

DUTCH TAXATION OF IRREVOCABLE DISCRETIONARY PRIVATE EXPRESS TRUSTS

Frank Biemans¹

1. Introduction

The last decades the use of the trust for tax planning reasons has increased rapidly, also in the Dutch tax jurisdiction. More and more the trust is used by taxpayers for tax avoidance purposes. By using the discretionary trust taxpayers were able to create ‘a floating’ capital, that could not be taxed in the Dutch tax jurisdiction. The Dutch legislator, determined to do something about it, introduced the so called separated personal assets regime. A new regime was introduced. The gist of the regime lies in the Dutch Personal Income Tax Act 2001 (hereinafter PITA 2001) and Inheritance Tax Act 1956 (hereinafter ITA 1956).² In this paper I will discuss the taxation of the trust in the Personal Income Tax, Corporate Income Tax and the Gift Tax.³ The trust occurs in Anglo-American law in many different forms. This paper only deals with the taxation of the irrevocable discretionary private express trust. More particularly, I will focus on the irrevocable private express trust *inter vivos*.⁴ This trust is founded by the settlor during his life and is not revocable.

First I will set out some general characteristics of the irrevocable private express trust. Then I will focus on the Dutch taxation of the trust where I will discuss the Personal Income Tax, the Corporate Income Tax and the Gift Tax. After that I will

1 F.H.G. Biemans, master student tax law Radboud University Nijmegen.

2 Article 2 14a PITA 2001; Article 16, 17 and 17a ITA 1956.

3 The Inheritance Tax will not be discussed.

4 The testamentary trust or trust *moris causa* is also possible. See for example G.D.L.M. Gilissen, *De express private trust. Fiscaalrechtelijke beschouwing over kwalificatie en gevolgen*, Deventer: Kluwer 2012, p. 296; W.J. Zwolve, C.Æ. Uniken Venema's *common law & civil law: inleiding tot het Anglo-Amerikaanse vermogensrecht*, Den Haag: Boom juridische uitgevers 2008, p. 279.

make some observations about the separated private assets regime. Finally, I will give you my conclusions.

2. Characteristics of the trust

The Netherlands is a civil law country. The Dutch civil law is, like the civil law of other countries on the continent of Europe, based upon (the reception of) Roman private law (*Corpus Iuris Civilis*), which has functioned as *ius commune* until the 19th century when the codification of civil law began.⁵ Before the reception of Roman law on the continent started, England had already its own 'common law'. This law didn't function as subsidiary law as the Roman law did on the continent, it was applied exclusively.⁶ The Dutch civil law is unfamiliar with the concept of trust that developed in common law.

For many years writers on the continent of Europe have tried to search for a comparable legal figure in the civil law tradition. However, there are some legal figures that are for a part comparable, there is, in my opinion, no legal figure in the Dutch civil law that is fully comparable with the common law trust. Only in the culture of common law were the right unique circumstances of common law and equity to let arise the figure of the trust.⁷ The Dutch civil law does not distinguish between legal ownership and equitable ownership. These types of ownership are not comparable to the Dutch civil law ownership. Dutch law only recognises an absolute ownership. This ownership can be split into a legal ownership and an economic ownership.

The trust is an entity in common law. The settlor is the founder of the trust. The trust is created to hold assets for the benefit of one or more persons, who are called the beneficiaries. These beneficiaries will receive assets or profits from the trust. The trust is managed by the trustee under the terms of the trust.

In case of the private express trust the settlor transfers assets to a trustee by means of a unilateral legal action. The trustee gets a legal title to the trust capital (he becomes the legal owner) and the obligation to administer the assets on behalf of one or more beneficiaries in accordance with the trust conditions mentioned in the trust instrument. The assets transferred to the trustee are not part of the trustees'

5 W.J. Zwalg, C.Æ. *Uniken Venema's common law & civil law: inleiding tot het Anglo-Amerikaanse vermogensrecht*, Den Haag: Boom juridische uitgevers 2008, p. 5.

