INTERNATIONAL TAX AVOIDANCE USING TRUSTS: HOW CAN CYPRUS FACILITATE THIS FORM OF TAX PLANNING

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Introduction

'Every man is entitled to do what he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be'[2].

The philosophy of tax planning stems from the *Duke of Westminster*[3] case, where Lord Tomlin in the House of Lords stated the above famous quote. The Duke of Westminster had covenanted to pay his gardeners remuneration which they could characterise as annuities and could be tax deductible rather than the weekly non-deductible payment he used to make to them.

The need of tax planning emerged through the increase of globalisation and international economic prosperity. Thus, an increased requirement of being effective and competitive quickly became inherent in the tax legislation of all countries as taxation is a central issue for each modern government both from the

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2 IRC v Duke of Westminster [1936] AC 1 at page 19

3 ibid

executive point of view and the taxpayers' point of view. A compromise should be made between the need of governments to conserve and increase their revenue streams for the social and economic welfare of the state and the desire of the taxpayers to protect their property and legitimate commercial activity from any arbitrary deductions[4]. The result can be either prudent tax planning or simply tax avoidance. It is argued by the Institute for Fiscal Studies that *'if governments wish to limit avoidance, they should avoid enacting the kind of legislation that positively invites it!'*[5].

Along with economic developments the idea of tax planning evolved as well as is evident from a range of opinions across different case law approaches. Philip Baker QC raises the point that '*merely taking tax into account in deciding whether or not to go ahead with a transaction or structuring a transaction should not be avoidance; that should still come within the category of mitigation. It goes back to homo economicus…*'[6].

The House of Lords in the *Willoughby*[7] case brought to the surface a more precise explanation of tax mitigation:

> The hallmark of tax mitigation […] is that the taxpayer takes advantage of a fiscally attractive option afforded to him by the tax legislation and genuinely suffers the economic consequences that Parliament intended to be suffered by those taking advantage of the option.

Furthermore, the Court of Justice of the European Union (hereinafter as "CJEU") in *Halifax*[8] has also confidently stated that '*taxpayers may choose to structure their business so as to limit their tax liability*'.

It is evident that at an international level tax planning nowadays is a reality. International trade, competition and globalisation are the driving forces towards an increased use of international structures aiming at an efficient and tax effective business. International trusts seemed to be one of these structures available to wealthy individuals and international companies seeking to preserve their wealth; however their use over the years was expanded also to medium-sized enterprises and entrepreneurs of more modest means.

4 Tax Law Review Committee, Tax avoidance (London, 1997)

5 ibid

6 Philip Baker, "Tax Avoidance, Tax Mitigation and Tax Evasion", http://www.taxbar.com/documents/Tax_Avoidance_Tax_MitigationPhilip_Baker.pdf (accessed 11/08/2011)

7 Inland Revenue Commissioners v Willoughby [1997] STC 995

8 Case C-255/02 Halifax plc and others v Commissioners of Customs & Excise [2006] ECR I-1609

The purpose of this study is to provide an analysis of how international tax avoidance in the sense of legal minimisation of tax liability can be achieved by the potential use of international trusts. By choosing the correct jurisdiction this practice can prove to be beneficial to all parties and an overview of the advantageous stance Cyprus can have on this matter will be demonstrated.

Part 1 will explain the issue of avoiding the tax by trying to define and clarify the mingled principles of tax avoidance, tax fraud, abuse of EU freedoms and giving as such a glimpse of what is the accepted form of tax mitigation. The terminology used in academia as well as in judicial decisions is greatly mixed with no constant referral to same principles in the same terms which may be attributed to the different translations provided in the international community. Even though the principles at first seemed to be vague, a distinction between them will be attempted based on established case law.

Part 2, will be an overview of the evolution of trusts and the emergence of international trusts law. A discussion of the advantages and disadvantages for establishing an international trust for tax purposes will lead to illustrating how taxation of trusts can be a hurdle for the tax advisor to overcome in respect of residency issues but at the same time be a solution to the taxpayer willing to benefit from provisions provided in legislation.

Part 3, is the merging of the issues discussed in the first two chapters as an illustrative example of how international trusts are useful tools of acceptable tax mitigation since they can come within the free movement of capital ambit of the EU. The impact of the Savings Directive, anti-avoidance provisions and anti-money laundering legislation has had great influence on the ability to escape tax which is pointed out.

Finally, Part 4 is demonstrating the Cyprus approach and experience on international tax avoidance and international trust planning providing as well examples and arguments of how structures used in similar jurisdictions have succeeded and whether this could be the case in Cyprus as well.

Part 1: Avoiding Tax

The concepts of tax avoidance, tax mitigation and tax fraud have been confused, mingled and used interchangeably by judges, lawyers, advisers, academics and even the legislature themselves. A difference between tax avoidance and tax evasion was an issue touched upon in a recent conference by scholars and practitioners[9] with some raising the point that the concepts are not used in the same way in the CJEU as they are used in national tax systems of Member States (hereinafter as "MS"). The Tax Law Review Committee clearly outlined[10] that in the UK "*tax evasion is the illegal non-payment of tax rightfully to the Exchequer whilst tax avoidance are lawful actions by taxpayers which, if effective, will reduce their liability to tax*". Unfortunately, such a distinction is not made at an international or European level even though a different approach to tax avoidance/mitigation and tax fraud/abuse is notable. In a very interesting discussion about these issues Philip Baker QC illustrates these concepts as parts of a "spectrum of conduct" on which bright lines have to be drawn[11].

The willingness of the CJEU to accept as a justification to a restriction of the fundamental freedoms the "need to prevent of tax avoidance" strengthened the importance of tax avoidance and the necessity for a better and clear understanding of these concepts. It can be observed that over the years the approach of the CJEU towards the issues is evolving and being clarified.

1.01 Tax avoidance

The first time the CJEU referred to the risk of tax avoidance was in the *Avoir Fiscal* case[12] where it was clearly stated tax avoidance risk cannot be a justification for cases of discrimination implying what was later clarified; it could only amount to a justification for a restriction of fundamental freedoms. More than a decade later in ICI[13], a case in respect to the UK consortium relief rules, it was disputed whether or not the residence of the seat of the parent company should be a condition as to the consortium relief being available to the group. The CJEU in its judgement implied that tax avoidance involves wholly artificial arrangements set up to circumvent the national tax system[14]. Continuing this long lasting attempt of establishing what amounts to tax avoidance and what not, in *de Lasteyrie*[15] it was indicated that a mere physical transfer of tax residence does not, in itself, imply tax avoidance, tax evasion or tax fraud and cannot justify a fiscal measure.

