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Trustee Residence: Bring Back King Log

Capital gains tax; Residence; Income tax; Trustees

The frogs in Aesop's fable asked Jove to give them a king. Jove first sent down a log but the frogs complained at their inactive monarch. So Jove sent them a stork which ate them all. The new rules for determining the residence of trustees can have disastrous tax consequences for international trusts and is driving international trustee and financial services business overseas.

When 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" those of us who have some experience of these things shivered. It wasn't that the system for taxing trusts was perfect or free from anomaly. Whenever, however, the Government uses the word "modernise" the experienced prepare themselves for ill-considered and unnecessary changes hedged around with over-complex anti-avoidance provisions which miss, apparently wilfully, the real faults which might usefully be corrected.

A cloud smaller than a man's hand

A paper published on December 17, 2003 giving an overview of the proposals explained that:

> "The Government recognises the important role that trusts play in society. As far as possible it wants a tax system for trusts that does not provide artificial incentives to set up a trust but, equally, avoids artificial obstacles to using trusts where they would bring significant non-tax benefits."

One of the three key criteria for the "modernisation" was to "support the competitiveness of the UK economy".

Commentators might have found all this encouraging except that the attentive saw that there was no reference to the fact that the United Kingdom is a global provider of trustee and related services. The Government seemed to be unaware of the fact that the provision of these services creates wealth in the UK economy, employment for UK citizens and tax revenues from UK-source profits.

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 (CGT) rules which, though not perfect, had worked well for almost 40 years, or adopting the income tax test.

The professional trustee rule

The capital gains tax test contained a special rule for professional trustees (the "professional trustee rule") which was important in attracting international trust business to the United Kingdom. Taxation of Chargeable Gains Act 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 United Kingdom because he was neither domiciled, resident nor ordinarily resident here, professional trustees could exercise their trusteeship and administer the trusts in the United Kingdom and yet the trust would not be treated as resident for CGT purposes.

As the Government's paper of December 17, 2003 ("Modernising the Tax System for Trusts Discussion Paper—Definitions and Tests") explained:

> "The purpose of this rule . . . [was] . . . to encourage the use of professional trustees and lawyers in the UK."

The paper went on to suggest a minor improvement to the rule:

> "We have been told that the rule can be too restrictive and sometimes gives the wrong result. We would like to take views as to the benefits of permitting an election to be treated either as UK resident or non-resident by such professional trustees."

The majority of the respondents to the consultation considered that the new common residence test should be modelled on the CGT provisions, but the Inland Revenue (as it then was) ignored this expert advice and decided to create a test which was a hybrid of the income tax and capital gains tax provisions. On August 13, 2004 they proposed that the CGT approach of treating trustees as a "single and continuing body of persons" should be adopted for the common test but that otherwise the provisions would be based on the more restrictive income tax test. By this stage, the professional trustee rule had disappeared from the proposals and the Chartered Institute of Taxation (CIOT) and the Tax Faculty of the Institute of Chartered Accountants in England and Wales jointly protested in a submission made on October 19, 2004 that:

> ". . . [W]e would not have thought that retaining this provision is anything other than in the interests of UK professional trustees and the UK economy, which is why the provision was enacted in the first place. The proposal to remove it is unreasonable and ignores the competitiveness of this sector in the UK economy."

So the professional trustee rule was brought back into the discussion.

HMRC claimed not to understand why adopting the "income tax test might make it difficult for professional trustees to attract trustee business to the UK . . . ".

If this expression of ignorance was sincere it showed a startling incomprehension of commercial life.

The CIOT responded in a submission on June 17, 2005:

> "We suggest it is self evident that, if a trust set up by a non-resident settlor and run wholly by UK resident professional trustees is to be subject to a 40% capital gains regime, a prudent settlor would not choose such trustees. For many trusts, capital gains taxation is a more significant factor than income tax. Furthermore, needing a non-resident trustee to satisfy the income tax test does deter people from using UK professionals when they would otherwise do so.
>
> In addition, the benefit of the professional trustee provision to capital gains tax purposes is that no non-resident trustee is also required for the trust to be non-resident. This simplifies structures and makes the UK a more attractive base."

When the draft legislation was published on January 31, 2006 two new factors emerged. First, the HMRC "Publication Announcement—Modernising the Tax System for Trusts" said in relation to the minor improvement to the professional trustee rule:

> "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."

This didn't, in words, say that the professional trustee rule would have to be withdrawn, but when one looked at the draft legislation one found that the new election was available only in circumstances where the professional trustee rule would previously have applied. It was, in fact, the professional trustee rule put in an elective form. The material released with the draft legislation did not explain why a provision, with one small alteration, which had existed for almost 40 years should suddenly have become at risk from European law nor did it explain why this risk had not been identified when the original proposals were made in 2003.

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 State aid. In view of this we have had to withdraw the measure."

So 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.

In its representations on the Finance Bill the CIOT asked:

> "Please explain to us the legal basis on which it is now thought that the exemption would constitute unlawful state aid. If this is indeed what is thought, then the appropriate procedure appears to be to notify the European Commission and obtain a ruling or derogation. What legal advice has been obtained on this?"

The CIOT went on to comment:

> "The benefits to the UK economy of retaining global trust business in the UK could still be achieved, it seems to us, by the simple expedient of amending the original draft clauses so that the trustees' residence requirement were enlarged from the United Kingdom to the European Union. Any person resident there could act as professional trustee with the same tax consequences. This was one area on which the representative professional bodies felt very strongly in favour at the consultations. It would be helpful to have more detail on why it was rejected."

