UK TRUST RESIDENCE: THE NEW RULES, AND HMRC'S JANUARY 2009 GUIDANCE

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The use of UK trusts and trustees is of importance in international tax planning, particularly as offshore[1] trusteeship becomes problematic for settlors of certain jurisdictions.[2]

Changes to the rules of trust residence became effective from 6 April 2007, and in January 2009 Her Majesty's Revenue & Customs (HMRC) published some useful guidance on the new rules, particularly in relation to the rules of assumed trustee UK residence where a non-UK resident trustee carries on business in the UK through a UK branch, agency or permanent establishment.

This article will describe the new rules of trust residence, and then outline the implications of the new rules for:

(1) Channel Islands and Manx professional trustees who may well travel to the UK regularly in the course of their trust business; and

(2) mixed residence trusts, where, for example, a trust created by a non-UK settlor has one UK resident trustee and one Jersey resident trustee who may be affiliated in some way.[3]

BACKGROUND

The residence of trusts[4] clearly matters.

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1 By 'offshore' is meant a trust whose trustees are resident in a territory that imposes no taxation on trusts and which has no multiple OECD-type tax treaty networks.

2 Italy is an example of a jurisdiction which has now discouraged resident settlors from creating offshore trusts by the introduction of specific anti-avoidance legislation.

3 For example, by belonging to the same group of companies.

4 Pedantically one should refer only to the residence of trustees, but as for both income tax and capital gains tax purposes the trustees of a settlement are deemed to be a single person distinct from the trustees, a more colloquial approach is it is suggested, acceptable, and accords with the terminology used informally by practitioners.

For example, if a discretionary trust is resident in Jersey, it will pay no tax in Jersey on trust income or gains. If on the other hand, a trust is resident in the UK under UK law, it will be liable to pay UK tax at the rate for trusts on worldwide trust income and gains.[5]

Under UK law, the rules of trust residence have always been convoluted, and the recent changes have regrettably not produced a simplified approach.

THE OLD LAWS OF TRUST RESIDENCE

Until 6 April 2007 there were two separate definitions of trust residence, one applicable to income tax, and one for capital gains tax (CGT).

Income Tax (pre 6 April 2007)

Where all the trustees were pre 6 April 2007 resident in the UK, then the trust in question was resident for UK income tax purposes.[6]

Where all the trustees were resident outside the UK then the trust in question was resident outside the UK.

Mixed Residence Trusts

Mixed residence trusts arise where one or more of the trustees is UK resident, and one or more of the trustees is non-UK resident. The rules for determining the income tax residence of such trusts prior to 6 April 2007 were contained in s 110 of the Finance Act 1989 (FA 1989).

These rules provided as follows:

'Residence of trustees

(1) Where the trustees of a settlement include at least one who is not resident in the UK as well as at least one who is, then for all the purposes of the Income Tax Acts—

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[5] The rate for trusts is 40%.

[6] In passing it should be noted that in determining trust residence pre or post 6 April 2007, and in applying the various rules of residence, one has to examine the actual place of residence of the trustees. Therefore, individual trustees' residence is tested under the UK rules of residence of individuals. A corporate trustee's residence is tested under one of the two rules of residence of companies; if it is incorporated in the UK, it is resident in the UK (unless the provisions of an appropriate double tax treaty provide otherwise); if its business is centrally managed and controlled in the UK, it is resident in the UK regardless of its country of incorporation.

(a) if the condition in sub-section (2) below is satisfied, the trustee or trustees not resident in the UK shall be treated as resident there, and
(b) otherwise, the trustee or trustees resident in the UK shall be treated as not resident there (but as resident outside the UK).

(2) The condition referred to in sub-section (1) above is that the settlor or, where there is more than one, any of them is at any relevant time

(a) resident in the UK
(b) ordinarily resident there, or
(c) domiciled there.'

In short, therefore, where the trustees were of mixed residence the decisive factor was the status of the settlor. If the settlor was neither resident nor ordinarily resident, nor domiciled in the UK, the trust was non-UK resident for income tax purposes. Where, however, the settlor was either resident, ordinarily resident or domiciled in the UK, the trust was resident in the UK for income tax purposes.