6 W.J. Zwalg, C.Æ. *Uniken Venema's common law & civil law: inleiding tot het Anglo-Amerikaanse vermogensrecht*, Den Haag: Boom juridische uitgevers 2008, p. 5.

7 W.J. Zwalg, C.Æ. *Uniken Venema's common law & civil law: inleiding tot het Anglo-Amerikaanse vermogensrecht*, Den Haag: Boom juridische uitgevers 2008, pp. 296 – 270.

personal capital. The trust capital is therefore unaffected by bequest, private creditors and bankruptcy of the trustee.

In case of a fixed trust the settlor appoints one or more beneficiaries, who become equitable owners of the trust capital with an equitable title. In case of a discretionary trust however, the settlor appoints a group of (legal) persons that only have conditional interests. In that case the trustee is given the power to decide which person of this group and when gets what title to the trust capital. For as long as the trustee has not used his discretionary power to appoint beneficiaries and laid down their capital rights, there are no (legal) persons with an equitable title to the trust capital and its proceeds. Nobody can claim the beneficial interests in the trust capital. Before the private assets regime came into force the capital of the trust was – from a Dutch point of view – ‘floating’.⁸

3. Dutch taxation of the irrevocable discretionary private express trust

Four taxes are involved in the potential taxation of the trust, the Personal Income Tax, the Corporate Income Tax, the Gift Tax and the Inheritance Tax. In this paper I will only discuss the Personal Income Tax, the Corporate Income Tax and the Gift Tax. To clarify the taxation I will use the following example.

Let's suppose the following conditions.

- 1) The settlor and the beneficiaries are Dutch resident taxpayers.
- 2) The trust is founded under the jurisdiction of a tax haven, let's say the Cayman Islands.
- 3) The trustee is H trust & co Ltd which is established in the Cayman Islands.
- 4) The settlor transfers assets to the trustee and creates a trust capital. The value of the transferred assets is € 5 million.
- 5) The settlor appoints his wife and his children as beneficiaries. The trustee gets the discretionary power to decide which person of this group and when, gets what title to the trust capital.

A distinction has to be made between the situation before the separated personal assets regime came into force and after it came into force.

In Dutch fiscal law ‘the principle of uniformity in law’ is applicable. For taxation purposes the Dutch fiscal system mainly uses terms that find their origin in the

8 Kamerstukken II 2008/09, 31.930, no. 3, p. 9.

Dutch civil law. Therefore, taxation is based upon characteristics of a legal figure in civil law.

Before foreign legal forms can be taxed under the Dutch tax legislation, they must be recognized under Dutch law. The Hague Trust Convention enforces the Netherlands to recognise the irrevocable private express trust as a legal form. According to the Supreme Court of the Netherlands (hereinafter: Supreme Court), the following approach aligns best with The Hague Trust Convention and the in case law prevailing opinion before the treaty was adopted.⁹ Firstly, it is necessary to verify if the trust is established in accordance with the law that is applicable to the trust. Secondly, it must be investigated how the Dutch fiscal law must be applied on the basis of the civil law characteristics that originate from the trust.¹⁰ Let's suppose that in the example the trust is founded in accordance with the law on the Cayman Islands.

3.1. Personal Income Tax and Corporate Income Tax

The Dutch tax system for Personal and Corporate Income Tax is set up as a subject-focused system. The subject does not only act as a taxable person, but also as an 'allocation centre' for tax objects.¹¹

The subject in the Personal Income Tax is the natural person. The subjects in the Corporate Income Tax are not so evident. Not only legal persons can be a subject but also certain entities without legal personality can be a subject. Unfortunately, there is no overarching characteristic that is decisive for the qualification of an entity as subject in the Corporate Income Tax.

The Dutch Personal and Corporate Income Tax can be assumed to be a coherent system. Overlaps and blank spots are not intended.¹² The Dutch tax system does not have a rule that determines that when a legal figure according to the normal rules cannot be taxed in both the Personal Income Tax and the Corporate Income Tax is still liable to the Corporate Income Tax.¹³ Because of the lack of this rule, it

9 HR 18 November 1998, *BNB* 1999/35c, 3.5.

10 G.D.L.M. Gilissen, *De express private trust. Fiscaalrechtelijke beschouwing over kwalificatie en gevolgen*, Deventer: Kluwer 2012, p. 276.

