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Get Ahead of the Game in the Tax Race

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For many years the United Kingdom has been one of the most effective onshore tax havens in the world for high net worth individuals. While the EU has been attacking Switzerland and other countries for supposedly harmful tax competition, it has been possible for a foreign billionaire to reside in London and pay no income tax at all. Given this kind of incentive, it is no surprise that London's prime residential areas have become enclaves of the foreign super-rich. Yet as a result of recent changes announced by UK Chancellor of the Exchequer, Alistair Darling, the days of tax exile in the UK are numbered.

This situation existed because the UK's tax legislation distinguishes between resident taxpayers who have a UK domicile and those who do not. The former pay tax on their worldwide income and gains, the latter pay tax on non-UK sourced income and gains only to the extent that such income or gains are remitted back to the UK. The so-called remittance basis meant that income or gains earned abroad were only taxed if the money was transferred into the UK. However, wealth acquired prior to arrival in the UK could be remitted free of any tax.

In theory the remittance basis meant that non-domiciled residents paid tax on the amounts required to fund their living costs in the UK where such expenses were paid out of income and gains arising during the period they were resident in the UK. However, a series of legal loopholes allowed clever lawyers to devise structures that enabled such individuals to avoid making remittances and therefore escape the UK tax net altogether. It was possible to purchase a house in the UK using an offshore mortgage and have the payments not treated as remittances. UK situs assets could be held in offshore trusts in order to shelter income and gains in relation to such assets from UK tax. Although in theory non-domiciled residents are taxable on UK income and gains the reality is that well-advised individuals have often not been. Labour politicians have long argued that such rules are discriminatory and unfair. Calls for change were consistently ignored on the grounds that any change to these rules would cause foreign financial institutions to case to regard London on the key financial market in Europe.

Yet having pointedly ignoring this anomaly since coming to power in 1997, the Labour Government has now introduced a radical overhaul of these rules. To continue to avail themselves of the beneficial remittance basis of taxation long-term non-domiciled residents must pay a £30,000 annual tax charge. Furthermore many of the existing loopholes that made the remittance basis so easy to exploit are going to be closed. The breadth of the changes has caused an outcry from high-net worth individuals and more disturbingly from many financial institutions in the City of London that hire non-domiciled professionals. Many commentators argue that these measures will lead to a significant fall in the values of prime London real estate and a loss of jobs in the already depressed London financial markets. But these are risks to which the Chancellor of the Exchequer, Mr. Alistair Darling, appears to be oblivious. Another ill-considered side effect of the changes is that non-domiciled individuals from the US who pay the charge will not receive a tax credit against their US liability hitting the substantial US investment banking community in London with a double tax charge.

The fact that these changes have triggered a flight of capital is undeniable. Many would-be émigrés from the UK are looking closely at the Swiss *forfait* regime. Perhaps more worryingly for the UK Government there are persistent rumours of an exodus of hedge and private equity funds to Switzerland and other low tax centres such as Cyprus, Monaco and the Channel Islands. At an already precarious time in the financial markets the departure of established businesses from London would be highly damaging to the British economy. The Government argues that these changes will promote fairness in the tax system but it may well turn out to be the case that the consequence of this fairness will be an increase in the tax burden of UK domiciled tax payers.

The self-defeating actions of the UK Government will unleash a round of tax competition as jurisdictions seek to attract the businesses that the UK may lose. Switzerland in particular has much to gain from these changes. Already attractive to high net worth individuals as a result of the *forfait* system it is beginning to be looked at favourably by financial institutions in London who have grown tired of the political climate on taxation issues which has turned against the very industry that ironically generates more taxable revenues in the UK than any other. Switzerland's suggestion of a 10% flat rate tax on hedge fund managers was noted with great interest by many London based fund managers. A formalization of that proposal or something like it would turn the flight of capital from London into a stampede.

Yet there is uncertainty as to how Switzerland's Federal Tax Administration will require the cantons to tax the carried interest earned by private equity and hedge fund managers. A special circular letter will soon be issued on this subject and there are fears that these guidelines will state that the whole of any such carried interest will be subject to income tax as employment income rather than any portion of it being treated as non-taxable private capital gain. This has been the FTA's stated position although it is understood that considerable pressure has been brought to bear on the FTA by the financial services industry and certain of the cantons to rethink this position in order not to undermine Switzerland's attractiveness to new business. Some compromise between treating a percentage of carried interest as employment income and recognising that these arrangements have the characteristics of (critically the risks) of real private investment should be found in order to take advantage of London's fiscal unattractiveness.

As is evidenced by its *forfait* regime and the availability of tax rulings for international companies Switzerland has understood better than many other countries that the art of effective tax collection is not high taxes but a pragmatic recognition of the mobility of capital in modern economies. The hapless British Chancellor has opened the door of opportunity for Geneva to become the new fund management capital of Europe. Another piece of smart Swiss pragmatism on the taxation of fund managers will ensure that this opportunity is not missed.