaty**"), the Double Taxation Relief (Estate Duty) (India) Order 1956 (the "**Indian Treaty**"), the Double Taxation Relief (Estate Duty) (Italy) Order 1968 (the "**Italian Treaty**") and the Double Taxation (Estate Duty) (Pakistan) Order 1957 (the "**Pakistan Treaty**"). It should be noted that the position under the Indian Treaty and the Pakistan Treaty is similar, and the

position under the French Treaty and Italian Treaty are also similar. Only the provisions, therefore, of the Indian Treaty and the French Treaty are discussed in detail (though key difference of the Italian and Pakistan treaties are highlighted). In relation at least to the deemed domicile rules the position is similar in respect of the other treaties.

3. *The French Treaty*

3.1. In considering each Treaty it is important to understand the territorial scope of the Treaty – to which parts of the contracting states they apply. The French Treaty when entered into related to British and Northern Irish estate duty and to French succession duty (Article I(1)). The French Treaty, Article I(2) provides that it applies to "a*ny other duties of a similar character …*" to the duty imposed on successions by death in France and the estate duty imposed in Great Britain[2]. This would, therefore, include inheritance tax, and indeed if it di not, IHTA, section 58(6) would not apply.

3.2. The French Treaty applies separately to Northern Ireland – Article 10. Any reference in the French Treaty to Great Britain refers to the United Kingdom, including Northern Ireland.

3.3. Pursuant to Article 10, France means France and the overseas regions. The overseas territories are, therefore, excluded. The overseas regions are Guadeloupe, Martinique, French Guiana, Réunion and with effect from 2011, Mayotte.

3.4. Article II(3) provides rules for determining the domicile of an individual under the French Treaty. It provides:

> "*(3)(a) For the purposes of the present Convention, the question whether a deceased person was domiciled at the time of his death in any part of the territory of one of the Contracting Parties shall be determined in accordance with the law in force in that territory.*
>
> *(b) Where by reason of the provisions of the preceding sub-paragraph a deceased person is deemed to be domiciled in the territory of each of the Contracting Parties, then this case shall be solved in accordance with the following rules:*

2 Article II provides definitions. "United Kingdom" is defined as Great Britain and Northern Ireland. Great Britain means England, Scotland and Wales, but does not include the Channel Islands and the Isle of Man. In this Note, the expressions are used as defined in the relevant Treaty.

> *(i) he shall be deemed to be domiciled in the territory of the Contracting Party in which he had a permanent home available to him at the time of his death; if he had a permanent home available to him in the territory of each of the Contracting Parties he shall be deemed to be domiciled in the territory of the Contracting Party with which his personal and economic relations were closest (centre of vital interests).*
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> *(ii) if the Contracting Party in whose territory he had his centre of vital interests cannot be determined, or if he had not a permanent home available to him in the territory of either Contracting Party, he shall be deemed to be domiciled in the territory of the Contracting Party in which he had an habitual abode;.*
>
> *(iii) if he had an habitual abode in the territory of each of the Contracting Parties, or in the territory of neither, he shall be deemed to be domiciled in that of which he was a national.*
>
> *(iv) if he was a national of both territories or of neither of them, the taxation authorities of the Contracting Parties shall determine the question by mutual agreement*"

There are, therefore, simple rules to determine domicile, which in the context of the French Treaty, override the rules relating to domicile in the UK and France. The result of IHTA, section 158(6) is that the rules in the French Treaty will apply, and the deemed domicile rules in IHTA, section 267 are supplanted.

3.5. Under the French Treaty it is possible to be domiciled in both jurisdictions (or, of course, neither, in which case the French Treaty will not be relevant). It is also possible for a French person to be domiciled in France under UK law, but domiciled in the UK under French law. The same applies to an English person (or person domiciled elsewhere in the UK).

3.6. To give an example, take a UK domiciled individual who moves to France, and acquires a French domicile of choice. Article II(3)(b) (the tie breaker provisions) will apply, and they will become French domiciled under the French Treaty. The three year period in IHTA, section 267(1)(a) will not then apply and on death it will only be possible to charge inheritance tax on assets sited in the UK (in accordance with the *situs* provisions in Article IV). It is by the application of the *situs* rules that the potential benefit arises as assets which would otherwise be chargeable will cease to be so.