11 J.P. Boer, *De Anglo-Amerikaanse trust in de inkomsten- en vennootschapsbelasting*, Den Haag: Sdu Uitgevers 2011, pp. 73 – 75.

12 J.P. Boer, *De Anglo-Amerikaanse trust in de inkomsten- en vennootschapsbelasting*, Den Haag: Sdu Uitgevers 2011, pp. 44 – 45.

13 See for an example of this kind of rule Article 3(1) of the German Körperschaftsteuergesetz.

is not impossible that there are overlaps and blank spots between the Dutch Personal Income Tax and Corporate Income Tax.

The trust can only be taxed as a non-transparent entity in the Corporate Income Tax if the trust as a legal figure can be qualified as a non-transparent legal figure and the Corporate Income Tax does also mention the trust as a subject in Article 2 or 3 CITA 1969. Whenever a legal figure can be found in a legal relationship, this form will be qualified either as a non-transparent entity or as a transparent entity. The qualification is based upon civil law characteristics of the legal figure that is involved.

These civil law characteristics of a legal figure reveal a certain degree of independence. The following main criteria can be identified.¹⁴

- *Entitlement to underlying assets/income (entitlement criterion)*
Has anyone a direct entitlement to the underlying assets/income without a decision to distribute income?
- *Liability underlying parties (liability criterion)*
Are the underlying persons liable beyond their amount of their contribution?
- *Open legal form (open character criterion)*
Is it an open legal form?
 - Are there participation certificates?¹⁵
 - If yes, can the participation certificates be transferred without any limitations? (Free accession and resignation is possible).
 - If no, is in respect of this legal figure free accession and resignation possible?

When there is no direct entitlement to the underlying assets/income and the underlying persons are not liable beyond the amount of their contribution, it should be concluded that the legal figure is a non-transparent entity. If there is someone with a direct entitlement to the assets/income of the legal figure and the underlying persons are liable beyond their contribution, the legal figure should be qualified as

14 J.P. Boer, *De Anglo-Amerikaanse trust in de inkomsten- en vennootschapsbelasting*, Den Haag: SDU Uitgevers 2011, pp. 122 – 142. For a detailed overview I refer to the above mentioned dissertation of Boer.

15 It's not necessary that there are participation certificates to come to the conclusion that a legal figure is an open legal form.

a transparent entity, unless it is an open legal form by which accession and resignation is possible.

In my opinion, the irrevocable discretionary private express trust should according to its civil law characteristics be qualified as a non-transparent entity. No one has a direct entitlement to the trust capital. The beneficiaries have conditional entitlements to the trust capital during the time the trustee has not used his discretionary power. The settlor has no interest in the trust capital after he separated his assets in the trust capital. The trustee has only the legal ownership, and therefore, no economic interest in the trust capital. There is nobody who has a direct entitlement to the underlying assets/income. Furthermore, the beneficiaries are also not liable for debts of the trust. So the liability criterion is not met. The trustee is with his private assets liable for debts incurred in connection with the administration of the trust. However, according to the provisions in the trust act these commitments undertaken in the context of the trust capital can mostly be recovered from the trust capital.¹⁶

The third criterion (open legal figure criterion) is according to case law not relevant when nobody has a direct entitlement to the underlying assets and the underlying persons are not liable beyond their contribution.¹⁷

Now the discretionary trust is qualified as a non-transparent entity, the trust itself (as a legal figure) could therefore – in potential – be taxed under the Corporate Income Tax as a special purpose fund. The Corporate Income Tax Act however, does only recognise a special purpose fund as subject for foreign taxpayers.¹⁸ When the trust is a domestic taxpayer the trust cannot be taxed. Furthermore, a foreign taxpayer can only be taxed for Dutch income. It is possible that a tax convention between the Netherlands and the country where the trust is established is applicable which influences the tax base of the Netherlands. But, it is also imaginable that this trust hasn't got Dutch income.¹⁹ In the above given example the trust is a foreign taxpayer, its residence is on the Cayman Islands.