In the Finance Committee debates on the Finance Bill 2006 the Paymaster General was asked whether the Government had taken legal advice on the matter and, if so, to share that advice with the committees. In response, she said that the Department of Trade and Industry had advised that the new test would constitute state aid. She refused to share this advice, which she referred to as "legal advice", with the committee, or anyone else.

James Kessler Q.C. (with the support of 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 obtained by HMRC 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 which was also refused.

The opposition spokeswoman, Mrs Villiers, who in the Finance Committee debates of 2006 and 2007 showed an impressive command of her brief, pressed the minister to consider the solution put forward by the CIOT of:

> ". . . giving the same treatment to companies [by which she presumably meant professional trustees generally] as to those based in the rest of the European Union . . . it seems to me to meet all the concerns of the professionals without breaching the state aid rules."

The minister failed to respond to the point.

Ironically, the legislation had failed to create a single definition of trustee residence for income and capital gains tax purposes. Rather it had created two identical definitions contained in separate legislation. Mr Brown had achieved the remarkable result of driving trust business away from the country which had invented the trust concept and had given it to the world without even achieving his original objective.

The trustee deemed residence rule

That was not, however, the end of the bad news that the draft legislation of January 31, 2006 contained.

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 United Kingdom at any time when one of two conditions is satisfied. The first condition is that all the trustees are resident in the United Kingdom. The second condition is that at least one trustee is resident in the United Kingdom and at least one is not and that a settlor in relation to the settlement is resident, ordinarily resident or domiciled in the United Kingdom at a time which 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 Finance Act 1989 s.110. There was, however, one significant addition. It is 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 (the ‘‘trustee deemed residence rule’’) was necessary. The provisions were duly enacted in the Finance Act 2006 which inserted the new CGT provisions into the Taxation of Chargeable Gains Act 1992 s.69 and the new income tax provisions as a new s.685E of Income and Corporation Tax Act 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 Income Tax Act 2007 ss.474–476.

Ironically, therefore, we still have two separate definitions of trustee residence for income tax and CGT 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.

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 worldwide income and gains of the trust will be brought within the scope of UK income and CGT. This will include gains realised during the residence period on assets the increase in the value of which has accrued wholly or partly before the trust became UK resident. If the trustee then becomes non-resident again, it 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 CGT. 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 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 here. Of course the meaning of "a business" has been considered in a large number of cases and is a term of broad impact and is a wider concept than a "trade"[1]. The terms "branch" and "agency" are also words of wide and inexact scope which have troubled and continue to trouble the courts. It is the term "permanent establishment", however, which 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 CGT in Finance Act 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 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".

This is a wider definition that the OECD model treaty definition, because under the OECD Model Treaty the equivalent to s.148(1)(b) is restricted to situations where the agent has authority to "conclude contracts" on behalf of the enterprise.

[1] *American Leaf Blending Co v Director General of Inland Revenue (Malaysia)* [1978] S.T.C. 561, PC.

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 which are of a preparatory or auxiliary nature.

The Society of Trust and Estate Practitioners (STEP) is concerned at 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 United Kingdom perhaps for some temporary purpose or simply because London is a convenient place for persons 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 United Kingdom: it is arguable that the accounting activity amounts to acting as a trustee in the United Kingdom (though see the next but two paragraph below). 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[2]. 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, however, 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 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 assets are held by the offshore trustee. 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 United Kingdom whenever it engages

[2] *Armitage v Nurse* [1997] 2 All E.R. 705.

accounting or investment management services in the United Kingdom. The courts may well adopt a pragmatic approach in construing this legislation.

What is more, HMRC have stated in correspondence with STEP that the provision of services on an arm's length basis would not cause non-UK trustees to have a permanent establishment and therefore would not of itself make the 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 the trustee. Of course, this statement is of no relevance to determining the law on the matter.

As STEP has pointed out, trustees are subject to an onerous duty of care and are therefore very risk averse. Because of the disastrous tax consequences which can flow from a corporate trustee becoming resident in the United Kingdom, 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 United Kingdom when they can engage similar services in, say, Paris or Geneva without being exposed to that risk.

Uncertainty in the scope of the trustee deemed residence rule: damaging to UK business

STEP has reported strong anecdotal evidence of business being lost to the United Kingdom for this reason. For example, it is aware of a potential initial public offering of a £12 billion 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 United Kingdom with representatives of corporate finance houses could constitute a permanent establishment. Of course, hard statistically based estimates of the business lost are very difficult to make but STEP has suggested that more than £19 billion of business is at risk.

Anecdotal evidence referred to in the Finance Committee debates on the Finance Bill 2007 suggests that the uncertainties of the trustee deemed residence rule has already resulted in financial staff being made redundant.

In that debate on June 7, 2007 the then Economic Secretary for 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:

> ". . . [T]he 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 income and gains of the settlement are taxed. Those income and 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 United Kingdom for the benefit of other foreign persons who also have no connection with the United Kingdom be subject to taxation here simply because the trustees exercise part of their functions in the United Kingdom? For after all, if the exercise of those functions is sufficient to constitute a permanent establishment, branch or agency, the attributable trading profits of the trustees will be assessable in the United Kingdom.

Secondly, the Economic Secretary asserted that the trustee 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 which 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 have developed a bad habit of publishing overgenerous constructions of the law in their ``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 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.

Repairing the damage

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 which 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 CGT 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?