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TRUSTS

THE INCOME TAX AND CAPITAL GAINS TAX TREATMENT OF UK RESIDENT TRUSTS

A Consultative Document

Representations would be welcome on the matters discussed in this document.

They should be sent, by 30 September 1991, to:

The Board of Inland Revenue
Resident Trust Review
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CHAPTER 10 : DETERMINING THE RESIDENCE OF TRUSTEES

Introduction

10.1 The residence status of trusts is currently determined in two somewhat different ways: one for income tax and one for capital gains tax. Although there are many similarities between the two tests, the differences can be confusing for trustees. A common test would probably be easier to understand and operate. Such a test is also inherent in the proposals in chapter 7 for an integrated system of taxing the undistributed income and chargeable gains of trusts.

10.2 This chapter summarises the existing residence rules and explains the differences between them. It suggests that both taxes should adopt the present income tax approach to trust residence, and considers possible modifications to that approach. It also makes recommendations on the related topics of ordinary residence and domicile.

The capital gains tax test

10.3 The capital gains tax legislation takes into account various factors in order to determine the residence of a trust. A trust is treated as resident in the UK unless

- the general administration of the trust is ordinarily carried on outside the UK; and
- all the trustees, or a majority of them, are not resident or not ordinarily resident in the UK.

10.4 For the purposes of the test, if the trust had a foreign settlor

- a UK resident professional trustee is treated as not resident (in relation to that trust); and
- if the trust has at least one UK professional trustee, its general administration is treated as ordinarily carried on outside the UK provided that the trustees, or a majority of them, are not resident (or are treated as not resident) in the UK.

10.5 A trust has a "foreign settlor" if the whole of the property in the trust consists of, or derives from, property provided by a person who was, at the time he provided it, not resident, not ordinarily resident and not domiciled in the UK. If property was put into the trust by more than one settlor, or on more than one occasion, these requirements have to be satisfied by each settlor, and on each occasion. Where a trust is created by a will or intestacy the requirement operates as if the trust had been made on the date of the settlor's death.

10.6 A "professional trustee" is any person who is acting as trustee in the course of a business which consists of, or includes, the management of trusts.

The income tax test

10.7 A trust is effectively treated as resident in the UK for income tax purposes unless

- none of the trustees is resident in the UK; or
- at least one trustee is resident in the UK and at least one is not so resident (that is the trustees have mixed residence) and the trust had a foreign settlor.

The treatment if none of the trustees is resident in the UK effectively follows from the general charging provisions in the income tax acts. The rules for trustees who have mixed residence are contained in Section 110 Finance Act 1989.

10.8 For income tax the term "settlor" is defined widely to include any person who has provided or undertaken to provide funds directly or indirectly for the purposes of the settlement. A settlor is treated as foreign in the same circumstances as for capital gains tax (paragraph 10.5).

A common test

10.9 The income tax rules in Section 110 were introduced in 1989 in response to the judgments in Dawson v CIR ([1989] Simon's Tax Cases 473). The House of Lords decided that, as the law stood at the time, a trust with mixed residence trustees could not be taxed as resident in the UK, however strong its connection with this country. Consequently, it would have been possible for a trust with UK resident trustees to escape tax simply by appointing a non-resident trustee and investing the trust funds overseas. The Government took the view that that would not be satisfactory.

10.10 In considering how to deal with the consequences of the Dawson decision, the Government decided that it would not be appropriate just to extend the capital gains tax rules to cover income tax. Instead the test of residence in Section 110 was introduced because

- it involves fewer factors than the capital gains tax test, so it is simpler and easier to apply;
- it offers greater certainty, because it does not involve trying to identify the trust's place of administration;
- it applies criteria which are more relevant since, where trustees have mixed residence, the residence or ordinary residence of a majority of them does not seem to be material; and
- it uses a wide definition of "settlor", so that, where the funds have been provided indirectly by someone resident in the UK, a trust cannot obtain the favourable treatment given to trusts with foreign settlors.

10.11 Because of these advantages it is proposed that, subject to the possible modifications discussed below, the income tax test of residence (paragraph 10.7) should be used as the basis for a common test under an integrated regime.

Possible criticisms of the income tax test

10.12 It has been suggested that, in some respects, the income tax test of residence is unnecessarily onerous compared with the capital gains tax test. The main features mentioned are the treatment of

- UK resident professional trustees; and
- non-resident trustees who become temporarily resident in the UK.

UK resident professional trustees

10.13 When the income tax rule for mixed residence trusts was introduced in 1989, the Government was concerned that it should not harm the business of UK professional trustees who act on behalf of foreign settlors. Section 110 achieves this by taxing as non-resident any mixed residence trust which has a foreign settlor. So any mixed residence trust which is treated as non-resident under the special capital gains tax rule for UK professional trustees (paragraph 10.4) is also treated as non-resident under the income tax test.

10.14 There is, however, a difference between the income tax and capital gains tax tests for trusts with a foreign settlor where all the trustees are resident in the UK. For capital gains tax, such trusts are non-resident provided the trustees (or a majority of them) are UK professionals. But, for income tax, such trusts are treated as resident.

