A PERMANENT FOG

Published guidance on the Deemed Residence Rule, says *Simon McKie*, is imprecise and, in places, misleading

The *Taxation of Chargeable Gains Act* 1992, s. 69 contains rules for determining where the trustees of a settlement are resident and ordinarily resident. *ITA* 2007, s. 475 and 476 contain similar rules for income tax purposes.

TCGA 1992, s. 69(2D) treats a trustee who is not resident in the United Kingdom as if he were so resident at '…any time when he acts as trustee in the course of a business which he carries on in the United Kingdom through a branch, agency or permanent establishment there'.[1]

Guidance on this rule (the Deemed Residence Rule) was published on 1 July 2009.

The Guidance's conceptual framework

Different tests for companies and other taxpayers?

The Guidance states:

> '…that for trustees the "*branch*" and "*agency*" tests apply to non-corporate trustees and the "*permanent establishment*" test to corporate trustees. Non-UK resident trust companies that are trustees therefore need only be concerned about being treated as UK resident if they carry on a business through a permanent establishment in the UK.'

It can be seen from s. 69(2D) above that nothing in that sub-section suggests that different tests apply according to whether the trustee is a natural or legal person.[2]

No reference to the statutory definitions

It is a peculiarity of the Guidance that it develops its examination of the meaning of 'permanent establishment' without referring to the statutory definition in *FA* 2003, s. 148, which applies for the purpose of determining whether a company has a permanent establishment in a country for the purposes of the tax acts[3] and of capital gains tax.[4] Rather the Guidance refers to the OECD's Model Treaty, which contains a definition of a permanent establishment for the purposes of the Treaty in Article 5 and the OECD's Commentary thereon. Clearly neither the Model Treaty nor the Commentary is directly part of UK law. The Treaty's definition of permanent establishment in Article 5 shows a number of differences from that of s. 148. It is true that a Court, in the absence of more direct authority, is likely to have regard to the views expressed in the OECD Commentary in construing phrases in s. 148 that are identical to those used for the same purpose in the Model Treaty, but there are important differences between the two definitions. The OECD's opinion is by no means determinative of the construction of s. 148 under English law.

Strangely, Annexe A to the Guidance highlights one of the key differences between the definition in Article 5 of the OECD Model Treaty and the statutory definition given by s. 148, without explaining that there is a statutory definition.

The three questions

The Guidance goes on to set out three questions, which it says are relevant to deciding whether or not a trustee is deemed to be resident in the United Kingdom.[5] Those tests are:

(a) Is the trustee carrying on a business in the UK?
(b) If the trustee is carrying on a business in the UK, is it carrying on a business through a branch, agent or permanent establishment in the UK?
(c) If so, is the trustee carrying on the activity of being a trustee of that particular trust in the course of its business through the branch agent or permanent establishment?

In relation to question (a) the Guidance says:

> 'This question is not related to the business of particular trusts that might be conducted by the trustees. It enquires whether the person who is a trustee carried out business activities (as a professional businessman and not as a trustee of a particular trust) in the UK.'

That certainly seems to me to be an arguable view of the provision, but it is also arguable that the provision is not restricted in this way. Rather, that because it is only necessary for the trustee to act 'as trustee in the course of a business which he carries on in the United Kingdom though a branch agency or permanent establishment there', that condition is satisfied both if he carries on a business of acting as a professional trustee and if he carries on a business for the account of the trust fund of the settlement concerned.

Question (c) is ambiguous. Section 69(2D) requires the person concerned to be acting as a trustee in the course of a business. That business must be carried on in the United Kingdom through a branch, agency or permanent establishment in the UK. Question (c) could be read as being consistent with this construction. It could, however, also be read as stating that the test will be satisfied only if the acts of the trustee in respect of the particular trust concerned are carried on through a branch, agency or permanent establishment in the UK. If so, that is a narrower view of the test than is justified by a close reading of the legislation.

Core activities

The Guidance then goes on to say that:

> ' … in line with the Commentary of the OECD Tax Model Convention, "carrying on the function of being a trustee" means in this context activities which are the core activities of a trustee and not those activities which are auxiliary or preparatory'.

In fact the Commentary only refers to core activities at two points, and neither of those is in relation to carrying on the function of being a trustee. Section 69(2D) makes no distinction between trustees' core activities and other activities. It provides that if the person concerned acts

as trustee in the course of business that he carries on in the United Kingdom through a branch, agency or permanent establishment, that person will be resident in the United Kingdom. There is no provision that this will not apply if the acts are preparatory or auxiliary.

The definition of a permanent establishment in s. 148[6] does refer to activities that are preparatory or auxiliary in character, providing that:

> 'A company is not regarded as having a permanent establishment in a territory by reason of the fact that:
>
> (a) a fixed place of business is maintained there for the purpose of carrying on activities for the company; or
> (b) an agent carries on activities there for and on behalf of the company.
>
> if, in relation to the business of the company as a whole, the activities carried on are only of a preparatory or auxiliary character.'

