Trust business turned away – surely some mistake?

Simon McKie is not impressed by what happens when the government attempts to 'modernise' complex provisions it does not understand and 'consults' only in order to ignore

In his pre-Budget report 2003, the then chancellor Gordon Brown announced plans to 'modernise and simplify the income tax and capital gains tax system for resident trusts'. One of the stated criteria of this 'modernisation' was that it should 'support the competitiveness of the UK economy'. Among the proposals was one to '… explore the possibility of creating a single test for trust residence for income tax and capital gains tax, building on the residence test for individual trustees and settlors'.

There was a choice between basing the residence test on the existing capital gains tax rules that, though not perfect, had worked well for almost 40 years, or adopting the income tax test. Ignoring the results of its consultation, HMRC plumped for the income tax test.

The Professional Trustee Rule

The CGT test had contained a special rule for professional trustees, which was important in attracting international trust business to the UK. *TCGA* 1992, s. 69(2) provided that:

'A person carrying on a business which consists of or includes the management of trusts, and acting as trustee of a trust in the course of that business, shall be treated in relation to that trust as not resident in the United Kingdom if the whole of the settled property consists of or derives from property provided by a person not at the time (or, in the case of a trust arising under a testamentary disposition or on an intestacy or partial intestacy, at his death) domiciled, resident or ordinarily resident in the United Kingdom, and if in such a case the trustees or majority of them are or are treated in relation to that trust as not resident in the United Kingdom, the general administration of the trust shall be treated as ordinarily carried on outside the United Kingdom.'

That provision meant that if a trust were made by a person who at that time had no tax connection with the UK because he was neither domiciled, resident nor ordinarily resident here, professional trustees could exercise their trusteeship and administer the trusts in the UK, and yet the trust would not be treated as resident for capital gains tax purposes.

When, after much consultation, the draft legislation was published on 31 January 2006, two new factors emerged. It was announced in relation to the Professional Trustee Rule that:

'There is a possibility that one of the proposals, the proposed election regime for the trustees of certain settlements to be treated as non-UK resident for the purposes of the *TCGA* and the *Income Tax Acts*, may constitute a State aid for the purposes of European law. We are in consultation with the Department of Trade and Industry about this. If the conclusion of those discussions is that the proposal does constitute a State aid then it is possible that the draft provisions may need to be revised or withdrawn.'

Budget Note 35, published on Budget Day 2006, stated that:

'As we explained when we published the draft legislation earlier in the year, there was a risk that the professional trustee measure would fall foul of the EU State aid rules. We have now consulted with the Department of Trade and Industry which has confirmed that it would indeed constitute a State aid. In view of this we have had to withdraw the measure.'

It had taken HMRC three years to consult another government department in relation to its trust proposals, and it was only at that stage that they discovered that the proposals were a major threat to a significant source of UK income and employment.

James Kessler QC – with the support of the Society of Trust and Estate Practitioners (STEP) and the CIOT) – made an application under the *Freedom of Information Act* 2000, s. 50 to the Information Commissioner for a decision that the government's refusal to release the advice that HMRC obtained on the state aid point was contrary to the provisions of that act. That application was refused, and an appeal has now been made to the Information Tribunal under s. 57 of the act. It is hoped that the Tribunal's decision will be received shortly.

The Trustee Deemed Residence Rule

So the removal of the Professional Trustee Rule had driven professional trustee business overseas. That was not, however, the end of the bad news.

The scheme of the new residence rules is that the trustees of a settlement are to be treated as if they were a single person. That single person is to be treated as resident and ordinarily resident in the UK at any time when one of two conditions is satisfied. The condition is that all the trustees are resident in the UK. The second is that at least one trustee is resident in the UK and at least one is not, and that a settlor in relation to the settlement is resident, ordinarily resident or domiciled in the UK at a time that is a relevant time in relation to them. The relevant time is, loosely, the time when the settlement is made for inter vivos settlements and immediately before the death of the settlor for settlements arising on a death. With modifications to take into account the fact that the trustees are to be deemed to be a single person (distinct from the persons who are trustees of the settlement from time to time), these rules essentially reproduced the old income tax residence test in *FA* 1989, s. 110. There was, however, one significant addition. It was provided that:

'A trustee who is not resident in the United Kingdom shall be treated for the purposes of subsections (2A) and (2B) as if he were resident in the United Kingdom 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.'