Capital Gains Tax (pre 6 April 2007)

Prior to 6 April 2007, s 69(1) of the Taxation Chargeable Gains Act 1992 (TCGA 1992) provided the test for trust residence in considering liability to UK CGT.

The relevant provisions were as follows:

'[trusts] shall be treated as being resident and ordinarily resident in the UK unless

(a) the general administration of the trusts is ordinarily carried on outside the UK and
(b) the trustees or a majority of them for the time being are not resident or not ordinarily resident in the UK.'

So prior to 6 April 2007, it would have been sufficient, to achieve non-UK residence for UK CGT purposes, to ensure that a majority of the trustees were non-UK resident, and that the general administration of the trust was carried on outside the UK.

PRE 6 APRIL 2007 CAPITAL GAINS TAX EXEMPTION FOR PROFESSIONAL TRUSTEES

There was, however, an eminently sensible exemption from UK CGT (which would otherwise have been leviable under s 69(1) of TCGA 1992) in favour of UK professional trustees. The exemption was contained in s 69(2):

'(a) ... a person:

(i) carrying on a business which consists of or includes the management of trusts, and

(ii) acting as trustee of a trust in the course of that business.

(b) shall be treated in relation to that trust as not resident in the UK

(c) if the whole of the settled property consists of ... property provided by a person not at the time ... domiciled, resident or ordinarily resident in the UK,

(d) and if in such a case the trustees or a majority of them are or are treated in relation to that trust as not resident in the UK, the general administration of the trust shall be treated as ordinarily carried on outside the UK.'

In other words, UK professional trustees who were managing a trust created by a non-UK resident/ordinarily resident and non-UK domiciled settlor were deemed to be non-UK resident for UK CGT purposes, and their administration of the trust in the UK was deemed to be carried on outside the UK.

The New Rules of Trust Residence from 6 April 2007

The new law creates a common test of trust residence for both income tax and CGT.

The new rules were introduced by the Finance Act 2006 (FA 2006), which adopt proposals originally made in the Trusts Consultative Document (1991), Chapter 10. This material is worth reading by those who wish to learn more about the background and thinking of the proposals.

The FA 2006 created amendments to s 69 of TCGA 1992[7] (as regards residence for CGT purposes) and s 685 of the Income and Corporation Taxes Act 1988[8] (ICTA 1988) (as regards residence for income tax purposes).

So the rules are now the same for CGT and income tax. The legislation sets out the new rules in full, twice over in the income tax and CGT legislation, respectively.

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[7] See new s 69(2D) of TCGA 1992.

[8] See s 685E of ICTA 1988, since replaced and re-written by s 475(6) of ITA 2007.

Applying the New Laws of Residence

All the trustees are UK resident from 6 April 2007

If all the trustees are UK resident, the notional single person[9] is also UK resident.[10] In the informal language of practitioners 'the trust is UK resident'.

There is now no exemption from this rule for professional trustees, who were, prior to 6 April 2007, treated as non-resident for capital gains tax purposes if the settlor was neither resident nor ordinarily resident, nor domiciled in the UK when he made the settlement.

All the trustees are non-UK resident from 6 April 2007

If all the trustees are non-UK resident, then so too is the notional separate body of persons.[11]

Of significance is the fact that from 6 April 2007 and in contrast to the pre 6 April 2007 law as regards capital gains tax residence, there is now no requirement that the place of general administration of the trust be outside the UK.

Mixed residence trusts: the settlor test

If one or more of the trustees is UK resident, and one or more is non-UK resident, then trust residence depends entirely on the residence and domicile of the settlor.

It is to be noted that the 'settlor test' is only applicable to mixed residence trusts. If the settlor, when he created the settlement, was UK resident, or ordinarily resident, or UK domiciled, then the notional tax personality of the mixed residence trust is UK resident.

If on the other hand, the settlor was neither UK resident nor UK ordinarily resident, nor UK domiciled when creating the settlement then the trust is non-UK resident.

