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The tax treatment of trusts in Continental Europe: Belgium, France, Germany, Italy, the Netherlands and Switzerland

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Introduction

No single institution can be found in civil law that can be assigned all those functions for which a common law trust can be used. This explains why trusts have been increasingly being used in civil law countries for both family and commercial purposes.

The first very widespread misconception is that the trust is not recognized by civil law jurisdictions with the consequence that it would not be possible for a resident of one of these countries to set up a trust and/or that it would not be possible either to hold assets in trust in a civil law jurisdiction unless it has ratified the Hague convention on the law applicable to trust which is presently only the case of Italy and of the Netherlands [(1)]. The fact that the trust is unknown in a civil law jurisdiction does not prevent recognition of trusts which are properly created under the foreign law that applies according to the conflict of law rules of this jurisdiction irrespective of whether or not if has ratified the Hague convention.

Although, there are no domestic French, Italian, Swiss… laws of trusts, the French, Italian, Swiss and other civil law countries courts have recognized foreign trusts established under the laws of another jurisdiction which does have its own domestic trust law. In practice, the only real difference between the civil law countries which have ratified the Hague Convention and those

[1] The Hague Convention has also been ratified by Luxembourg

which have not relates to real property. Whereas for example Italian land registration authorities have to permit land to be registered in the name of a trust or its trustees, the French land registration authorities have not and will not.

Of course, the foreign law under which the trust has been created will be applied to the extent that the result of its application is not contrary to public policy. The main obstacle to full recognition of a family trust will be the rules of forced heirship.

The tax treatment of transfers into trusts and distributions out of trusts is obviously critical to their usefulness.

When comparing the tax treatment of trusts in civil law jurisdictions, we find that there are a few general principles which seem to be followed by most if not all of them, at least, up until the tax authorities of a particular jurisdiction decide to adopt a specific provision in order to put on end to what they consider to be tax avoidance.

The purpose of this short article is to briefly describe what the general principles which govern taxation of trusts are and to give an indication of the exceptions.

As a general rule civil law countries levy the following taxes:

- gift/inheritance tax

In many countries progressive rates of tax are charged depending on the value of the property and the degree of relationship between donor and recipient. The rates can be particularly high: e.g. 60 %.

- Income tax/capital gains tax

All countries have an income tax. In continental Europe, it is not uncommon to have marginal rates of 50 % or more. Capital gains are part of income tax sometimes with a lower rate e.g. 27 % in France.

- Wealth tax

In addition a few countries e.g. France and Switzerland have a tax on net assets to be paid whether or not they generate income.

A common characteristic of civil law countries is that with a few exceptions and contrary to the situation in common law countries they do not have specific tax legislation applicable to trusts. This means that general principles governing taxation have to be applied to trusts (even if these rules are inappropriate and/or inconsistent).

How are the general principles governing taxation be applied to trusts?

1. In most civil law countries, the trust is not a taxable entity as such. This means that it will be either the settlor, the trustees and/or the beneficiaries who will be subject to tax and that the taxpayer may be different according to the particular tax to be levied.

2. It is commonly accepted that tax law should be applied strictly. This means that as a general rule and subject to exceptions tax provisions should not be based on analogy and should not be extended to those cases not falling exactly within the ambit of the law. For example, contrary to a common mistake made by many French lawyers, those tax provisions applicable to the draft French law on Fiducie should not be applied to a trust.

3. Trusts are extremely flexible instruments. This means that when confronted with a trust what one should do is to analyse the trust in question on a case by case basis. In this respect a common mistake made both by the civil law tax authorities and by many civil law lawyers is to think that the same tax treatment should be applied to all trusts. It is very unlikely for example that revocable trusts and irrevocable trusts will be treated in the same way. We should also expect that trusts with interests in possession and those without interests in possession will be treated differently.

   Firstly, it seems to be widely accepted that if the settlor has the right to revoke the trust or if he has reserved to himself extensive rights of direction and/or appointment he will normally be treated as if he (or she) owns the trust funds directly. In this case during his/her lifetime the settlor will be subject to the same tax treatment as if no trust had been constituted and the assets held in trust are likely to be treated as part of his/her estate when he/she dies.