9 6th Annual 'Avoir Fiscal' EU Tax Conference , School of Advanced Study, 28 January 2011

10 Tax Law Review Committee, supra n.3

11 Philip Baker, supra n.5

12 Case C-270/83 Commission v French Republic [1986]ECR 273 para 25

13 Case C-264/96 Imperial Chemical Industries plc (ICI) v Kenneth Hall Colmer [1998]ECR I-4695

14 ibid para 26

15 Case C-9/02 Hughes de Lasteyrie du Saillant v Ministère de l'Économie, des Finances et del'Industrie [2004]ECR I-2409 para 51

The high-profile *Marks and Spencer*[16] case came to give an extra glimpse into the muddy waters of what is tax avoidance and when a risk of tax avoidance could be accepted as a justification for restrictive domestic rules. The CJEU pointed out that the risk of tax avoidance may also entail the danger that losses could be used twice (double dipping)[17] or that losses can be transferred to companies established in Member States with high tax value of losses (loss trafficking). In this case, the Marks and Spencer group consisted of subsidiaries established and resident in Germany, France and Belgium. The subsidiaries incurred losses outside the UK, where the parent company was resident. By December 2001 the French subsidiary had been sold to a third party and their trading operations were discontinued whilst the German and Belgian subsidiaries were essentially dormant. Offsetting of losses to the parent company was denied as well as group loss relief. The CJEU decision was that the UK group relief rules were compatible with the EU and that the justification for the prevention of tax avoidance was accepted for such restriction of the freedom of establishment – i.e. no group loss relief. However, the case was lost by the HMRC on grounds of proportionality on the basis that the losses incurred by the subsidiaries had no other possibility to be taken into account anywhere else other than in the parent company[18]. This became a great caveat provided by the CJEU whilst following the principles by earlier cases.

It seemed up to this point that there were two justifications involving tax avoidance that could have been accepted by the CJEU, or at least argued by governments, however, this was not clearly set out and explained by the court until in SGI case was came about[19]. In *SGI*[20] it was confirmed that '*a national measure […] may be justified where is specifically targets wholly artificial arrangements designed to circumvent the legislation of the Member State concerned*' establishing as such a stand-alone justification. This means that if rules are proportional, according to the guidance provided by the court in later paragraphs[21], then Belgium could maintain its transfer pricing rules in the intra – group situations. Any national rules aiming at combating structures that are less than wholly artificial arrangements may only be justified if they aim at the with the need to preserve the balanced allocation of taxing rights. Therefore, it is clear that the Court is not classifying all forms of tax

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16 Case C-446/03, Marks and Spencer plc v David Halsey[2003] ECR I-10837

17 ibid para 47

18 ibid para 55

19 Tom O' Shea, 'ECJ upholds Belgian Transfer Pricing Regime' [2010] WTD 19-1

20 Case C-311/08 Societe de Gestion Industrielle SA (SGI) v Etat belge [2010]ECR1-0000 para 65

21 ibid paras 72 and 74

avoidance as "wholly artificial arrangements". There are lesser forms of tax avoidance which are perfectly acceptable to the Court[22].

In the UK courts the *Furniss v Dawson*[23]case raised the issue if taxpayers wished to sell family company shares to an independent purchaser and prearranged a plan to defer their capital gains tax liability. The House of Lords held that steps inserted in a prearranged series of transactions with no commercial purpose other than tax avoidance should be disregarded for tax purposes.

Analysing the above decision, it can be argued that the issue of artificiality is not an easy one to define and restrict. It can be have a different approach at a European level, a domestic level and even from time to time. It cannot be ignored that EU law is at the top of the "triangular model"[24] and is supreme. Decisions of the CJEU can thus provide good guidance and its attempt of clarification and remaining constant is helpful in the tax avoidance area.

1.02 Tax abuse

Whether a form of tax avoidance is accepted or not may be questionable depending on the approach however, if tax abuse is detected the answer is more than apparent. Two decisions of the CJEU have opened up an interesting perspective and it can finally be argued that a coherent general theory of abuse of law is adopted. The *Halifax*[25] and the *Cadbury Schweppes*[26] decisions even though involving litigation in two totally different fields of taxation, VAT scheme planning and corporate direct taxation, both developed the same concept of tax abuse[27].

In *Halifax* the issue in dispute was the tax schemes used involving associated companies and a series of transactions at the end of which Halifax were effectively able to reclaim all of the input VAT. These schemes were attacked by the tax authorities as an "abuse of rights" under EC law. The CJEU provided in paragraph 69 a definition for abusive practices as: '*transactions carried out not in the context of normal commercial operations, but solely for the purpose of*

22 Tom O' Shea, 'Tax Avoidance and Abuse of EU Law' [2010-11] ECTJ 77-110

23 [1984] AC 474

24 Tom O'Shea, *EU Tax Law and Double Tax Conventions* (Avoir Fiscal, 2008)

25 Halifax supra n.7

26 C-196/04 Cadbury Schweppes plc and others v Commissioners of Inland Revenue [2006] ECR I-7995

27 Prof. Frans Vanistendael 'Halifax and Cadbury Schweppes: one single European theory of abuse in tax law?' [2006] EC Tax Review vol.4

wrongfully obtaining advantages provided for by Community law' stating as well that '*application of Community legislation cannot be extended to cover abusive practices by economic operators'*. However, it has been expressly recognised[28] that '*a trader's choice between exempt transactions and taxable transactions may be based on a range of factors, including tax considerations* [...] *the Sixth Directive does not require him to choose the one which involves paying the highest amount of VAT*'. Therefore, it is acceptable in the eyes of the CJEU that taxpayers may choose to structure their business so as to limit their tax liability. As such, the court stipulates in paras 74 and 75 of the decision a two-prong test to be passed in order to classify an "abuse":

(i) if the transactions concerned result in the accrual of a tax advantage contrary to the purpose of the provisions and

(ii) if objective factors prove that the essential aim of the transactions is to obtain such advantage.

The CJEU repeated this definition of abusive practices in paragraph 26 of *Weald Leasing*[29] and continued applying the Halifax two-prong test in later cases[30].

In *Cadbury*[31], the issue concerned the UK CFC rules and the facts briefly were that Cadbury Schweppes, a UK resident company indirectly owned two subsidiaries in Ireland which were subject to tax at a rate of 10%. Thus, they were subject to a "lower level of taxation" within the meaning of the UK legislation on CFCs. CFC rules applied so the UK parent company was taxed on the profits of the Irish subsidiaries. The justification for the restriction on the freedom of establishment used by the HMRC was the need to prevent tax avoidance, the same justification used as the basis for the UK CFC rules. However, this was dismissed by the CJEU and the tax planning scheme of setting up a subsidiary in Ireland, which was proved to be carrying out a genuine economic activity, was not restricted. In paragraph 50 of the judgement it was pointed out that there is no '*general presumption of tax evasion to justify a measure which compromises the exercise of a fundamental freedom'* but para 55 provides that prevention of abusive practices can justify restrictions of '*a conduct involving the creation of wholly artificial*

28 Halifax supra n.7 para 73

29 Case C-103/09 Commissioners for Her Majesty's Revenue and Customs-v-Weald Leasing Ltd[2010]

30 Case C-277/09 The Commissioners for Her Majesty's Revenue and Customs v RBS Deutschland Holdings GmbH [2010]; for an earlier discussion of the *Halifax* test see *Ampliscientifica* (C-162/07) and *Part Service* (C-425/06); for a comprehensive discussion of the issue see Tom O'Shea 'ECJ Takes a Stand on "Abusive Practices" in UK VAT Cases' [2011] TNI 417;

31 Cadbury supra n.25

arrangements which do not reflect economic reality, with a view of escaping the tax normally due'. Reiterating the two-prong test established in *Halifax* regarding the satisfaction of the subjective element consisting of intention to obtain the tax advantage and the objective element of the freedom being pursued for an abusive practice[32], the CJEU enquired whether the Irish subsidiaries were pursuing an economic activity or not so to characterise them as wholly artificial arrangements. The UK resident company were able to prove that the activities of the Irish subsidiaries were genuine and so could not be caught by the CFC rules.