Who is the Settlor?

The settlor is separately defined in the income tax and CGT statutory codes. So as with the residency rules, the same rules are applied to both codes. The fundamental position is that a person is a settlor if he has 'made the settlement'.[12] A person is

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[9] Section 474(1) of ITA 2007 and s 69(1) of TCGA 1992 both continue to treat the trustees of a settlement as if they were a single person separate or distinct from the trustees themselves.

[10] See s 475(2) of ITA 2007, and s 69(2A) of TCGA 1992.

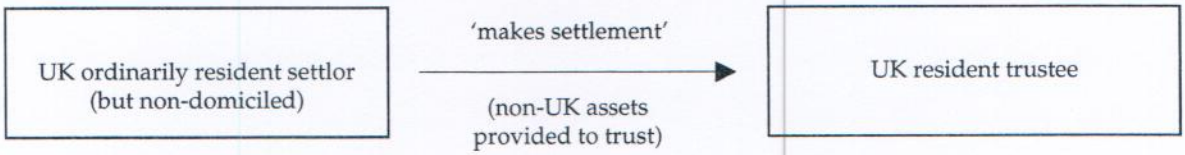
[11] See s 475(3) of ITA 2007, and s 69(2E) of TCGA 1992.

[12] See s 467(1) of ITA 2007 and s 68A(1) of TCGA 1992.

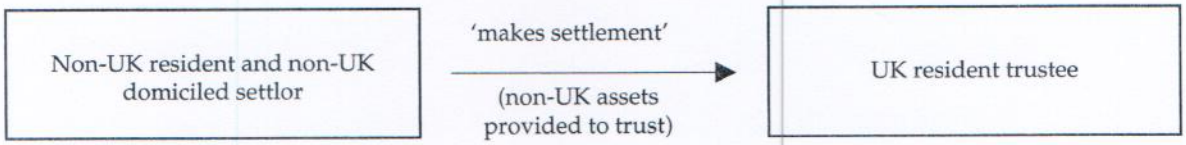
treated as a settlor under this test if the trust arises under his will or intestacy. A person is also treated as having 'made the settlement' if he makes it indirectly through, for example, a nominee, or if he provides property for the purposes of the settlement.[13]

FURTHER EXAMPLES OF THE NEW RULES FROM 6 APRIL 2007: ASSUME ALL TRUSTEES ARE PROFESSIONAL TRUSTEES

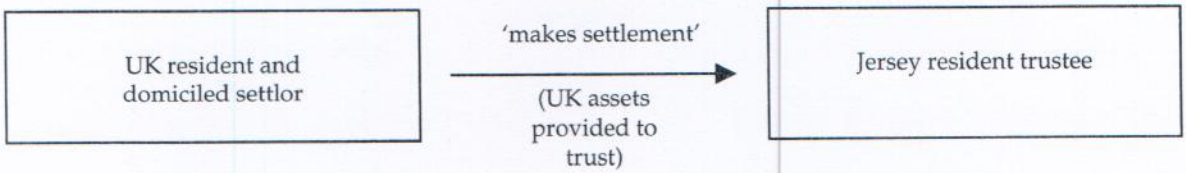
Example 1: the trust is UK resident



Example 2: the trust is UK resident

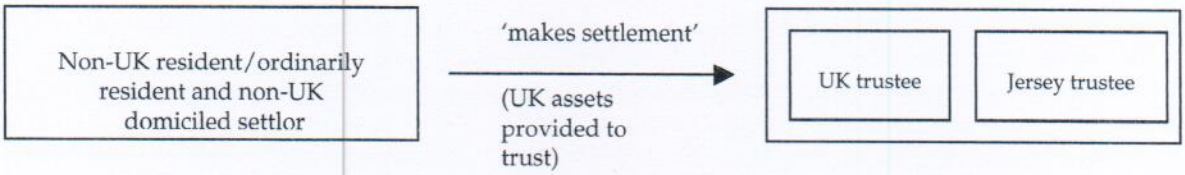


Example 3: the trust is non-UK resident



[13] If a person makes the settlement pursuant to reciprocal arrangements with someone else, the other person is treated as the settlor.