   It seems to be generally accepted that trusts entail different tax consequences depending on:

- Whether they are established during the life of the settlor (intervivos trusts) or on death (testamentary trusts),
- Whether they are with or without an interest in possession.

Lastly it seems that it is a general principle (although there are also exceptions) that if the settlor has definitely been deprived of assets in his lifetime even if the beneficiary can be favoured before or after the death of the settlor there is no testamentary disposition and on the death of the settlor the trust assets no longer form part of his estate with inheritance tax not being due.

1. Taxation upon the constitution of a trust

A number of civil law countries charge gift tax on gifts made by resident donors with respect to their worldwide assets whereas non-residents are generally only chargeable on gifts of local assets. In some countries the scope of gift tax is broader. In France for example gift tax is also due if the donee is resident. In the Netherlands citizens who emigrate continue to be considered as resident for gift tax purposes for 10 years after their emigration. On the other hand gift tax has been abolished in Italy and is only due in Belgium in limited circumstances.

From a tax standpoint then the question is whether or not gift tax is due upon creation of a trust.

If the trust is revocable the answer is likely to be no because as indicated above the settlor will probably be treated as if he is still the owner.

If the trust is irrevocable the answer is not so easy unless of course there is a specific statutory provision or case law deeming the constitution of a trust to be an event giving rise to gift tax, as it is now the case in Germany and in the Netherlands.

When there is no such deeming provision which is still the most frequent situation the answer is more difficult to give in those jurisdictions which follow the principles of the Napoleonic Code. This is because a civil law gift requires a number of conditions which will not necessarily be met upon the creation of a trust.

These conditions are generally:

- An impoverishment of the donor
- An enrichment of the donee

- A donative intent

In addition, in some countries the consent of the donee is also required for a gift to be completed. It is clear for example that under both the French and Belgian Civil Codes, a donation is a contract which means that a donation is not completed without the consent of both the donor and the donee.

In the case of a fixed interest trust where the settlor assigns his assets irrevocably and the beneficiaries receive fixed claims to shares of the trust assets, both enrichment and acceptance have occurred and a gift may therefore be deemed to have been completed.

On the other hand in the case of an irrevocable discretionary trust, although a benefit is handed over without payment by the settlor to the beneficiaries the trustees retain the authority to decide at their own discretion whether and to which beneficiary benefits are to be provided.

This means that when the trust is set up the beneficiary's rights are merely expectations. The beneficiary cannot be considered either as being enriched or as having accepted the gift.

Of course the trustee cannot be considered to have been enriched either because he is merely able to dispose of the trust's assets in a trust capacity.

As a consequence the levying of gift tax would not be justified when an irrevocable discretionary trust is set up unless of course tax law provides otherwise (e.g. Germany and the Netherlands).

Looking now at the situation in various countries the situation is a follows:

Belgium:
In Belgium the gift of moveable assets only gives rise to gift tax when the gift in question is evidenced by a deed of a notary public having its seat in Belgium or if the documentary evidence (whatever its nature) is registered in Belgium. In the absence of a Belgian notary's deed or registration of the trust deed in Belgium, gift tax is not due (Belgian real estate cannot be transferred into a trust).

France:

Gift tax which is a tax on the donee is only due when a gift is completed for civil law purposes which only happens when the assets put in trust are distributed by the trustee to the beneficiaries and not at the time of constitution of the trust (see below).

Germany:

Before new legislation came into effect on 5th March 1999 the creation of an intervivos trust and the creation of testamentary trusts were not considered to be taxable events (with the exception of fixed interest trusts). The situation was the same as it is still in France. In other words gift tax was suspended up until the trust was liquidated.

Unfortunately the situation changed dramatically in 1999. The German Tax Code now deems the transfer to assets into an irrevocable trust to be a taxable transfer. The German Tax Code distinguishes between a gift, i.e. the transfer intervivos, and the transfer upon the death of the donor. In either case the transfer of property in trust is a taxable event.

In addition it is the prevailing view that the distributions of both capital and income made by the trustee(s) are subject to German Inheritance and Gift tax (see below).

Italy:

According to an administrative ruling of 1998 (SECIT 37/98), the transfer of assets to a trust constitutes a gift for tax purposes. However, gift tax has been abolished and it has been established by more than one Regional Tax Commission that the constitution of a trust will attract only registration tax at the fixed rate of Euro 129, 11. The transfer of assets to the trust however may, in certain circumstances attract registration tax at the specific rate applicable to the assets transferred.