Accordingly it can be reasonably concluded that the CJEU is clear on its approach to tax abuse and/or abusive practices since it has applied the same "two-prong test" in both the direct and indirect tax areas. However, this should not be overestimated since it seems to be only the case where "wholly artificial arrangements designed to circumvent the tax system" are concerned. The ease with which such artificiality is established is controversial. In cases of structures not crossing this threshold the issue may be of tax avoidance rather than tax abuse. As discussed above, not all forms of tax avoidance are acceptable to the court.

1.03 Abuse of rights and EU freedoms

According to Tax Law Review Committee[33] the civil law concept of abuse of rights is:

> [a] strategy that is both lawful and carefully structured by the taxpayer so as to secure a tax benefit by arranging the facts and the legal basis of transactions. Thus it may apply where a taxpayer has a right to enter into a particular kind of transaction but exercises that right solely to avoid or reduce tax liability.

This can be compared to both tax avoidance and even tax abuse as it involves the taxpayer's right to minimize his taxes while at the same time striking down various artificial transactions designed to reduce those liabilities. However, it is different from the exercise of fundamental freedoms within the EU and the abuse of such an exercise as illustrated in CJEU jurisprudence.

In *Segers*[34], it was ascertained that a subsidiary formed in a different MS from the parent company and conducting its whole business there is entitled to national treatment of that MS. The fact that the parent company conducts no business in its MS is of no relevance. If the connecting factors outlined in Article 54 TFEU are

32 ibid para 64

33 Tax Law Review Committee, supra n.3

34 Case 79/85 Segers v Bestuur van de Bedrijfsvereniging voor Bank [1986] ECR 2375

met then *'the fact that the company conducts its business through an agency, branch or subsidiary solely in another member-State is immaterial'*[35]. In contrast, this should be distinguished from the situation arising in *Daily Mail*[36], where the applicant wanted to transfer its management and control from the UK to the Netherlands. The court decided that the Treaty is not conferring any such right to a company incorporated under the law of a MS to transfer their central management and control while retaining their status as companies in the first MS[37].

It can be deduced that Member States can take action to prevent abuse of the freedom in situations where actual fraud or improper conduct utilising the right of free movement can be proved However, circumstantial evidence alone is not sufficient, nor are the motives for exercising EU law rights. National courts are eligible to look into fraudulent and improper uses of the freedoms on a case-by-case basis and the burden of proof lies with the person trying to obtain the benefit of the freedom to show that there are proper reasons for their actions. As argued by Dr O'Shea whilst "the motive" behind a person's use of the right of free movement has been recognised by the Court as immaterial, once fraudulent conduct or improper use of the EU rights has been demonstrated on the balance of probabilities, motive may play an important role in rebutting the presumption of fraudulent or abusive conduct. The decisive factor will be proportionality of the national rules restricting any potential "fraudulent" abuse of EU freedoms[38].

It is submitted that ECJ's jurisprudence in respect to "abuse of EU freedoms" lays the foundations for acceptable tax-planning through the use of the fundamental freedoms. Adopting Dr O' Shea conclusions:

> [EU law] cannot be relied upon for abusive or fraudulent purposes; "motive" is mostly irrelevant when it comes to determining whether the freedoms have been exercised in an abusive way; and the Member States can take action to prevent abuse of their national laws through an inappropriate use of the freedoms[39].

1.04 Tax planning

Tax planning or tax mitigation sound the most friendly to the tax authorities and to courts in respect to all of the above terms. As stated already since 1936 the notion

35 ibid para 16

36 C-81/87 The Queen v H.M.Treasury and Commissioners of Inland Revenue, ex parte Daily Mail and General Trust plc [1988] ECR-05483

37 ibid para 24

38 Tom O' Shea, supra n.21

39 ibid

of legitimately structuring one's financial affairs in order to minimize effectively the tax burden attached to them was respected[40]. David Goldberg QC[41] argues that in the UK the *Lupton*[42] case, '*marked a watershed […] a golden age for tax planners which did not last for very long*' since the revenue started to attack them. However, this meant further development.

A notable case of acceptable tax planning by the CJEU is *Barbier*[43]. Mr Barbier moved from the Netherlands to Belgium where he was a director of a company resident in Netherlands. He acquired properties situated in the Netherlands, received rent which was included in his gross domestic income and also mortgaged such properties. He separated their legal and financial ownership, transferring the financial ownership to Netherland private companies he controlled and as a result such companies took over the mortgage debt while he was still the mortgagor. These gave rise to a tax advantage of avoiding 6% registration duty. On Mr Barbier's death his heirs were obliged to pay transfer duty tax due to the unconditional obligation to transfer back legal title of the properties. The issue arising was that no deductions were allowed and that there was a difference in tax treatment according to the deceased's residence[44]. The CJEU accepted that 'tax consequences in respect of inheritance rights are among the considerations which a national of a Member State could reasonably take into account when deciding whether or not to make use of the freedom of movement provided for in the Treaty"[45]. Therefore, Mr Barbier's inheritance tax planning was allowed since his motive is to "use" –as opposed to "abuse"– the Dutch system allowing him to separate the legal and financial ownership of the immovable property and obtain as such a tax advantage. Attempting to apply the "wholly artificial arrangements test" as far as the objective of the rules in question was met and there was genuine activity carried out the tax planning is accepted by the court.

In *Leur-Bloem*[46] the taxpayer asked the Netherlands tax authorities to treat the proposed transaction of exchange and transfer of shares between the BVs as a 'merger' which would allow her to receive a tax exemption n any gain made in the transfer of shares and to have the possibility of setting off losses within the tax

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40 ibid n.1

41 David Goldberg QC 'The approach of the Courts to Tax planning schemes' http://www.taxbar.com/documents/Approach_Courts_David_Goldberg.pdf (accessed at 11/08/2011)

42 Lupton v F.A. & A.B. Ltd [1971] 47 TC 618

43 Case 364/01 Barbier v Inspecteur van de Belastingdienst Particulieren [2003] ECR I-15013

44 ibid para 29

45 ibid para 75

46 Case C-28/95, A. Leur-Bloem v Inspecteur der Belastingdienst [1997] ECR I-04161 para 7

entity thus created. A "merger by exchange of shares" is defined in Art 2(d) of the Merger Directive. The Dutch tax Inspector ruled that the transaction purported by Mrs Leur-Bloem would not fuse the two BVs and the holding company subsequently created into a unit from a financial and economic point of view so she would be ineligible for the tax exemption under domestic legislation. The ECJ decided that Article 2(d) of the Merger Directive does not require the acquiring company, to carry on business itself or there to be a permanent merger, from the financial and economic point of view, of the business of two companies into a single unit. Similarly, the fact that the same natural person who was the sole shareholder and director of the acquiring companies becomes the sole shareholder and director of the acquiring company does not prevent the operation in question from being treated as a merger by exchange of shares, which could arguable seem another tax planning scheme being accepted.