After I have discussed the possibility of taxing the trust as a legal form itself, the question arises if it is possible to tax the underlying persons in the trust relationship. Below I will first discuss the situation before the separated private

16 J.P. Boer, *De Anglo-Amerikaanse trust in de inkomsten- en vennootschapsbelasting*, Den Haag: SDU Uitgevers 2011, p. 281.

17 J.P. Boer, *De Anglo-Amerikaanse trust in de inkomsten- en vennootschapsbelasting*, Den Haag: SDU Uitgevers 2011, p. 282.

18 Article 3 CITA 1969.

19 Dutch income is formulated in Article 17(3) and Article 17a CITA 1969

assets regime came into force, than I will discuss the situation after the separated private assets regime came into force.

The underlying persons can only be taxed if they have an economic interest in the trust capital. This interest can, dependent on the circumstances, for example, be qualified as annuity,²⁰ or as income from savings and investments.²¹ The irrevocable discretionary private express trust can, in my opinion, be qualified as a non-transparent legal figure in the Dutch Corporate Income Tax sphere. In the Personal Income Tax sphere this trust is therefore also seen as a non-transparent figure and cannot be taxed as a transparent legal figure.

The settlor has, after he separated assets to the trustee, no interest in the trust capital. The trustee has only a legal right to the trust capital. This legal interest is not enough to be taxed. The legal interest does not give the trustee a direct economic interest, so he can't be taxed. The beneficiaries have, as long as the trustee has not used his discretionary power, not a direct economic interest in the trust capital and as a result they can't be taxed either. Therefore, from a Dutch point of view, the trust capital was 'floating'.

The separated private assets regime was introduced on the first of January 2010 to remove problems relating to existence of untaxed, not immediately allocable assets. The gist of the regime lies in the allocation of the assets, debts, revenues and expenses of the trust to the settlor.²²

In accordance with the separated private assets regime, the assets of the trust are allocated to the settlor of the trust. The trust assets and the resulting income are attributed to the settlor during his life, and under circumstances to his heirs.²³ So the settlor is as a result of this new regime subject to Personal Income Tax. The nature of the assets determines if the assets and there proceeds are taxed in box 1 (income out of work and home), box 2 (income of substantial business interest) or box 3 (tax on savings and investments).²⁴ It is important to bear in mind that the allocation to the settlor does not take place if reasonable tax is levied on the level of the trust (or other private fund) itself. The allocation of assets to the settlor by

20 Article 3.101(1) PITA 2001.

21 Article 5.3 PITA 2001.

22 Article 2.14a PITA 2001.

23 Unlike the settlor, an heir can deliver opposite evidence that he has no interest in the trust capital and never will get an interest in the trust capital. I'm not discussing the collecting of the tax and the new Article 23a of the Collection of State Taxes Act 1990.

24 Article 2.7 PITA 2001.

fiction does not mean that the trust for tax purposes is qualified as a transparent legal figure. In the Corporate Income Tax the trust can still be seen as special purpose fund.²⁵ In other words, the regime does not affect Article 3 CITA 1969.

3.2. Gift Tax

Subject in the Inheritance Tax Act 1956 for acquisition through inheritance and gifts is the transferee.²⁶ This can be a natural person, a legal person, and according to the case law from the Supreme Court, also a special purpose fund.²⁷

For the taxation of gifts in Dutch law it is required that the wealth of the donor of the gift is reduced out of generosity and the receiver of the gift is enriched or will be enriched.

The following conclusions can be drawn about the Gift Tax before the separated private assets regime came into force. The trustee in the example is not a Dutch resident. And if he were, he could not have been taxed because he has only a legal right to the trust capital, not an economic one. Therefore, he is not enriched. What about the beneficiaries? As long as the trustee hasn't used his discretionary power to appoint beneficiaries and laid down their capital rights, there are no beneficiaries with a legal title to the trust capital and its proceeds. It cannot be said that there is a beneficiary that is enriched.