Example 4: the trust is non-UK resident (NB – 'mixed residence trust', so apply settlor test)



In the case of example 4, because the trust is of mixed residence, consisting of one or more UK resident trustees, and one or more Jersey resident trustees, one invokes 'the settlor test'. As the settlor is neither UK resident nor ordinarily resident, nor UK domiciled at the time the trust is created, the trust is treated as non-UK resident.

Note that the non-UK resident status of the trust in example 4 is not affected even if the general administration of the trust is conducted within the UK.

TRAPS

In the case of examples 3 and 4, above, the principal dangers to guard against are:

(1) The sole trustee becoming UK resident (eg in example 3).[14]

(2) A non-resident trustee of a mixed residence trust becoming UK resident (eg in example 4).[15]

(3) A non-UK resident and non-UK domiciled settlor of a mixed residence trust becoming UK resident prior to settling further assets into the trust fund.

In assessing the dangers of these potential traps it will be necessary to determine the locus of the central management and control of corporate trustees, the rules of UK residence of individuals in the case of individual trustees; and finally the rules of residence and domicile in the case of settlors. But it is now also necessary to determine if an otherwise non-UK resident trustee can become resident in the UK under a new test of residence now set out in s 475(6) of the Income Tax Act 2007 (ITA 2007). This is causing a great deal of worry.

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[14] By either central management and control in the case of a corporate trustee being relocated to the UK or by the Jersey trustee carrying on the business of the particular trust via a UK permanent establishment. On this latter point see further below.

[15] Ibid.

Important Extension of the Concept of Trust Residence: UK Branches, Agencies and Permanent Establishments

Section 475(6) of ITA 2007[16] reads as follows:

> 'If at a time a person ("T") who is a trustee of the settlement acts as trustee in the course of a business which T carries on in the United Kingdom through a branch, agency or permanent establishment there, then ... assume that T is UK resident at that time.'

This provision is new, and constitutes a possible trap for the unwary. The provision is not wholly unreasonable, as without it offshore trust companies could conduct trust business through a UK permanent establishment and achieve a more favourable tax treatment than UK trust companies on behalf of a particular trust. Without s 475(6) of ITA 2007 or s 69(2D) of TCGA 1992, a non-UK settlor could create a non-UK resident trust simply by dealing with a UK permanent establishment of a Jersey trustee, rather than dealing with a UK professional trustee.

The issue, then, is to assess what kind of threat the extension of the trust residence rules contained in s 475 of ITA 2007 and s 69 of TCGA 1992 poses to non-UK trustees, such as Jersey, Guernsey and Isle of Man trust companies, who provide offshore trusteeship and whose executives and administrators travel regularly to the UK to meet settlors and beneficiaries, and to promote their trust services to UK professional intermediaries. In many instances the offshore trustees and their representatives will use the UK offices of associated UK companies.

HMRC guidance on the extension of the trustee residence rules to branches, agencies or permanent establishments was published in January 2009.[17]

HMRC guidance has been issued as part of a consultation process which ends on 13 March 2009. The guidance is particularly addressed to overseas trust companies owned by UK groups.

As most professional trustees in the British offshore islands are corporate, the guidance of HMRC will be summarised insofar as it deals with corporate trustees.

The Three-Step Test Propounded by HMRC

HMRC propose a three-step test in determining if an otherwise non-UK resident offshore corporate trustee is nevertheless resident in the UK under the extension rules:

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[16] The CGT equivalent is s 69(2D) of TCGA 1992.

[17] See: http://www.hmrc.gov.uk/cnr/trust-res.htm.

T1	Is the trustee carrying on business in the UK?
T2	If 'yes' is the answer to question 1, is the business being carried on through a permanent establishment?
T3	If 'yes' is the answer to tests 1 and 2, is the corporate trustee carrying on the business of a particular trust in the course of its business through the permanent establishment? If so, the trust under examination will be UK resident

The following comments may be made:

(1) Many offshore companies from the British offshore islands 'carry on business' in the UK by making regular visits to the UK to market their services, or to hold meetings with potential settlors, or their advisors. Even assuming that such activity is conducted in the UK through a UK permanent establishment (so that tests 1 and 2 are 'positive') as these activities do not relate to a particular trust, they are entirely tax neutral.