3.7. It should be noted that the French Treaty does not apply to life time transfers (see the references to "… *at the time of his death* …" in Article II(3)) and the deemed domicile provision in IHTA, section 267 could still apply in those circumstances. Take the following example. An individual who has just moved to France and acquired a French domicile of choice was previously domiciled in England and is, therefore, deemed domiciled under IHTA, section 267. He makes a transfer of value of his English situate property (worth £1,000,000). The French Treaty effectively only applies to transfers on death and, therefore, the individual transferring the English situate property will be caught by the deemed domicile rules in Section 267.

3.8. The French (and the Italian) Treaty contain "tie-break" provisions for determining domicile. Article II(3)(b) provides for this situation (in a manner similar to the OECD model provisions – see paragraph 7 below). Thus the scenario whereby a person is considered domiciled in both contracting states under treaty provisions (as can occur under the Indian and Pakistan Treaties) and is therefore outside the protection of the treaty cannot arise with the French (or Italian) Treaty.

4. *The Italian Treaty*

4.1. Article II(2)(a) sets out the domicile rule. This provides that:

> *For the purposes of the present Convention, the question whether a deceased person was domiciled at the time of his death in any part of the territory of one of the Contracting Parties shall be determined in accordance with the law in force in that territory.*

4.2. A person may be domiciled in both Italy and the UK or in neither. There is also the possibility that a person may be domiciled in Italy under UK law, but domiciled in the UK under Italian law. In the case of a person domiciled in Italy under UK law and in UK under Italian law, the situs rules of the Italian Treaty will apply. Where a person is domiciled in both the UK and in Italy, there are tie breaker provisions contained in Article II(2)(b)[3].

4.3. Article V(2) sets out the charging provisions. It provides:

> *(2) Where duty is imposed in the territory of one Contracting Party on the death of a person who at the time of his death was not domiciled in any part of that territory but was domiciled in some part of the territory of the other Contracting Party, no account shall be taken, in determining the amount or rate of such duty, of property situated*

3 These are similar to the tie-breaker provisions found in the OECD Model Treaty.

> *outside the former territory, provided that this paragraph shall not apply to duty imposed in the territory of a Contracting Party on property passing under a settlement governed by its law.*

4.4. The Italian Treaty does not refer to property "… *passing under a disposition or devolution regulated by the law of some part of Great Britain ...*" There are, therefore, no concerns in relation to the Italian Treaty that where there is non-UK situate property the will disposing of it should be governed by a law other than the law of any part of the UK.

5. *The Indian Treaty*

5.1. In common with the French Treaty, the Indian Treaty applies to Northern Ireland, although it can be amended separately in relation to Northern Ireland (see Article X)[4].

5.2. "India" is defined in Article II(i)(a). It means:

> … *all the States and territories comprised in the Union of India.*

It is not clear whether the areas disputed between India and Pakistan would be covered by the Indian Treaty. It should, however, be noted that the provisions of the Indian Treaty and the Pakistan Treaty are relatively similar. In the case where they are covered by both treaties by virtue of living in a disputed area there is a possibility that they will be able to claim the protection of neither, because it is not sufficiently certain which Treaty applies.

5.3. Article III provides:

> *(3) Duty shall not be imposed in Great Britain on the death of a person who was not domiciled at the time of his death[5] in any part of Great Britain but was domiciled in some part of India on any property situate outside Great Britain:*
>
> *Provided that nothing in this paragraph shall prevent the imposition of duty in Great Britain on any property which passes under a disposition or devolution regulated by the law of some part of Great Britain.*

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4 Any reference in the treaty to "Great Britain" should be read as a reference to the United Kingdom and Northern Ireland.

5 In common with the French Treaty, the protection is only offered at death and the Indian Treaty could not save a lifetime gift of somebody falling foul of the deemed domicile rule from being chargeable to inheritance tax.

Of course, the Indian Treaty will not displace IHTA, section 267 unless there is a specific domicile provision in the Indian Treaty.

5.4. Article III(3) can cause problems because non-UK situs assets can fall within the charge to tax if they are disposed of by a will subject to the law of some part of the UK. Such difficulties can be avoided by ensuring that any will disposing of non-UK situs property is regulated by the law of any jurisdiction which is not subject to the law of some part of the UK[6]. This problem will arise whether or not the deemed domicile rules are in point.