Consequently, careful planning and structuring of transactions can amount to an acceptable form of "legal tax avoidance" in both direct and indirect taxation areas. The main prerequisite can be argued to be the genuine economic activity of the structure and the burden of proving that it is not a wholly artificial arrangement used to circumvent the national tax system. If this is enough to satisfy the proposal made by Prof. Philip Baker that 't*axpayers in all countries are entitled to know their legal position; they are entitled to know what will be regarded as fraud, what will be regarded as avoidance, and what acceptable mitigation is'*[47]is a challenge.

Part 2: International Trusts Law

2.01 The trust relationship

A trust is a relationship; an equitable obligation created by the "settlor", binding a person (called the "trustee") to deal with property over which the trustee has control (called the "trust property"), for the benefit of persons (called the "beneficiaries" or "*cestuis que* trust") of whom he may himself be one, and any of whom may enforce that obligation[48]. As specifically mentioned in Article 2 of The Hague Trusts Convention[49] as well '*the term "trust" refers to the legal relationship created inter-vivos or on death […] for a specified purpose…'*. Therefore, it can be easily deduced that a trust is not a legal entity; it has no legal personality. However, it is a legally binding relationship between the parties.

47 Baker supra n.5

48 David Hayton *Underhill and Hayton law relating to trusts and trustees* (LexisNexis, 2010) page3

49 Hague Convention on the Law Applicable to Trusts and on their Recognition conclude on the 1st July 1985

Historically, the main purpose of that 'relationship' was to separate legal ownership from equitable ownership. Since the 12th century during the time of the Crusades the landowners recruited to fight in them had to leave their land and family for an extended period of time. Someone had to be left in charge of managing their land however the Crusaders were expecting all income and profits from the land to be reserved for them when they returned. There was no provision under the law at that time so any petition they made to the King was forwarded to his Lord Chancellor who made a "just and equitable" decision on the matter[50]. As a result the trusts law became a reality first in the English legal system and eventually in most common law-based jurisdictions[51].

Nowadays, the trustees acquire legal ownership in the trust property given to them by the settlor whilst the beneficiaries retain the equitable ownership which is created once the trust is constituted. The settlor, having absolute ownership of the trust property decides to part with that for the benefit of a third party, however this benefit is usually not intended to be given immediately. It is more often than not for the settlor to be a beneficiary themselves which as emphasised by Langbei[52] may not constitute a 'true trust' but wayward towards a real trust or is a legal trick to bring trust-like relationships into trusts; an argument that was even advanced in a Jersey court case[53]. The trustee is the intermediate who acquires the ownership of the trust property on behalf of the beneficiaries without being able though to extract any personal benefit and thus being under an obligation to keep the trust property separated from his own. The beneficiary is the ultimate recipient of the profits and advantages of the trusts property.

It has be extensively argued that the beneficiaries rights are only rights *in personam,* which means that as far as they only hold an equitable interest in the trust property the only right they have is against the trustees to enforce their obligations under the trust; beneficiaries have no right *in rem* which is a right enforceable against the trust property. This can be contradicted though by the principle established in *Saunders v Vautier*[54], an English trusts law case which has been affirmed in several common law jurisdictions. In that case, all the beneficiaries were holding the 100% of the equitable interest in the trust fund and it was held that if they were all adults and of no disability they could act

50 Jill Martin Hanbury & Martin Modern Equity (Sweet&Maxwell, 2005)

51 Bahamas, Cayman Islands, Channel Islands, Hong Kong, Cyprus, Australia, USA, Canada, New Zealand, South Africa, Ireland.

52 John H., Langbein, 'The Contractarian Basis of the Law of Trusts' [1995] Faculty Scholarship Series, paper 502

53 Rahman v Chase Bank (CI) Trust Co Ltd [1991] JLR 103

54 [1841] 4 Beav 115

collectively and have a right in the trust property itself, demanding for a transfer of the legal title to themselves or disposal of the income of the trust property. Therefore, their right was elevated from a personal claim against the trustees to a proprietary right which could be recognised in equity. The significance of this principle is that beneficiaries having *rights in rem* – or rather having this "bundle" of rights in rem and in personam – could mean they may be liable for any taxable returns of the trust property itself.

The international trust can be a useful tool in tax planning in the sense that it permits this principle to be legally avoided.

2.02 Creation of an international trust

An international trust can be created either by will or during the lifetime of the settlor (inter vivos). The trust property must be ensured to be capable of being held on trust; it can be any type of asset such as shares of companies, investment portfolios, royalties, bank deposits, loans, bonds, life assurance policies and/or land and so on. The settlor must ensure that the trust property can be transferred to the trustee who will be the legal owner and capable of transferring this to another person – usually the beneficiaries. There should be evident certainty of intention, subject matter and beneficiaries[55]. In addition, for the transfer to take place the settlor should also take into account all the formalities that need to be complied with for the effective creation and transfer of the trust[56].

These formalities are usually statutory and could be different from one jurisdiction to the other, nonetheless it is common for the creation of an international trust to be in writing in the form of a trust deed, a declaration or disposition, or a "letter of wishes" given by the settlor to the trustees. For instance in the Virgin Islands Special Trusts Act 2003 it is specified in s. 4(4) that '*the trust is created by or on the terms of a written testamentary or inter vivos instrument*'. New Zealand and Canada Trust laws also require the existence of a Trust Deed or Letters of Wishes respectively while the Cyprus International Trusts Law of 1992 refers in several sections to the 'instrument establishing the trust'. By contrast in the Jersey Trusts Law there is no such requirement for the creation of an international trust, thus it can be either by an oral disposition, written instrument or even by conduct.

The image has been formed by the von Overbeck Report[57] in relation to transnational trusts of the rocket launcher and the rocket. The preliminary matters

55 *Knight v Knight* [1840]3 Beav 148

56 John Glasson, Thomas Geraint (ed) *The International Trust* (2nd ed, Jordans, 2006)

57 Alfred E.von Overbeck, *Explanatory Report on the 1985 Hague Trusts Convention* (HCCH Publications, 1985)

necessary for the creation of the trust – capacity of the settlor to dispose of his property, vesting of the property in the trustee and the validity of the formal instrument of the trust are the rocket launcher while matters affecting the trust once it comes into existence such as the role of the trustees, administration of trusts and relationship between trustee and beneficiary are the actual rocket. The capacity of the settlor can be a controversial issue particularly if they have capacity to transfer property on trust and whether the legal title has passed from the would-be settlor to the would-be trustee and equitable title passed to the would-be beneficiary[58].