Switzerland:

The creation of an irrevocable trust is treated as a gift for tax purposes.

If a Swiss resident settlor of a trust does not keep a power of revocation or a power prevailing over the powers of the trustee the transfer is to be analysed as a gift. Such a gift is taxable in the canton of residence of the settlor. The rate of tax varies depending on the type of trust:
In the case of a fixed trust the applicable rate is based on the relationship between the settlor and the beneficiaries.

When the trust is discretionary the rate of gift tax is that which applies to gifts made to third parties. However, in the event that the class of beneficiaries includes only direct heirs of the settlor it is generally possible to obtain a ruling from the local tax authorities providing that the applicable rate is the rate which would have applied in the event of a direct gift to the heirs. If there are more classes of beneficiaries, the tax authorities levy the higher tax rate applying to the category of heirs who are the furthest from the settlor.

In some cantons, an irrevocable trust is treated as a revocable trust (i.e. tax transparent) when the settlor is Swiss citizen and/or the settlor and his/her spouse are the beneficiaries.

The Netherlands:
Up until 1998 the situation was the same as it still is in France. In other words the transfer of assets to a trust was not treated as a gift for tax purposes because such a transfer is not a gift under the civil code. This was confirmed by a decision of a Court of Appeal.

However, in 1998, the Supreme Court of the Netherlands ruled that the transfer of property to an irrevocable discretionary trust is to be considered as a gift to a third party and is therefore subject to gift tax at the progressive rates applicable to third parties.

2. Taxation during the lifetime of a trust

This raises the following questions:
Is a resident beneficiary subject to income tax when a distribution is made by the trust?
Is a distinction made depending whether the distribution is income or capital?
Are there circumstances under which undistributed income accumulated in the trust is subject to income tax in the hands of beneficiaries?
Is a resident beneficiary subject to wealth tax in respect of the property held in trust?

2.1 Income tax

As a general rule revocable trusts are treated as transparent for the settlor.
Concerning irrevocable trust a distinction should be made between distribution of current income and distributions of accumulated income:

- Distributions of current income

In general a beneficiary with an interest in possession is likely to be taxed on the income as it arises.

If the beneficiary does not receive the income as of right but on a discretionary basis, he is also likely to be subject to income tax on the income paid to him as this is the case in France but there are exceptions. In Italy and in Belgium for example, income tax is payable only in respect of income that falls onto certain defined categories and since there are not yet any category for income from trusts it is possible for Belgian and Italian beneficiaries to receive benefits from trusts without any tax liability.

- Distributions of accumulated income

In this case, the situation is unclear in certain countries. Whereas distribution of accumulated income to a French beneficiary for example is clearly subject to tax in his hands it is not so as clear in other jurisdictions. Also if the income is not income, it is then presumably capital and might be taxable as a gift in the hands of the beneficiary in certain jurisdictions.

In some countries anti-avoidance provisions have been adopted under which resident beneficiaries might be taxable as if they owned the assets absolutely (CFC Legislation). This is the case in France for example although we think it does not apply to the beneficiaries of discretionary trusts.

2.2 Wealth tax

It is generally accepted that beneficiaries of a life interest trust are subject to wealth tax and that the taxable basis is to be calculated by reference to the capital corresponding to the income from which the beneficiary benefits.

On contrary, in a discretionary trust, the beneficiaries have no rights to any of the trusts property. Their expectations are too vague to have a monetary value to them and even if the beneficiaries had received more than a mere expectation of payment, they would not be able to convert it into money on a commercial market. They should not consequently in our opinion be treated as owners for wealth tax purposes.

The tax treatment of the trust during its lifetime in the various countries under consideration is as follows:

Belgium:

The Income Tax Code provides that only "interests … and all other returns of loans, deposits … or any **debt** of the same kind" are subject to income tax. When the trust is discretionary, the beneficiary has no right to any distribution and there is consequently no **debt**. Most Belgium tax practitioners consider that in the absence of a proper debt, distributions made under a discretionary trust cannot fall within the scope of the Income Tax Code which means that the Belgian resident beneficiary is not subject to income tax in respect of such distributions. There are however, several qualifications to such a favourable tax treatment:

First, all tax experts admit that it is generally accepted that under certain conditions, "fixed interest" trusts are may be considered as transparent for Belgian income tax purposes. In this case income generated by the assets held in trust is subject to income tax as if the beneficiary had perceived such income directly.