The draft Explanatory Notes did not explain why this Trustee Deemed Residence Rule was necessary. The provisions were duly enacted in the *Finance Act* 2006, which inserted the new CGT provisions into *TCGA* 1992, s. 69 and the new income tax provisions as a new s. 685E of *ICTA* 1988. Section 685E was then rewritten in the Tax Law Rewrite Project so that the trust residence provisions for income tax are now found in *ITA,* s. 474 to 476.

Ironically, therefore, we still have two separate definitions of trustee residence for income tax and capital gains tax purposes, couched in different language but intended to have the same effect. Only time will tell whether the same meaning is expressed by different words or whether subtle but significant differences will emerge. Mr Brown has achieved the remarkable result of driving trust business away from the country that invented the trust concept and gave it to the world, and has not even achieved his original objective.

The full significance of the Trustee Deemed Residence Rule only became apparent with time.

Many international trusts have a single corporate trustee. If that trustee becomes UK-resident, the trust's worldwide income and gains will be brought within the scope of UK income and capital gains tax. This will include gains realised during the residence period on assets whose increase in value has accrued wholly or partly before the trust became UK resident. If the trustee then becomes non-resident again, the trustees will be deemed to have disposed of the trust assets for their market value immediately before the change of residence, bringing all accrued gains into charge to UK capital gains tax. So an inadvertent change of residence could have absolutely disastrous tax consequences.

As we have seen, under the Trustee Deemed Residence Rule a trustee is treated as if he were resident in the UK at any time when he acts as trustee in the course of a business he carries on in the UK through a branch, agency or permanent establishment here. The terms 'business', 'branch' and 'agency' are all terms of wide meaning that present significant uncertainties in their construction, but it is the term 'permanent establishment' that has most worried trust practitioners. The phrase has a long history in double taxation treaties and in recent years has been utilised in relation to corporate taxation. It is defined for income tax and capital gains tax in *FA* 2003, s. 148, which provides that:

'(1) For the purposes of the Tax Acts a company has a permanent establishment in a territory if, and only if –
(a) it has a fixed place of business there through which the business of the company is wholly or partly carried on, or
(b) an agent acting on behalf of the company has and habitually exercises there [sic] authority to do business on behalf of the company.

This general definition is subject to the following provisions.

(2) For this purpose a "fixed place of business" includes (without prejudice to the generality of that expression) –
(a) a place of management;
(b) a branch;
(c) an office;
(d) a factory;
(e) a workshop;
(f) an installation or structure for the exploration of natural resources;
(g) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources;
(h) a building site or construction or installation project.'

Section 148 then provides a number of exclusions from the definition, the most important of which is 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 the business'. There are also exclusions for activities that are of a preparatory or auxiliary nature.

STEP is concerned by the practical effects of these provisions.

Consider, for example, a situation where staff from a foreign trust corporation use the premises of a UK group member to meet beneficiaries or the settlor. This might be because the beneficiary or settlor is living in the UK, perhaps for some temporary purpose or simply because London is a convenient place for people from different jurisdictions to meet. Could this use of meeting rooms in London, if repeated regularly, constitute a permanent establishment of the foreign trust corporation?

Or consider trustees who engage accountancy services from an accountant based in the UK. It is arguable that the accounting activity amounts to acting as a trustee in the UK. The duty to account to a beneficiary is part of the irreducible core of trustee obligations, which is fundamental to the concept of a trust (*Armitage v Nurse* [1997] 2 All ER 705). The accountant's office will normally be a permanent establishment.

It may be that such activities fall within the exclusion for business carried on 'through an agent of independent status acting in the ordinary course of his business'. It is not clear that the accountant will be acting as the trustee's agent in providing the service and, if the accounting business is a member of the same corporate group or independent association as the trustee, it is not at all clear that it will necessarily be of 'independent status'.

The provision of investment management services raises similar concerns. Where a

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discretionary investment management service is provided, the manager will usually hold the managed investments as bare trustee for the client, in this case the offshore trustee. The manager will normally have notice of the trusts under which the offshore trustee holds the assets. As such he is impressed with those trusts. In these circumstances it is not at all clear that the manager is simply acting in relation to the invested assets as the trustee's agent, or is an agent of 'independent status'.

That is not to say that the Trustee Deemed Residence Rule will apply to deem a non-resident trustee to be resident in the UK whenever it engages accounting or investment management services in the UK. The Courts may well adopt a pragmatic approach in construing this legislation.