5.5. The domicile provision is contained in Article II. Article II provides:

> *(2) for the purposes of the [Indian Treaty], the question whether a deceased person was at the time of his death domiciled in any part of the territory of one of the Contracting Governments shall be determined in accordance with the law in force in that territory.*

5.6. The question as to whether a person dies domiciled in India, will be a matter for Indian law, for England a matter of the laws of England and Wales[7]. I do not attempt here to cover the different relevant concepts of domicile. It is noteworthy that there are no tie-breaker rules included in the Indian Treaty. Thus where a person dies domiciled in the UK according to the law of part of the UK and in India for Indian law purposes, then HMRC are in a position to tax fully because the individual will be UK domiciled.

6. *The Pakistan Treaty*

6.1. "Pakistan" is, According to Article II(1) the Provinces of Pakistan and the Capital of the Federation. Bangladesh is not covered by the Pakistan Treaty. Again, this definition may include disputed areas and those domiciled in one of these areas may well be domiciled both in India according to Indian law and in Pakistan according to its law. The effect of this may be that they could claim protection of neither the Indian Treaty nor the Pakistan Treaty.

6.2. The domicile rules are found in Article II(2). This provides:

> *(2) For the purposes of the present Agreement, the question whether a deceased person was at the time of his death domiciled in any part of Great Britain or in any part of Pakistan shall be determined in*

6 A similar provision is also found in the French Treaty and the Pakistan Treaty. Care should also be taken in relation to these treaties.

7 excluding IHTA, section 267 by virtue of the application of IHTA, section 58(6).

accordance with the law in force in Great Britain and Pakistan respectively.

While the wording is not identical, it is thought that the effect of this provision is the same as that of the equivalent provision in the Indian Treaty. It is, therefore, also important to remember that if someone dies domiciled in Pakistan according to the law of Pakistan and in Great Britain according to the law of some part of Great Britain, the Pakistan Treaty will not apply.

7. *The OECD Model Treaty*

7.1. Treaties based on the OECD Model Treaty on estates and inheritances and on gifts will not override IHTA, section 267 by virtue of IHTA, section 58(6), or for any other reason. In non-deemed domicile cases they may still be benefits under such a treaty.

7.2. In the OECD Model Treaty the important concept is that of "fiscal domicile" under Article 4. This provides:

For the purposes of this Convention, the term "person domiciled in a Contracting State" means any person whose estate or whose gift, under the law of that State, is liable to tax therein by reason of the domicile, residence or place of management of that person or any other criterion of a similar nature. However, this term does not include any person whose estate or whose gift is liable to tax in that State only in respect of property situated therein.

The effect of this is to apply the taxing provisions of the state of domicile. This, of course, leaves the position where an individual is domiciled in two states, each according to its own law. Tie breaker provisions are provided. It should also be noted that the OECD Model Treaty treaties will not, unlike the French, Italian, Indian and Pakistan Treaties, apply to lifetime gifts.

7.3. Article 4(2) provides the tie breaker provision for natural people and Article 4(3) for individuals who are not natural people. These provide:

(2) Where by reason of the provisions of paragraph 1 an individual is domiciled in both Contracting States, then his status shall be determined as follows:

(a) he shall be deemed to be domiciled in the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be

deemed to be domiciled in the State with which his personal and economic relations are closer (centre of vital interests);

(b) if the State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be domiciled in the State in which he has an habitual abode;

(c) if he has an habitual abode in both States or in neither of them, he shall be deemed to be domiciled in the State of which he is a national;

(d) if he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

(3) Where by reason of the provisions of paragraph 1 a person other than an individual is domiciled in both Contracting States, then it shall be deemed to be domiciled in the State in which its place of effective management is situated

As mentioned above, the tie breaker provisions in the OECD Model Treaty are similar to those found in the French and Italian Treaties. The deemed domicile provisions will not, however, be overridden by a treaty based on the OECD Model.

7.4. The commentary on the OECD Model Treaty explains:

… in accordance with the provisions of the second sentence of para 1, however, a person is not to be considered a "person domiciled in a Contracting State" in the sense of the Convention if, although he is living in that State, his estate or gift is subject to tax only insofar as it includes property situated in that State. That situation exists in most States in relation to individuals, for example, foreign diplomatic and consular staff, serving in their territory …

This is unlikely to be pertinent in most circumstances but, as it can disapply a treaty in certain circumstances, it is important to bear in mind.