2.03 Advantages and disadvantages of establishing an international trust

The advantages of a trust over other forms of business structures are ranging from the sphere of tax to other non-tax, commercial and family reasons. International trusts provide estate planning benefits, inheritance planning for the mentally handicapped or minors, anonymity and confidentiality, no exchange control restrictions, mobility and flexibility since assets can be easily transferred and/or removed from one jurisdiction to the other thus the trust can be easily varied[59], opportunity for an overseas investment and maintenance of a fund abroad. As regards the main tax advantages the creation of a trust offers a basic tool for effective tax planning based in respect to income tax and capital gains tax.

(a) Income Tax

In the UK the basic rule under ss.720-730 of the Income Tax Act 2007, is that the UK resident responsible for setting up a non-resident company or trust, is liable for its taxable income. This anti-avoidance provision though can be subject to criticism under EU law since the exercise of fundamental freedoms will preclude any charge of such income tax insofar as the trust is not an artificial arrangement. Even more, if the settlor is excluded from the beneficiaries of the trust no anti-avoidance legislation attributes the income of the trust to them[60]. The House of Lords in the *Willoughby*[61] case had even discussed the case where the settlor was not ordinarily resident in the UK at the time the trust was established but they became later so. Furthermore, if the beneficiaries are spread around the world would mean that the motive, exercise and purpose of the trusts were not only tax driven which could help even more the trust income from escaping such anti-

58 The Report gives a detail discussion of these issues which is outside the scope of this study.

59 E.g. under the Trusts Variation Act in the UK

60 Giles Clarke *Offshore Tax Planning* (17th ed. LexisNexis, 2010)

61 Inland Revenue Commissioners v Willoughby [1997] STC 995

avoidance provisions[62]. If the trustees have discretion as to the distribution of income or have a power to accumulate the income any payment of income they make can be claimed by the beneficiary to be exempted under Schedule D case V[63].

(b) Capital Gains Tax

As stated in the Commentary on Article 13 of OECD Model Tax Convention on Income and Capital 2010 (hereinafter as "OECD Model") the taxation of capital gains varies considerably from country to country. Article 13 provides for capital gains tax is usually imposed by the source state. The Commentary[64] expressly states that gains from trusts may fall under the scope of Article 13. Unfortunately there is no definition provided for what capital gains is and how it should be taxed therefore it is largely left ton domestic provisions. Nonetheless, it should not be ignored that in cases of transfer of assets any taxation should be in accordance with Article 7 on the taxation of business profits and/or on the arm's length principle pursuant to Article 9. Most often than not the capital gains accrued by trusts is exempt from domestic tax legislation. Even more the transfer of assets from the settlor to the trustee is a movement of capital under the Nomenclature in the Annex I to the Article 1 of the Directive 88/361/EEC[65].

(c) But…

In common law jurisdictions the trust usually is an integral part of the domestic law however a problem would arise in cases of civil law jurisdictions where such a concept is alien to them. The life of a trust may become easier if the civil law jurisdiction has ratified the Hague Convention on the Law Applicable to Trusts and on their Recognition 1985[66]. The Convention was prepared under the auspices of the Hague Conference on Private International Law as a collaborative effort between common law and civil law countries. This can be a significant drawback in establishing international trusts which even though possible to overcome it may pose an extra burden on the investor and potential taxpayer in his choice of where and when to establish the international trust.

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62 Clarke supra n.58

63 Robert Venables QC Non-resident trusts (8th ed. Key Haven Publications Plc, 2000)

64 (2010) OECD Commentary to Art.13, para 28.5

65 Council Directive 88/361/EEC of 24 June 1988 for the implementation of Article 67 of the Treaty

66 As in the case of Italy, The Netherlands, Luxembrourg etc

It is quite reassuring though that at least three of the EU countries (UK, Ireland, Cyprus) embrace trusts in their domestic legislation and other major civil law jurisdictions have ratified the Hague Convention.

Where the Convention is inapplicable the civil law countries will usually try to adopt an analogue of the trust which can prove though to be a difficult decision due to the various types of trusts which can be either testamentary or inter-vivos. For instance in *Courtois v De Ganay*[67] the settlor, who was of French nationality and residence, transferred securities situated in America to an American insurance company and executed a trust deed before the American consul in Paris. The trust income was to be paid to the settlor during her life and then capital and income was to be paid to certain members of her family, the defendants, who resident in America. The plaintiffs were legatees under the settlor's will and claimed that the trust was a gift under the French law of succession. The Paris Court of Appeal held that the trust 'does not depend on the law of succession but on the law of autonomy'; thus the trust was accepted as a sort of synallagmatic contract. Nonetheless it is still a reality that non-recognition at an international level amounts to judges being reluctant to accept trust structures and tend to categorise such as 'shams'.

Finally, Robert Venables QC argues that the '*best time to put assets into a trust is when they are not pregnant with any appreciable chargeable gains […] immediately after acquired*'[68]. Following this piece of advice though may prove to be challenging since even if beneficiaries may not be specified or can easily be the settlor's children or himself as such, the trustee office has to be constituted and administered for the trust to come into effect. Notable offshore jurisdictions are able to provide professional trustee services however anti-avoidance provisions in transnational cases are an obstacle that needs careful planning.

2.04 Taxation of international trusts

In respect to the taxation of international trusts there are four hurdles that need to be overcome for both the possible legislator and subsequently any tax adviser:

(i) establishing that there is a taxable event;

(ii) what is going to be taxed

(iii) who is going to be taxed[69]; and

67 Paris Court of Appeal (10 Jan 1970)

68 Venables supra n.61

69 Graham Moffat *Trusts Law: text and materials* (5th edition, Cambridge University Press, 2009) chapter 8

(iv) where is the tax to be levied.

There are different approaches to the taxation of trusts by different countries. Generally speaking the US and UK tax systems adopt a two-tier hybrid process of taxing trusts. This means that trusts can be taxed on a personification level, i.e. the trust is taxed itself as a separate entity and then on a transparency level, if needed, i.e. any distribution to the beneficiaries will be taxed as income of the beneficiaries[70]. On the other hand, most low tax jurisdictions countries impose no tax on trust income provided that the structure can be qualified as a particular type of trust in that jurisdiction, for instance the international trust established in Cyprus.

2.05 Residence issue of the international trust

The exceptional feature of international trusts is their transnational nature. The settlor can be a resident of one state disposing a trust property situated in another state to be held on trust by trustees for beneficiaries who are permanent residents in a third state. As a consequence the issue of residence for tax purposes is evident.

The residence of the trust, the trustee, the settlor and the beneficiaries can all come into play in order to determine the "winning" jurisdiction. In the case of an international trust it is more likely that all parties will be in difference jurisdictions. The instrument establishing the trust usually makes direct references to the governing law and/or the jurisdiction forum of the trust[71]. However, this is not always the case and even when such provisions are made in the trust deed when it comes to taxation of the trust all involved jurisdictions may claim a right to tax. Questions of overlapping jurisdiction to tax may lead to double taxation because of dual residency and in cases of international trusts it can even lead to a typical triangular case[72]. As this is explained by Jonathan Schwarz[73] is the situation when a person from a third country locates its business management and control in a treaty country in order to benefit from a particular UK treaty. Even though possible, if not quite likely, for trusts to fall in such "pitfall" the *Commerzbank* [74]case decided by CJEU that treaties between two non-UK companies have no bearing on the UK treaty.