Before the adoption of the separated private assets regime, the Supreme Court decided that under circumstances the trust itself can be subject to the Gift Tax as a special purpose fund.²⁸ The Supreme Court decided in a case of a discretionary trust that a person living within the borders of the realm cannot out of generosity part his assets (for example by creating a trust) without being subject to the Gift Tax. According to the Supreme Court, the creation of a discretionary trust inter vivos results in the creation of a special purpose fund belonging to nobody, and is set aside for a particular end, so that for the levying of the Gift Tax the discretionary trust, as an independent entity under fiscal law, must be considered as a special purpose fund, resulting in the Gift Tax rate for non-relatives.²⁹ The

25 With the introduction of the separated private assets regime the Corporate Income Tax is only in a very summarily changed. See Article 8(15) CITA 1969.

26 In case of acquisition through inheritance this is the heir and in case of a gift this is the donee.

27 HR 18 November 1998, *BNB* 1999/35c.

28 HR 18 November 1998, *BNB* 1999/35c, 3.5.

29 G.D.L.M. Gilissen, *De express private trust. Fiscaalrechtelijke beschouwing over kwalificatie en gevolgen*, Deventer: Kluwer 2012, pp. 656 and 277 – 278.

trust was therefore, before the separated assets regime came into force, taxed as a separated purpose fund.

The above mentioned ruling of the Supreme Court gave rise to tax planning. In case the trust capital is transferred by a non-resident as meant in article 3 ITA 1956 or the transferred assets do not have much value yet (for example: options or patents), the gift cannot be taxed.

After the separated private assets regime came into force, the taxation in the Gift Tax is different. According to Article 17a ITA 1956 the transfer of assets from the settlor to the beneficiary cannot be taxed. The transfer of assets by the settlor can no longer be seen as a gift. Article 17 ITA 1956 gives a fiction by which all interests out of the trust capital are designated as taxable gifts of the settlor to the beneficiaries.

4. Main observations separated private assets regime

The following main observations can be drawn about the separated private assets regime relating to the Personal Income Tax Act and Corporate Income Tax Act.³⁰

- The separated private assets regime disregards civil law reality, due to its allocation rules. As mentioned before, the assets of the trust are allocated to the settlor (and under circumstances his heirs). Under the separated private assets regime trusts are ignored as an independent non-transparent entity, while on the bases of its civil law characteristics it can be qualified as a non-transparent entity. Also, the before mentioned allocation of the trust assets to the settlor leads to the extension of the Dutch tax jurisdiction.
- The allocation of separated assets of the trust to the settlor (and under circumstances his heirs) is without further justification and contrary to the ability-to-pay principle. It may result in persons being taxed for income and assets which they do not and maybe never will possess.
- The different allocation of assets is not the same as the situation that – for tax purposes – the trust is qualified as a transparent entity. Therefore, the trust as an entity ‘is still there’ which leads to several complications of the separated private assets regime. The beneficiaries retain a legally full enforceable right to the trustee. As a result there is no tax transparency towards the beneficiaries.

30 J.P. Boer, *De Anglo-Amerikaanse trust in de inkomsten- en vennootschapsbelasting*, Den Haag: SDU Uitgevers 2011, pp. 390 – 391.

- The distinction between taxable and non-taxable separated private trust assets results in a dual approach causing an unequal treatment of separated and non-separated assets due to non-allocation to the settlor (and under circumstances his heirs) if reasonable tax is levied on the level of the trust (or other private fund) itself. The objective of the Dutch legislator was to treat separated and non-separated assets equally as much as possible. This objective has not been achieved. Primary because the allocation does not apply if the separated private assets are subject to reasonable taxation.

In accordance with the above-mentioned general observations, it should be concluded that the separated private assets regime does not fit well in the Dutch taxation system.