That, however, is only relevant to deciding whether or not a company has a permanent establishment, not to whether a person is acting as a trustee.

The Guidance goes on to say that:

> 'There are other activities which trustees carry on which are not core activities central to [the trustees'] conduct and management of the trust, but are instead preparatory or auxiliary activities. These generally can include information-gathering meetings, including meetings with independent agents or with beneficiaries but, as mentioned below, each case will have to be considered individually.'

This shows an important misunderstanding. Gathering relevant information about beneficiaries' circumstances or about the performance of an independent agent's duties are important parts of the duties of trustees. Meetings with beneficiaries, lawyers, investment managers, land agents and others for the purpose of gathering information relevant to the trustees' stewardship of the settled property or the exercise of their dispositive powers will inevitably be acts by a professional trustee in the course of his business of providing professional trustee services.

The Guidance goes on to say that:

> 'In deciding whether the conduct and management of a particular trust is being carried on in the course of the corporate trustees' business through a permanent establishment, HMRC … would also consider the issue of frequency.'

It may be true that in deciding whether or not the trustee is carrying on a professional trustee business in the United Kingdom through a branch, agency or permanent establishment, the frequency of his actions in the UK will be relevant. Once one has established that the trustee provides professional trustee services in the UK through a permanent establishment, however, a single act in the course of that business in respect of a settlement will be sufficient to make the trustee resident in the UK in relation to that trust.

The examples

The Guidance then provides a series of examples of the application of the Deemed Residence Rule.

Since the Guidance has ignored the statutory definition of a permanent establishment, invented an illusory distinction between corporate and individual trustees for the purposes of the rule and confused the provisions relevant to deciding whether there is a permanent establishment with those relevant to whether a trustee carries on business in the UK through a permanent establishment, branch or agency, it is unsurprising that the examples are, in the main, incorrect or misleading.

Example 2

Example 2 illustrates the danger of the Guidance's error in applying a core activities test in deciding whether or not the trust company is acting as a trustee. It gives an example of a trust company that:

> '…holds quarterly meetings in the UK at its London offices [presumably in respect of the settlement concerned] with investment advisors. The purpose of these meetings is for …[the trust company]… to collect purely factual information about potential assets to inform future investment strategy for the…[trust]. The actual decisions about the investment strategy are taken by … [the trust company]… outside the UK.'

The Guidance correctly says that the trust company has a permanent establishment in the UK. It goes on to say, however, that '… the significance of the meetings with the investment advisors is not sufficient for [the trustee] to be regarded as acting as trustee in respect of [the trust] through that permanent establishment. They will not, therefore, be regarded as UK resident for the purposes of [the trust]'. Obtaining information to enable the trustees to make prudent investment decisions, however, is an important duty of trustees, and when a company does so it is clearly acting as a trustee and in the course of its business of providing trustee services. If the offices at which the meetings take place are a permanent establishment, and part of the company's business of acting as professional trustees is carried on in the United Kingdom through those offices, all the ingredients for deemed residence under the Professional Trustee Deemed Residence Rule are present.

Example 2b

Example 2b shows how the view expressed in the Guidance that the frequency of the trustee's acts is relevant to deciding whether the Professional Trustee Deemed Residence Rule is satisfied leads to an incorrect conclusion. The example is as follows:

> 'July Ltd, a non-UK resident trust company, is trustee of the August Trust. It always carries out the core activities of the August Trust at its office overseas. The beneficiary of the trust has a single one-off meeting with July Ltd at July's Manchester office to discuss the potential release of capital from the August Trust. The discussion involves the imposition of certain conditions on the beneficiary before such a release.
>
> 'HMRC view: On the face of it July Ltd by discussing the release of capital and the imposition of conditions with the beneficiary has engaged in a core activity and this has taken place at what is July's permanent establishment in the United Kingdom. So *prima facie* July Ltd is acting as trustee of the August Trust through a permanent establishment. However, the whole context has to be looked at – ie, where the decision making on the trust is being carried on and if the meeting in the United Kingdom was a one-off. If the trustee took the information from the meetings out of the United Kingdom with them and then discussed and made the decisions outside the United Kingdom, they would not be UK resident. If there was any doubt as to where the decision making is taking place we would as part of our considerations consider the frequency of any meetings both within and outside the United Kingdom.'

Assuming that July Ltd's offices are used for the purposes of its trade as a professional trustee generally, it is clear that it carries on a business in the United Kingdom through a permanent establishment here. Discussions with a beneficiary in respect of a proposed capital advance are clearly an act undertaken as a trustee of the particular trust concerned and that act is in the course of the trustee's business of providing professional trustee services. So the conditions of *TCGA* 1992, s. 69(2D) are clearly satisfied. The frequency of the meetings is irrelevant.