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70 Camfield Dickinson Turnier *Taxation of Estates, Gifts and Trusts 1989-1990* (2nd ed, Commerce Clearing House,1989) chapter 22

71 supra n. 49

72 OECD, Report on Triangular cases adopted by the OECD Council on 23 July 1992

73 Jonathan Schwarz, *Schwarz on Tax Treaties* (CCH, Walter Kluwer Ltd, 2009) at p.80

74 Case C-330/91 The Queen v Inland Revenue Commissioners, ex parte Commerzbank AG [1993] ECR I-04017

The OECD Model Tax Convention allocates unlimited right to tax to the residence state whilst the source state is given limited right. The result is sharing of taxing rights achieved by Articles 23A and 23B providing for the elimination of double taxation through the credit or exemption method. However, the principal issue is determining which the residence state is. This is dealt with by Article 4 of the OECD Model and Article 4(3), the tie-breaker rule article, provides for the resolution of a dual residency issue. In the Commentary to Article 4(3) it is stated that '*…applies to companies or other bodies of persons irrespective of whether they are or not legal persons*' which embodies international trusts into that provision. The criterion to be taken into account when deciding residency is the place of effective management which is the place where the key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance made. As provided in the Commentary to Article 4(3) there may be more than one places of effective management however, an entity can only have one such place at any one time[75]. The OECD Model suggesting that a case-by-case approach should be taken in determining the place of effective management of an entity diminishes the degree of certainty however it creates an avenue for courts to evolve the principle.

The Tax Court of Canada is a vivid example of how courts can clarify the concepts. In *Thibodeau Family Trust v The Queen*[76] a Canadian resident settlor established a trust in Canada with the jurisdiction of the trust being moved subsequently to Bermuda. Two trustees resident in Bermuda and one trustee resident of Canada were appointed. The share certificates of the trust were held in Bermuda and any decisions were taken there by majority – no unanimity being required as stated in the trust deed – as well books and records being kept in Bermuda. The Court decided that the residency of the trust is determined by reference to the residency of the trustees. This was the prevailing view in Canada as a result of this landmark case[77].

In *Garron and Garron, Trustees of the Garron Family Trust v. The Queen*[78], a novel test to determine the residency of a trust in Canada was established rejecting the principle established in *Thibodeau*. In *Garron* the issue was the residency of two trusts formed in Barbados the settlor being a resident of St. Vincent and the beneficiaries being Canadian residents. There was a protector, resident in St Vincent, of each trust who had the right to replace the trustee of each Barbados

75 (2010) OECD Commentary to Art 4(3) para 24

76 78 DTC 6376 (F.C.T.D.)

77 Jack Bernstein, 'Residency of Trusts for Canadian Tax Purposes' IBFD Bulletin March 1998

78 2009 TCC 450, released on Sept 10, 2009

trust. The sole trustee of each Barbados trust was a Barbados resident trust corporation, St. Michael Trust Corp. The Barbados trusts paid 25% of tax for capital gains of over $450.000.000 realised on shares in Canadian holding companies and subsequently filed Canadian tax returns claiming a refund under the Barbados-Canada DTC. In Barbados there is no tax imposed on capital gains therefore, if the Treaty exemption was applied any the gains will escape the Canadian tax leading to non-taxation of the capital gains incurred. Nonetheless, the Court determined that the trusts were resident in Canada, based on the fact that St Michael Trust Corp had no active role in the management of the affairs of trusts. From paragraph 194 onwards in the judgement of the case, Madam Justice Woods illustrates that, more likely than not, the trustee 'had agreed from the outset that it would defer to the recommendations' of the Canadian resident beneficiaries in respect to sale of the shares of the holding companies, the investment of cash proceeds, any potential distributions to the beneficiaries and any steps to minimize the tax burden of the beneficiaries. As a consequence of the trusts being resident in Canada, they were liable to capital gains tax on their realised gains of the shares. This decision marks a turnkey into the Canadian tax law but at the same time makes the OECD Model provisions glow. The place of effective management, which is the established test for determining the residency of a corporation, should also apply to a trust.

Most recently in the UK the case of *Smallwood*[79] added more to the value place on the effective management and control test when determining the residency of the trust. Mr Trevor Smallwood, a UK resident, was the settlor of a Jersey trust. A Mauritian trustee was appointed who resigned though after the shares in the trust were sold and Mr Smallwood and his wife were appointed as trustees. Mr Smallwood appealed on the decision of the special Commissioner to tax any capital gains realised from the sale of the shares pursuant to the provisions of Article 13(4) of the UK-Mauritius Double Tax Convention (hereinafter as "DTC"). It was held that the place of effective management and control where the decisions were taken was the UK through the trusts UK tax advisers. Therefore the HMRC won the case in the Court of appeal and the trustees had to pay the £2.727.356,00 tax on the gain of the disposal of the shares.

Consequently, it is evident that the test of place of effective management and control established as the tie-breaker rule test for the residence of corporation can be applied to trusts as well. Moreover, it is quite common to see in DTCs that the trust is defined as being a "person" for the benefits of the treaty, for example Article III(1)(e) of the Canada-US DTC provides as follows '…*the term "person" includes an individual, an estate, a trust, a company and any other body of*

79 Revenue and Customs Commissioners v Smallwood and another [2010] EWCA Civ778

persons'[80]. It is worth noting here that such references may be seen as anti-treaty shopping approaches towards the creation of trusts. It has been argued by governments that establishing "artificial structures" in a state with the purpose of accessing treaty benefits which are exclusively available for the benefit of the Member States concluding the bilateral treaty can be classified as an abuse or improper use of the DTCs. Thus, it is reasonable and acceptable for the residence and the definition articles to be specifically applied to international trusts.

International trusts law has developed into a means of utilising the domestic laws and as stated by John Tiley *'sophisticated rules offer sophisticated responses to sophisticated schemes and so reinforce a climate in which sophistication can be attempted'*[81].

Part 3: International Trusts And Tax Mitigation

'Trust me, I am a trust'

Blending together from Chapter One the principle of tax mitigation and from Chapter Two the basic requirements needed for the establishment of a successful and efficient international trust can tax advisors can shape a very useful tool; a legitimate profits saving pile notwithstanding the respect that the tax authorities should be accorded. This means that proportionate anti-avoidance provisions and restrictive measures imposed by domestic law have to be taken into account. The EU is a great opportunity to develop such practices only and if the international trust can fall within the free movement of capital ambit.