10.15 It may be that the income tax test is not in practice more restrictive because, under it, a trust is treated as non-resident if the settlor retains at least one non-resident trustee. It is quite likely that a foreign settlor would require such a trustee for non-fiscal reasons. Nevertheless, if there were perceived to be significant difficulties in adopting a common residence test based on the present income tax treatment for trusts with a foreign settlor and only resident trustees, some modification of the income tax test could be considered.

Trustees who become temporarily resident in the UK

10.16 A trust could face an unexpected tax liability if it became resident in the UK as a result of a trustee becoming temporarily resident here. That could happen with the income tax test only if

- the trust had a UK settlor, and all the trustees were previously non-resident; or
- the settlor was foreign, and the trustee in question was previously the only non-resident trustee.

10.17 It is not thought that either of these situations is likely to arise very often. If the trustee in question knows in advance that he is coming to this country steps can be taken to preserve the trust's non-resident status, because that trustee could be replaced by another non-resident. Alternatively, in the second situation, an extra non-resident trustee could be appointed. In any case, the second situation might cease to be relevant if the income tax test were modified for trusts with a foreign settlor and only resident trustees (paragraph 10.15).

10.18 Difficulties could, however, conceivably occur if a trustee came to this country at very short notice or became resident here inadvertently. It is not easy to judge whether that is likely to happen often in practice. If there were reason to believe that significant numbers of trustees were likely to become resident inadvertently or at short notice in the situations mentioned in paragraph 10.16, consideration could be given to introducing a rule to prevent the corresponding unexpected changes in the residence of trusts.

Transitional rules

10.19 If a common test of residence, based on the present income tax test, were applied to all trusts under an integrated regime some trusts which are currently non-resident for capital gains tax purposes would become resident, and vice versa. There may not be many trusts affected and those which are might be able to make the transition without significant problems. In particular, it seems unlikely that trusts becoming non-resident would have held-over gains since they would have foreign settlors, so there should be no claw-back charges (Section 79 Finance Act 1981).

10.20 Nevertheless the change could mean that some trusts would face unexpected capital gains tax charges and the migrant settlements provisions (Section 81 Finance Act 1981) would apply. If it were shown that trusts needed to be protected against the effects of the change some transitional provision could be considered. This might take the form of a breathing space in which trusts could retain their existing status for capital gains tax purposes. This would allow time for the appointment of different trustees to enable a trust to achieve its old residence status under the new rules, or for the trustees to prepare for the change.

UK branches of foreign trust corporations

10.21 The income tax test might need to be modified for certain foreign corporate trustees. A trust company, resident outside the UK, could be the sole trustee of a trust which was dealt with in this country by the company's UK branch. It would not be appropriate if such a trust were treated as non-resident, because it would then be taxed more favourably than a similar trust dealt with by a branch of a UK corporate trustee, or by some other UK professional. That could both lead to a loss of tax and put UK professionals at a competitive disadvantage. It is therefore suggested that the UK branch of a foreign trustee should be treated as a trustee resident in the UK for the purpose of the common residence test.

Ordinary residence and domicile

10.22 The capital gains tax rules treat a trust as ordinarily resident in the UK if, and only if, it is resident in the UK. There is no rule determining domicile because that factor can never affect the capital gains liability of a trust.

10.23 There is no income tax rule determining either the ordinary residence or the domicile of a trust. Basic income tax principles, therefore, apply and a trust is effectively treated as not ordinarily resident or not domiciled in the UK if, and only if, all the trustees are not ordinarily resident, or not domiciled, as the case may be.

10.24 For income tax this means that the treatment of a trust can be affected by the ordinary residence and domicile of the trustees. For example, the remittance basis applies to a trust's foreign income if the trustees are resident in the UK but they are all domiciled outside this country.

10.25 It is suggested that here the capital gains tax approach is preferable to the income tax approach. The ordinary residence and domicile of the trustees have no real relevance to the taxation of a trust as they give little or no guidance as to the closeness of the trust's connection with this country. Instead, for income tax a trust should be treated as ordinarily resident and domiciled in the UK whenever it is treated as resident here.

10.26 That approach would mean that the remittance basis could no longer apply to trust income. That basis, however, rarely operates in practice, and there seems to be no good reason why it should continue to be available.

Summary

10.27 This chapter has proposed that

- the present income tax test for determining the <u>residence</u> of a trust should be adopted for capital gains tax as well; and
- a trust should be treated as <u>ordinarily resident</u> and <u>domiciled</u> in the UK if, and only if, it is treated as resident.

10.28 The questions which arise from those proposals are:

a. Would the income tax test cause significant practical difficulties where a trust with a foreign settlor had trustees who were all resident in the UK?

b. Is a provision needed to prevent a trust from being treated as resident in the UK just because a trustee becomes temporarily resident in this country?

c. Would any transitional provisions be required?

d. Should a UK branch of a foreign corporate trustee be treated, for the purpose of a common residence test, as a UK resident trustee of any trust which it was administering in this country?

e. Would any difficulties arise if trusts were treated as ordinarily resident and domiciled in the UK whenever they were treated as resident in this country?