Second, even when the trust is discretionary if the distributions by the trustee to the beneficiary follow a regular pattern the tax authorities would probably uphold that the discretionary character of the trust is a sham and that there is a proper debt with the consequence that the Belgian resident beneficiary is subject to income tax as if it was a fixed interest trust.

Third, article 344 §2 of the Belgian income tax code provides that the Revenue is not bound by any transfer of property by a Belgian resident to a non-resident which is not subject to income tax or is subject to a tax treatment more favourable than the Belgian one. In such a case the Revenue is entitled to levy tax on the Belgian transferor in respect of the income generated by the transferred assets as if the transfer had not taken place. The issue is then whether or not article 344 §2 applies to assets transferred by a Belgian resident to a trustee established in a tax haven. There is no known case in this issue and some authors take the view that article 344 §2 does not apply because the transfer of assets into a trust does not entail a transfer of ownership as defined by the Belgian Civil Code.

France:

The French Tax Code provides specifically that when French resident beneficiaries receive a distribution of income from a trust such income becomes subject to income tax.

Although the French Tax Code contains a CFC provision under which under certain circumstances income accumulated in a low tax jurisdiction is subject to income tax in France it is generally accepted that this provision does not apply to irrevocable and discretionary trusts.

Italy:

According to a tax ruling of 1998 (see above) the Italian tax authorities consider that the Italian resident beneficiary is subject to income tax when there is a distribution of trust income (as in France). The same ruling describes the distribution of income as the distribution of sums produced by the administration of the trust. It seems however, that there is some uncertainty on this point. Some authors take the view that since income tax is payable only on income that falls into certain defined categories and since there is as yet no category for income from trusts it is possible for Italian beneficiaries to receive distributions from trusts without tax liability. However, considering the SECIT ruling of 1998 this view cannot be considered reliable.

Germany:

If the trust is revocable the assets are considered as not having been transferred to the trust. As a consequence the relationship between settlor and trustee is treated as if it was a fiduciary relationship which is as a general rule deemed to be "transparent for tax purposes. In other words the income of a revocable trust is taxable in the hands of the German resident settlor.

If the trust is irrevocable the settlor may also be subject to income tax in respect of the income generated by the assets held in trust when the trust is assimilated to a "family foundation". German tax law defines the term "family foundation" as a foundation which benefits the settlor or his relatives to a level of more than 50%. The German Federal Fiscal Court held in 1992 that the Family Foundations provisions of the German Tax Code also apply to trusts if the trust benefits the settlor or his or her relatives for more than 50%. Even when these provisions do not apply recurrent distributions to German resident beneficiaries could also be subject to German income tax.

Netherlands:

The tax treatment of distributions from a trust to Dutch resident beneficiaries does not seem to be absolutely clear.

It is generally accepted that a distinction should be made between fixed trusts and irrevocable discretionary trusts.

A payment from an irrevocable discretionary trust can in the opinion of most practitioners only be taxed when such a payment is part of a range of payments which can be considered as periodic payments for income tax purposes. The payment will then be taxed in Income Tax Category 1 which among others includes wages and periodic payments and grants (no distinction between income and capital is made).

The undistributed income in an irrevocable discretionary trust can only be taxable in the hands of a beneficiary if the tax authorities can prove that this beneficiary has more than mere expectations.

Concerning life interest trusts in which for example the trustee pays out income from the trust capital to the settlor during his lifetime and after his death pays out the trust assets to his children, an analogy is made with the situation where full ownership is split between usufruct and bare ownership. By settling such a trust the Dutch resident settlor is treated as if he has gifted the bare ownership of the assets to his children (which is a taxable event for gift tax purposes) and has reserved the right of usufruct. Income tax wise both the settlor and his children are taxed in income tax category 3 which applies to income from savings and investments. In this category income tax is levied based on the assumption that a taxable return of 4% is made on the net assets irrespective of the actual return such as interest, dividends and capital gains.

Switzerland:

A revocable trust is always treated as transparent for income tax purposes. In other words income is taxable in the hands of the settlor.