3.01 Free movement of capital

Free movement of capital is one of the fundamental freedoms guaranteed by the Treaty of Functioning of the European Union (hereinafter as "TFEU"). Intrinsic in the main purpose of the functioning of the EU as outlined in Article 26 TFEU is the elimination of any internal frontiers within the internal market. This enhances the promotion of competition, international co-operation as well as the encouragement of cross border investment by companies and individuals. However, in order to be able to benefit from the freedoms, a person, company or body of persons should come within their ambit. This means that there should be a movement across the borders of one Member State to another Member State[82]. The

80 Also outlined as such in Art 2(d) of Cyprus-US DTC

81 John Tiley *Revenue Rule* (Hart Publications, Oxford, 2008) page1199

82 Article 63(1) TFEU

additional advantage that is provided by Article 63 is that third countries[83] are also able to enjoy such a right; being able to fall under the free movement of capital 'umbrella' would mean that they can enjoy the benefits of that freedom as any EU MS.

3.02 What amounts to a movement of capital?

There is no legal definition of the concept of capital movements in the TFEU. There was an attempt back in 1984 by the ECJ to provide a definition of what is meant by capital movements in the case of *Luisi and Carbone*[84] where it was held that *'movements of capital are financial operations essentially concerned with the investment of the funds rather than remuneration for a service'*. Later in 1997 in *Trummer and Mayer*[85] the Court recognised and gave status to Annex I to the Article 1 of the Directive 88/361/EEC[86]. Article 1 of the Directive provides that Member States should abolish restrictions on movements of capital taking place between persons resident in Member States and this has direct effect so in effect Article 63 TFEU now provides that all restrictions on the movement of capital and payments between Member States and between Member States and third countries are prohibited.

Annex I encompasses a non-exhaustive list of what are considered to be capital movements under the Directive 88/361/EEC. It is argued that under the movement of capital it may not be necessary that the provider of capital or the recipient of capital exercise an economic activity. Avoidance will take the form in particular, of avoiding taxation of payments for making capital available (eg taxation of dividends and interest) [87].

The first case where it appeared that the scope of the free movement of capital extends to Member States' direct tax system was in *Verkooijen*[88.] In this case Mr Verkooijen resided in the Netherlands and was employed there by a distributor of petroleum products indirectly controlled by Petrofina NV, a public limited liability company established in Belgium and quoted on the stock exchange. In the context of an employees' savings plan open to all employees of the group, Mr Verkooijen

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83 Not EU countries, EEA countries, Overseas Countries and Territories, ACP countries

84 Joint Cases C-286/82 and C-26/83 Graziana Luisi and Giuseppe Carbone-v-Ministero del Tesoro[1984] ECRI-377

85 Case C-222/97, Manfred Trummer and Peter Mayer[1999]ECR I-01661

86 Supra n.61

87 Daniel S Smit, Ben J. Kiekebeld, EC Free movement of capital, income taxation and third countries: four selected issues (Kluwer Law International, 2008)

88 Case C-35/98, Staatssecretaris van Financiën and B.G.M. Verkooijen[2000]ECR I-4071

acquired shares in Petrofina NV. A dividend was distributed in respect of those shares, which was subject to a deduction at source of 25% in Belgium. Mr Verkooijen included that as part of his income in his Netherlands and he was denied the dividend exemption on the ground that Netherlands had not taxed it. It was established by the CJEU that the receipt of a national of MS residing in that MS of dividends of shares in the company whose seat is in another MS is covered by Directive 88/361/EEC.

The CJEU held that *'…Directive 88/361/EEC precludes a legislative provision [which] makes the grant of an exemption[…] payable on dividends paid to natural persons who are shareholders subject to the condition that those dividends are paid by a company whose seat is in that Member State'*. The fact that the taxpayer was under an employees' savings plan was irrelevant[89].

3.03 How do trusts fit into the free movement of capital?

According to the CJEU the concept of establishment involves the actual pursuit of an economic activity through a fixed establishment in another Member State for an indefinite period[90]. This fixed establishment may find expression in the form of an agency, branch, and subsidiary. It can be at issue whether or not a trust will fall under the freedom of establishment or the free movement of capital. It is submitted and agreed by most academics that the criterion of entrepreneurial 'influence' should be applied as a distinctive factor and in the cases of portfolio investments only the free movement of capital can apply[91].

From the CJEU jurisprudence it follows that any restrictive measure, or even simply a minor interference, is liable to constitute a restriction within the meaning of Article 63 TFEU. Still there should be some connection between the contested measure and the movement of capital in order to establish that the direct tax measure at issue actually constitutes a restriction[92]. So if no such sufficient connection is shown, no causality will be proved and the movement of capital will not restricted by the contested measure. This principle is referred to as the rule of remoteness, an example of which can be seen in the *Verkoojen* case[93].

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89 ibid para 67

90 Joined Cases C-46/93 and C-48/93 Factortame Ltd et al [1996]ECR I-01029

91 Joint Cases C-436/08 and C-437/08, Haribo Lakritzen Hans Riegel BetriebsgmbH (C-436/08), Österreichische Salinen AG (C-437/08) v Finanzamt Linz[2011]ECR-00000

92 Smit supra n.82

93 ibid

Even though the CJEU has not yet ruled particularly on trusts a sensible point to be made is that trusts can be comparable to foundations[94]. In *Ospelt*[95] the transfer of assets to a foundation was a movement of capital. The question referred to the Court for a preliminary ruling was if the free movement of capital article was to be interpreted as meaning that rules whereby transactions in agricultural and forestry plots are subject to restrictions imposed by the administrative authorities in the public interest of preserving, strengthening or creating a viable agricultural community are also permitted in relation to Member States of the EEA as "third countries" under Article 63 TFEU having regard to the fundamental freedoms guaranteed by an applicable law of the EU. It was decided that the transfers of agricultural and forestry plots to a foundation which would continue leasing the plots to farmers and have as a first beneficiary Ms Ospelt were considered capital movements.

3.04 Anti-Avoidance provisions

Nonetheless, it should be noted that trusts can also be caught by anti-avoidance provisions as well.

(a) The Savings Directive in the EU

The Directive 88/361/EEC providing for the liberisation of capital movements as well as Article 63 TFEU established an *erga omnes* liberisation of capital flows, meaning that such capital flows can go beyond EU frontiers and apply to third countries as well. This idea increased the awareness about potential tax fraud and/or possible development of abusive practices since significantly decreased amounts of tax revenue were noticeable. Not to mention that the double non-taxation is also threatening the balance of the internal market[96].

Dr. Sabine Heidenbauer[97] illustrates this with the example of a beneficial owner, resident in R receiving an interest payment from an agent in P. In state P this beneficial owner is only subject to limited liability which is the source-base tax. The beneficial owner's residence state will impose tax on his worldwide income. However if the interest he receives remains unreported then this would amount to double non-taxation.

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94 Clarke supra n.57

95 C-452/01 Ospelt v Schlossle Weissenberg Familien Stiftung [2003] ECR I-9743

96 Reuven S. Avi-Yonah, 'Tax Competition, Tax Arbitrage and the International Tax Regime'[2007] Bull.Int'l.Tax.61, no. 4

97 Lang, Pistone, Schuch, Staringer, Introduction to European tax law on Direct Taxation (2nd ed, Spiramus Press, 2008)

As a result the Directive 2003/48/EEC[98] was introduced aiming at the effective taxation of cross-border interest payments in the state of residence of the beneficial owner which is achieved by the obligatory automatic exchange of information between the Competent authorities of the states involved. However, it should be explicitly noted that this Directive does not apply to third countries as it forms only part of the EU harmonised laws although there are parallel agreements formed with Switzerland, Liechtenstein, San Marino, Monaco and Andorra on this regard which came into force on 1 July 2005[99]. The Directive aims to ensure the effective taxation of savings income in the form of interest payments which are generally included in the taxable income of resident individuals in all MS[100].