What is more, HMRC has stated in correspondence with STEP that the provision of services on an arms' length basis would not cause non-UK trustees to have a permanent establishment and therefore would not of itself make trustees to whom the services are provided UK-resident. They have further said that this would apply even where the service provider is a subsidiary of a trustee. Of course, this statement is of no relevance in determining the law on the matter.

As STEP has pointed out, however, trustees are subject to an onerous duty of care and are therefore very risk-adverse. Because of the disastrous tax consequences that can flow from a corporate trustee becoming resident in the UK, such a company cannot take the risk of becoming so. There is intense international competition in accountancy, and investment management services. There is no need for trustees to take the risk of having a permanent establishment in the UK when they can engage services in, say, Paris or Geneva without being exposed to that risk.

STEP has reported strong anecdotal evidence of business being lost to the UK for this reason. For example, it is aware of a potential initial public offering of a £12bn Ukrainian company held through a trust where it was decided not to list on the London Stock Exchange because the trustees were advised that the Trustee Deemed Residence Rule might make the trust UK-resident. STEP's experience is that foreign trustee shareholders are becoming reluctant to sponsor UK listings of companies because of the risk that regular meetings in the UK with representatives of corporate finance houses could constitute a permanent establishment. Of course, hard statistically-based estimates of lost business are very difficult to make, but STEP has suggested that more than £19bn of business is at risk.

Anecdotal evidence referred to in the Finance Committee debates on the *Finance Act* 2007 suggests that the uncertainties of the Trustee Deemed Residence Rule have already resulted in financial staff being made redundant.

In that debate on 7 June 2007, the then economic secretary to the Treasury, Ed Balls, finally provided an explanation of the purpose of the Trustee Deemed Residence Rule. It was remarkably unconvincing.

First, he explained that 'the changes [it is to be presumed in the context that he referred to the Deemed Trustee Residence Rule] dealt with concerns that professional trustees in overseas institutions were able to develop a substantive UK presence while remaining non-resident for tax purposes'.

This is surely a bizarre justification. The economic secretary failed to distinguish between the place where a business is carried on, which determines how the profits of that business are taxed, and the place where trustees are resident for the purposes of determining how the incomes and gains of the settlement are taxed. That income and those gains are not held beneficially by the trustees. Why should the income and gains of a trust settled by foreign persons with no connection to the UK for the benefit of other foreign persons, who also have no connection with the UK, be subject to taxation here simply because the trustees exercise part of their functions in the UK? For after all, if the exercise of those functions is sufficient to constitute a permanent establishment, branch or agency, the trustees' attributable trading profits will be assessable in the UK.

Second, the economic secretary asserted that the Trustees Deemed Residence Rule is necessary to prevent tax avoidance. He said:

' …that in this complex area there is the potential for considerable tax avoidance. We do not intend to allow that avoidance to occur. … I have no statistics on the extent of the potential tax avoidance, but our integrity and probity [sic] depend on us taking a robust approach towards it. Many opportunities for tax avoidance in this area can be prevented'.

He was challenged to provide an example of any tax avoidance that would be countered by the Trustee Deemed Residence Rule or of any tax avoidance schemes that had been shut down as a result of it. He declined to do so.

The economic secretary's response to the criticism of these provisions was to promise that HMRC would publish 'guidance'. That is no answer at all. HMRC's guidance cannot affect what is or is not the law. HMRC has developed a bad habit of publishing overgenerous constructions of the law in its 'guidance' as a substitute for sponsoring good legislation. Offshore trustees selecting investment managers, stock exchanges or accountancy firms are not going to rely on the UK government's relieving them of a liability due under the law by unacknowledged concessions when they can obtain similar services in other jurisdictions without taking that risk.

Legislative change

The only way of repairing the damage caused by this ill thought-out legislation is legislative change.

The whole sorry story is an object lesson in what happens when the government attempts to 'modernise' complex provisions it does not understand and 'consults' only in order to ignore. Much damage has already been done to our international trust industry and related financial services. The damage could be minimised if the government immediately introduced a common Trustee Residence Test based on the old residence test for capital gains tax purposes. That test would not contain the Trustee Deemed Residence Rule and would have the Professional Trustee Rule in an elective form and extended to situations where the general administration of the trust concerned is carried on in any European Union country.

Will the government recognise the need to repair its mistake, or will it 'support the competitiveness of the UK economy' by driving important professional and financial business into the arms of our competitors overseas?

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