When the trust is an irrevocable fixed interest trust the tax treatment is that applying to usufruct. This means that the beneficiary who has a fixed interest is subject to income tax even if the income is accumulated in the trust. It is worth mentioning that as opposed to the situation in other jurisdictions such as France, capital gains distributed to Swiss resident beneficiaries are not subject to income tax to the extent that these gains can be clearly distinguished from the income accrued by the trust. In addition repayment of capital contributed to the trust should also escape taxation. This obviously requires that the accounting of the trust makes a strict distinction between the sources of funds.

On the other hand when the trust is discretionary the Swiss resident potential beneficiary is not subject to income tax as long as the trustee does not make any distribution. Provided the trust's accounts strictly make the appropriate distinctions regarding the origin of the assets distributed, distributions of capital and accumulated capital gain are in principle tax free. Distribution of income is subject to income taxation. It is important for this reason to avoid interposing an offshore company holding the assets. Such an offshore company would trigger the negative tax effect to convert non taxable capital gain into taxable dividend or interest income (converting effect). The solution is that the offshore company holds the assets on a nominee or fiduciary basis.

2.2 Wealth tax

The tax is only levied in France and Switzerland

France:

In France when a trust is irrevocable it is generally accepted that the settlor drops out of the picture which means that the French tax authorities will have to chose between the beneficiaries and the trustee as the party to be taxed.

When the trustee is a corporate trustee wealth tax is not an issue because only individuals are subject to wealth tax.

Turning now to beneficiaries, a court case of 4th May 2004 confirms that French resident beneficiaries of a discretionary trust are not subject to wealth tax.

Switzerland:

As already indicated a fixed interest trust is subject to the tax treatment applying to usufruct which means that the beneficiary who has a fixed interest is subject to wealth tax. On the other hand as long as the trustee accumulates the income into the trust it is not possible to attribute anything of value to the beneficiaries who are not consequently subject to wealth tax.

3. The tax treatment of liquidation of trusts

It seems that there is a common understanding that gift or inheritance taxes are only levied once either when transferring capital to a trust or when distributing capital from a trust.

Examples:

- In the Netherlands, gift tax due upon donation,
- In France, gift tax due upon distribution
- In Germany which hopefully will remain an exception, gift tax is due both upon formation and distribution.

Belgium:

The distribution of assets made by the trustees is treated as a distribution of capital which as a general rule should not be subject to income tax.

However, if the settlor was domiciled in Belgium on his death, the testamentary trust will be treated as a legacy and trigger inheritance tax. On the other hand, if the settlor was not domiciled in Belgium on his death, the distribution will in no circumstances trigger inheritance tax.

If the settlor was domiciled in Belgium, the tax authorities' stance, as expressed in the only administrative decision concerning an inter-vivos trust, is that distribution made by the trustee in accordance with an inter-vivos trust, after the decease or in the three years preceding the decease, will trigger inheritance tax. Although this view could be challenged before courts we consider that the issue of such a trial would be uncertain.

France:

The gift which was suspended upon the creation of the trust is completed and gift or inheritance tax become due when the trust fund is distributed to the beneficiaries of the trust capital.

Germany:

As a consequence of the settlor of a revocable trust being treated as if he were the beneficial owner of the assets of the trust, distribution of such assets by the trustee to the settlor is not taxable.

When the trust is irrevocable, the distribution by the trustees of assets to the beneficiaries is subject to German Inheritance and Gift tax although this tax has already been collected upon constitution of the trust.

Italy:
According to the tax authorities the distribution of trust capital is not subject to income tax but to gift tax which is good news since gift tax has been abolished. In certain circumstances however registration tax might be applicable.

The Netherlands:
The distribution of assets made by the trustee upon liquidation of the trust is treated in the same way as already explained.

Switzerland:
The distribution made upon liquidation of the trust is treated in the same way as a distribution made during the lifetime of the trust.

Conclusion

The absence of specific tax legislation for trusts with the absence of sufficient understanding of trusts by the tax authorities of most civil law countries means:

On the one hand that the tax treatment of trusts is the subject of uncertainty in a number of civil law countries.

On the other hand and for the same reason, the trust is still very often more tax efficient in civil law countries than in common law countries because of the lack of specific anti avoidance provisions.