(2) If it is further assumed that the offshore corporate trustee 'carries on business' in the UK (test 1) through a UK permanent establishment (test 2), and the activities relate to a particular trust, then HMRC makes it clear that it will still be necessary to examine what those activities are before concluding that an offshore trust is UK resident. The HMRC guidance states that only the 'core activities' of trusteeship conducted through a UK permanent establishment on behalf of a particular trust will count as 'business carried on in the UK' in order to result in a trustee residence finding.

HMRC indicate that 'core activities' include:

- the general administration of the trust;
- the over- arching investment strategy;
- monitoring of investments;
- trustee decision-making;
- accounting, tax compliance and record-keeping.

Non-core activities – which are preparatory or auxiliary in nature – include information gathering, and meetings with beneficiaries and agents. These non-core activities are discounted in deciding whether an offshore trustee acts as a trustee in the course of a business which he carries on through a branch, agency, or permanent establishment in the UK.

(3) The guidance from HMRC clarifies that even if an offshore trustee carries on core trust business through a UK permanent establishment it is still necessary to prove that the trust in question is one which the trustee manages and administers through the UK permanent establishment.

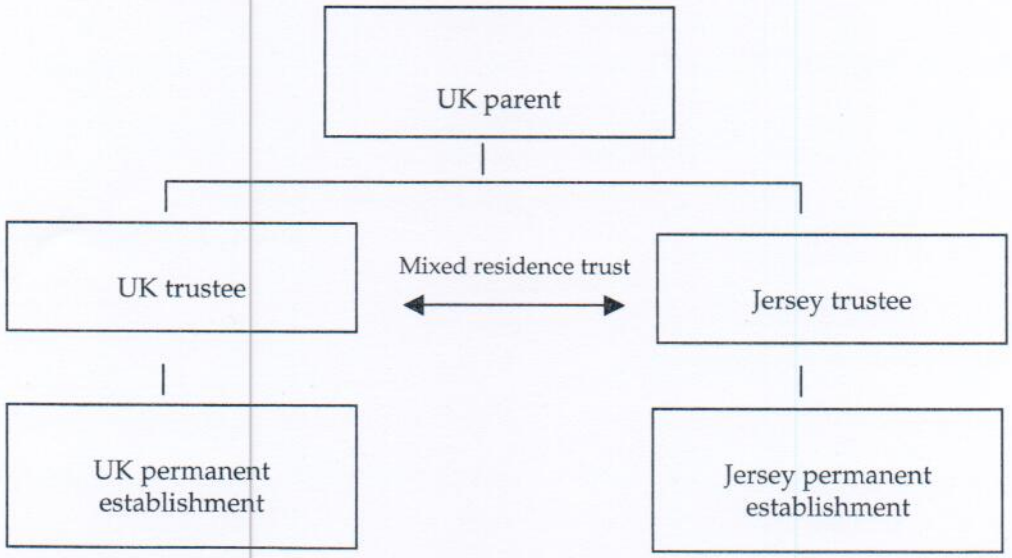
(4) In practice very few offshore trustees conduct 'core activities' as defined in the guidance via permanent establishments in the UK.

(5) Therefore, it may be concluded that the extension rules are much less dangerous than they appear at first sight in the light of HMRC's interpretation of the rules. Readers are recommended to read HMRC's case study examples, which support this 'relaxed' view.[18]

(6) Offshore trustees (eg Jersey or Guernsey trustees) should therefore conduct the core activities of trusteeship (ie all trust management and administration) from their offices in the Channel Islands and confine any UK activity (whether or not from a permanent establishment) to tasks of marketing and business development and, in the case of 'live' trusts, to 'catch-up' or 'communication' meetings.