In my opinion, a possible alternative for the separated private assets regime can be found in the taxation of the trust through an entity approach. In this entity approach the trust will be taxed as a special purpose fund in the Corporate Income Tax. In this approach, the trust is taxed as a non-transparent legal figure. In this way the taxation of the trust aligns with the economic reality and it fits well in the Dutch tax system. This entity approach has the major advantage that the tax due by the trust is effectively charged to the ultimate beneficiaries (in an indirect way). On the other hand, taxation of the trust through an entity approach also presents some drawbacks. The major disadvantages of applying an entity approach are that more detailed legislation is required and the power to tax is to be established based on the national residences of the trust.³¹

5. Conclusion

In this paper I have made some observations on the taxation of the irrevocable discretionary private express trust under Dutch tax law. The Dutch system of Personal Income Tax and Corporate Income Tax is subject focused. In these taxes the subject does not only act as a taxable person, but also as an 'allocation centre' for tax objects. The subject is in principle decisive for the applicability of the Personal Income Tax or Corporate Income Tax. The subject in the Personal Income Tax is clear. The subjects in the Corporate Income Tax are not so evident. In general it can be said that legal figures with a certain degree of independence are subjects in the Corporate Income Tax. However, there is not one decisive overreaching characteristic which is decisive for giving a legal figure subjectivity in the Corporate Income Tax. The Dutch Personal and Corporate Income Tax can be assumed to be a coherent system. Overlaps and blank spots are not intended. It

31 J.P. Boer, *De Anglo-Amerikaanse trust in de inkomsten- en vennootschapsbelasting*, Den Haag: SDU Uitgevers 2011, p. 421.

is, however, not impossible that there are overlaps and blank spots between the Dutch Personal Income Tax and Corporate Income Tax.

Through an example I have illustrated the taxation of the discretionary trust in the Personal Income Tax, Corporate Income Tax and the Gift Tax. A distinction has to be made between the situation before and after the separated private assets regime came into force.

The qualification of a legal figure upon its civil law characteristics as a non-transparent or transparent legal figure is the first step in the determination process by which it is determined whether the legal figure can be taxed in the Personal or Corporate Income Tax. For being recognised as a taxable subject for the CITA 1969, it is not only necessary that a legal figure (such as the trust) can be qualified as a non-transparent entity, it also has to be mentioned on the exhaustive list of subjects laid down in article 2 and 3 of the CITA 1969.

It has been concluded that according to its civil law characteristics, the irrevocable discretionary private express should be qualified as non-transparent legal figure. This means that – in potential – the irrevocable private express can be taxed as a special purpose fund in the Corporate Income Tax. Due to the fact that the CITA 1969 only recognizes a special purpose fund as subject for foreign taxpayers, only trusts that are resident of a jurisdiction other than the Netherlands, can be taxed in the Corporate Income Tax for their Dutch income. In other words: trusts that are resident in the Netherlands cannot be taxed in the Dutch Corporate Income Tax.

In the situation before the separated private assets regime came into force, the underlying persons in the trust relationship could not be taxed, because the trust capital was floating and could not be attributed to any underlying person. For the Gift Tax it is concluded that before the private assets regime came into force, the irrevocable private express trust itself could only be taxed as special purpose fund.

The private assets regime, which came into force on the first of January 2010, leads for the Personal Income Tax to a different allocation. The assets of the trust are by fiction attributed to the settlor during his life and afterwards to his heirs.

The private assets regime does not fit well in the Dutch fiscal system. This is mainly caused by the allocation by fiction, which does not follow the economic reality. Through the allocation by fiction the trust as a non-transparent figure is ignored. Furthermore, the allocation can lead to a contradiction of the ability-to-pay principle. When the settlor separates the assets for the trust, he has no interests left in the trust capital and he will be taxed for assets he does not possess and probably will never possess.

In my opinion, a possible alternative for the separated personal assets regime can be found in the taxation of the trust through an entity approach. In this entity approach the trust itself as a non-transparent legal entity is taxed in the Corporate Income Tax. This entity approach has the major advantage that the tax due by the trust is effectively charged to the ultimate beneficiaries.