7.5. In relation to the tie breaker provisions for natural persons the commentary explains:

17 … as far as possible the "preference criterion" must be of such a nature that there can be no question but that the person concerned will satisfy it in one State only, and at the same time it must reflect

> *such an attachment that it is felt to be natural that the right to tax devolves upon that particular State.*

This is sensible: it avoids the problem of an individual falling without the treaty because they are considered to have a fiscal domicile in both states.

7.6. The commentary continues:

> *18 The Article gives preference to the Contracting State in which the deceased or the donor has a permanent home available to him …*
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> *19 Paragraph 2(a) means, therefore, that in the application of the Convention (that is, where there is a conflict between the laws of the two States) it is considered that the domicile is that place where the individual owns or possesses a home; this home must be permanent, that is to say, the individual must have arranged and retained it for his permanent use as opposed to staying at a particular place under such conditions that it is evident that the stay is intended to be of short duration.*
> *…*
>
> *21 If the deceased at his death, or the donor at the time of the gift, has a permanent home in both Contracting States, the Article gives preference to the State with which his personal and economic relations are closer, this being understood as the centre of vital interests. In the cases where the centre of vital interests cannot be determined, para 2 provides as subsidiary criteria, firstly, habitual abode, and then nationality; if, when nationality is considered, the deceased or the donor is a national of both Contracting States or of neither of them, the question shall be solved by mutual agreement between the States concerned according to the procedure laid down in Art 11.*
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> *22 Leaving aside what has just been said about short stays, para 2(a) is applicable without it being necessary to have regard to any intention (unfulfilled) which the deceased or donor may have had to leave the home in order to settle elsewhere, or to any intention to return to a former domicile, for example, to his native country …*
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> *24 … regard will be had to his family and social relations, his occupations, his political, cultural or other activities, his place of business, the place from which he administers his property, etc. The circumstances must be examined as a whole but it is nevertheless obvious that considerations based on the personal acts of the individual must receive special attention …*

7.7. In relation to paragraph 2(b), this establishes criterion for determining domicile in two different circumstances. First where the individual has a permanent home available to him in both Contracting States and it is not possible to determine in which one he has his centre of vital interests and secondly where the individual has a permanent home available to him in neither Contracting State. The commentary provides:

> *26 In the first situation … the fact of having an habitual abode in one State rather than in the other appears therefore as the circumstance which … tips the balance towards the State where he stays more frequently. For this purpose, regard must be had to stays made not only at the permanent home in the State in question but also at any other place in the same State.*
>
> *27 [In] the second situation … all stays made in a State must be considered without it being necessary to ascertain the reasons for them.*
>
> *28 … the comparison must cover a sufficient length of time for it to be possible to determine whether the residence in each of the two States is habitual and to determine also the intervals at which the stays take place …*
>
> *29 Where, in the two situations referred to in sub-para (b), the individual has an habitual abode in both Contracting States or in neither, sub-para (c) gives preference to the State of which he is a national. If the individual is a national of both Contracting States or of neither, sub-para (d) assigns to the competent authorities the duty of resolving the difficulty by mutual agreement according to the procedure established in Art 11…*

7.8. There is also commentary on Article 2(3). This provides:

> *31 It would not be an adequate solution to attach importance to a purely formal criterion like registration. Therefore para 3 attaches importance to the place where the company, etc is actually managed.*
>
> *32 As a result of these considerations, the "place of effective management" has been adopted as the preference criterion for persons other than individuals. The very rare cases where a charitable institution falls under para 3 because it is, under para 1, deemed to be domiciled in both Contracting States, may not always be solved by applying the criterion of "management", since that term refers more to business enterprises. In such a case the two*

Contracting States should rely on the mutual agreement procedure provided for in Art 11.

7.9. The tie breaker provisions are complex, and largely reliant on the collection and assessment of factual background to the life of the person, or existence of the company. This can make determining the domicile a difficult matter, and open to different interpretations by taxing authorities. The tie-breaker provisions do, however, ensure that the individual does not lose all benefit of a treaty because they are considered to have a fiscal domicile in both contracting states.

7.10. The countries which have treaties with the UK based on the OECD Model Treaty on inheritances an gifts are Ireland, the Netherlands, South Africa, Sweden, Switzerland and the USA.