MIXED RESIDENCE TRUSTS

Consider the following example:

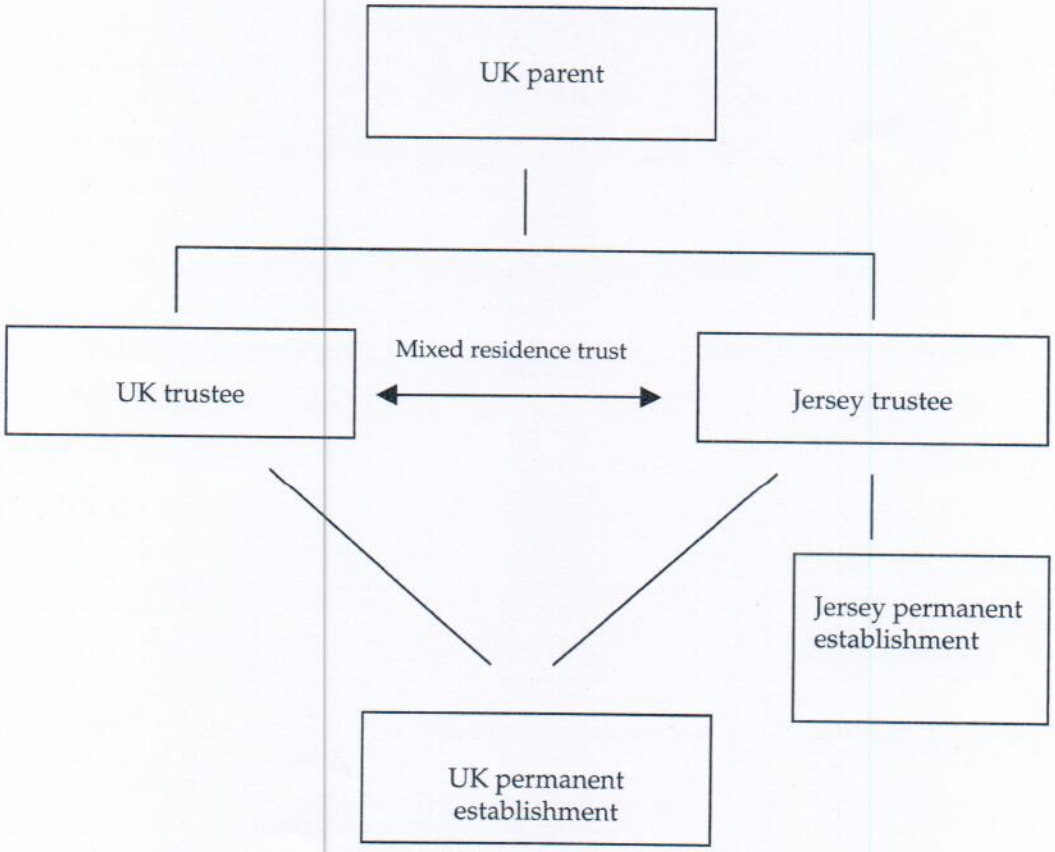


[18] Ibid.

Mixed residence trusts of this kind with non-UK settlors should not be affected by the extension rules.

Provided each trustee conducts its core activities as a separate trustee, the UK permanent establishment of the UK trustee is not problematic, because it is not, per se, a permanent establishment of the Jersey trustee under OECD principles.

But what if the Jersey resident trustee regularly uses the UK permanent establishment?



Even this is not problematical following the HMRC guidance, provided that the Jersey trustee only conducts 'non-core' activities via the UK permanent establishment and ensures that the core activities of its trusteeship, ie trust management and administration are carried on only at the permanent establishment in Jersey.

CONCLUSION

The new extension rules have arguably added some complexity and certainly a great deal of worry in the Channel Islands and Isle of Man concerning the whole issue of trust residence in the UK. However, HMRC guidance is reassuring.

Offshore trust companies can, in the light of the HMRC guidance and general principles, continue to carry on business in the UK, and in fact can do so through UK permanent establishments, provided that the business carried on does not amount to the core activities of trusteeship. HMRC's examples provide useful guidance.

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