Agents of independent status

FA 2003 s. 148(3) provides that:

> 'a company is not regarded as having a permanent establishment in a territory by reason of the fact that it carries on business there through an agent of independent status acting in the ordinary course of his business'.

The Guidance refers to creating 'a dependent agency permanent establishment'. If this phrase has any meaning, the Guidance has converted a negative rule ('is not regarded as having a permanent establishment') into a positive one.

The Guidance goes on to say:

> 'Where the services that are provided to the trust are only those that the person is contractually obliged to provide under their agreement with the non-UK resident trustee and are remunerated at arm's length, then this is unlikely to create a dependent agency permanent establishment.'

Because the Guidance has transformed a negative test into a positive one, it does not deal with the difficulties that emerge where the relationship with a service supplier is not a simple agency. For example, it is common for investment managers to hold the managed assets as nominee for their clients so that the managers hold the assets as trustee and not as agent. Trustees exercise many of their activities of holding and dealing with the trust assets through the mechanism of such nominee arrangements. If the investment manager operates through a permanent establishment in the UK, it is clear that a trustee will be acting through that permanent establishment. The Guidance says, however:

> 'Where, say, a UK subsidiary is providing services to a trust, then unless the powers granted to it by a non-resident trust company are such that it becomes a "*dependent agent with authority to do business on behalf of the non-resident trustee*" (see paragraph 5 of Annex A) we will not contend that the UK company's actions cause the non-UK resident trustee company to have a permanent establishment.'[7]

Perhaps the phrase 'we will not contend' acknowledges that here the Guidance is actually offering a disguised concession. If so, it is arguable that the disguised concession is *ultra vires*.[8]

Example 3a

In Example 3a a non-resident trustee engages an investment manager on terms that the manager has the authority to buy and sell commodities with a view to realising profits for the trust subject to trading limits set by the trustee. The Guidance says that:

> 'the investment manager is appointed by the trustee and so is its agent. If it receives an arm's length fee for the investment management services, it will not ordinarily constitute a dependent agent of the non-UK resident trustee. If, however, October Ltd was providing investment management services to the trustees other than on arm's length terms, ie, was acting as their dependent agent, rather than simply providing a service to them, in that case the trustees would be likely to have a dependent agent permanent establishment.'

If all the Guidance is saying here is that a person charging less than the market rate for a service is likely also not to be independent, then that is no doubt true; but it is hardly useful to say so. If, however, the Guidance is attempting to say that charging less than a market rate for services has the result that the provider is a dependent agent, then this is clearly not the case.

Accurate and useful?

The Guidance is imprecise and, in places, misleading. Is it useful in that it can be relied on as indicating that HMRC will not apply the full rigour of the statutory provisions? Unfortunately, it is not. The Guidance is liberally sprinkled with words and phrases such as 'generally', 'unlikely', 'could not by itself', 'will be likely' and 'normally', which indicate HMRC's determination not to be too closely bound by its general statements.

The Guidance will do nothing to retrieve the business that has been lost to the United Kingdom due to the uncertainty that the Deemed Residence Rule created.

This article is based on a longer one that will appear in Private Client Business *shortly. Simon McKie is a designated member of McKie & Co (Advisory Services) LLP. Tel: 01373 830956 (www.mckieandco.com)*

1. *TCGA* 1992, s. 69(2D). It will be noted that this provision uses the masculine gender. The *Interpretation Act* 1978, s. 6 provides that words importing the masculine gender include the feminine and vice versa, but it does not provide that words importing the masculine gender include the neuter. Is it perhaps arguable that *TCGA* 1992, s. 69(2D) applies only to natural persons? The equivalent provision in *ITA* 2007, s. 475(6) is differently worded, being in the Rewrite style, and does not use the masculine pronoun to refer to the trustees.
2. *FA* 2003, s. 148, which contains a statutory definition of a permanent establishment, applies only for the purpose of determining whether a company has a permanent establishment in a territory (see below). It may be because of this that HMRC have adopted their view of the dual structure of s. 69(2D). If so, that is surely too shifting a ground on which to found such a radical restructuring of the provision.
3. The *Income Tax Acts* and the *Corporation Tax Acts.*
4. *TCGA* 1992, s. 288(1)
5. *TCGA* 1992, s. 69(2)(d) and *ITA* 2007, s. 475(6)
6. Article 5 of the OECD Model Treaty contains similar provisions
7. It may be that *FA* 2003, s. 448(3) and Sch 26 paras (3) and (4) will provide some relief here, but that is dependent on falling within the detailed provisions of those paragraphs.
8. *R (on the application Wilkinson) v Inland Revenue Commissioners HL* [2005] STC 270