The Commission on 13 November adopted an amending proposal[101] to the Directive which basically aims for a selective look-through approach so that transparent entities can also be caught under the Directive. Annex III of the Directive explicitly refers to Cyprus trusts which would mean that they will be classified as "paying agents" under the Directive and liable to comply with it[102].

(b) Anti-Money Laundering Legislation

Another consequence of the liberisation of capital would be the high possibility of money laundering processes taking place in the form of either abuse of freedoms and rights in the attempt of "flying undeclared income" and wealth to low tax jurisdictions and depositing it behind sham and artificial tax shield structures and/or "financially criminal" amounts of money moving around easily and escaping any form of tax[103]. In order to combat any such practices and curb their effects the Directive 91/308/EEC[104] was adopted. Under the provisions of this Directive the MS are required to check the identity of their clients through the 'know-your-customer' procedure and to report any suspect transactions to the

98 Council Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments

99 Ben J.M. Terra, Peter J. Wattel European Tax Law (5th ed, Kluwer Law International, 2008)

100 Christiana HJI Panayi, '*European Tax Law: Legislation and Political Initiatives'* in *Gore Brown on EU Company Law*

101 Council Directive amending Directive 2003/48/EC on taxation of savings income in the form of interest payments COM(2008) 727 final

102 ibid p.42

103 Terra supra n.95

104 Council Directive 91/308/EEC of 10 June 1991 on prevention of the use of the financial system for the purpose of money laundering

authorities. This was a great compliment to the Directives on mutual assistance on the collection of taxes and exchange of information[105].

Directive 2001/97/EC[106] of the European Parliament and of the Council of 4 December 2001 amending Council Directive 91/308/EEC states in its preamble as one of its purposes that:

> Notaries and independent legal professionals, as defined by the Member States, should be made subject to the provisions of the Directive when participating in financial or corporate transactions, including providing tax advice, where there is the greatest risk of the services of those legal professionals being misused for the purpose of laundering the proceeds of criminal activity.

Therefore, it is evident that at a European level as well as at the international community as such even though the concept of tax planning and tax mitigation has been greatly endeavoured by tax advisors and "ambitious" taxpayers it has also been significantly regulated by the EU. Either called anti-avoidance provisions or harmonisation rules they still pose a barrier to tax abuse and artificiality so promote prudent and acceptable forms of tax mitigation through legitimate means by just taking advantage of provisions the legislature has already provided for.

Prof. Philip Baker gives an illustrative example of what may be debate to come under the scope of tax fraud when using trusts[107]. Supposedly, a taxpayer transfers assets to an overseas trust with the genuine knowledge and understand that if they come to be liable to tax they could claim not being able to pay the tax because the assets are in the trust; would this be considered as fraud or as aiming at a "good" settlement, i.e paying less tax than one might otherwise pay is controversial but still open for discussion[108].

No matter what the conclusion is though it should certainly be applied equally and non-discriminatory alongside both governmental and non-governmental bodies and taxpayers. This gives a hint of political interference and influence on decisions of tax policy and especially in matters concerned with tax avoidance.

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105 Council Directive of 19 December 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation and taxation of insurance premiums (77/799/EEC)

106 The Directive amending the anti-money legislation of the EU.

107 Baker supra n.5

108 ibid

Part 4: International Trust Planning In Cyprus

4.01 Background

Cyprus entered timidly in the field of international tax planning with its shipping legislation of 1963[109]. Despite the political uncertainty surrounding the "Cyprus problem" in 1974 Turkish invasion there has been no further political instability on island since then. However, the Turkish invasion in the island, less than two decades after its independence from the British colony, was detrimental for the overall economy of the country. Nonetheless, the south part of the country remained intact with the western ideologies; British influenced legal and banking system, Greek orthodox religion and excellent European and international relations. Tax planning was stipulated as an exceptional way to boost the economy at the time and until today it is a prosperous practice amongst lawyers, accountants and business consultants[110].

Cyprus is a low-tax jurisdiction, not a tax haven. This is evident from the fiscal and regulatory regimes of the country being aligned with the E.U.'s *acquis communautaire* and Code of Conduct for Business Taxation as well as the requirements of the OECD which all led to the inclusion of Cyprus in the OECD Progress Report of 2009 as a "jurisdiction that has substantially implemented the internationally agreed tax standard"[111] and its continuance as a "white list" state even in the latest Progress Report released on 10th August 2011[112]. Part of this adaptation to EU standards and regulation was the amending and repairing of the Cyprus tax system. It has been declared with accession of Cyprus to the European Union that '*an important tax planning jurisdiction has been added to the list of favoured E.U. tax planning countries*'[113].

4.02 Inward Investment and Capital Import Neutrality

Cyprus has a declared policy of encouraging foreign investment which is reflected in various laws, regulations, international conventions and treaties[114]. This favours

109 Chrysses Demetriades Cyprus in international tax planning: a practical guide for foreign firms and individuals (Kluwer Publications,1980)

110 Elias A.Neocleous International Trust Precedents (September 2001) Rel 26

111 Progress report 2009 on the jurisdictions surveyed by the OECD global forum in implementing the internationally agreed tax standard http://www.oecd.org/dataoecd/38/14/42497950.pdf

112 ibid (2011) http://www.oecd.org/dataoecd/50/0/43606256.pdf

113 Bartjan Zoetmulder, Michael Ellul and Elias Neocleous 'Tax Planning in the New EU countries: Malta and Cyprus", [2005] BNA International's Tax Planning International European Union Focus

114 Neocleous supra n.104

the concept of Capital Import Neutrality (hereinafter as "CIN") which attempts to achieve tax neutrality between resident and non-resident investors. This is based to source-based taxation and its rationale is to promote fair competition between domestic and foreign suppliers of capital to any given national market. CIN focuses on the impact of tax on imported capital and tries to ensure that capital funds originating from various countries compete at equal tax terms in the capital market of any one country[115]. The alternative to that is the Capital Export Neutrality which is preferred by capital export countries that treat in the same way capital investments made either domestically or abroad.

Based on its declared encouraging foreign investment policy Cyprus can clarify as a CIN country so as a residence state, exempts any source-based income earned outside Cyprus. This means that investments within the country owned by a foreign investor face not less favourable tax treatment than a domestic investor. The International Trusts Law[116] clearly manifests in clause 12(1) that: *"The income and gains of an international trust derived or deemed to be derived from sources outside the Republic shall be exempt from all taxes imposed in the Republic".* Moreover, the absence of exchange controls, excellent international banking services, a good network of DTCs and other international treaties and agreements and generally the commercial infrastructure would all add as advantages for an inward investment in Cyprus. Not to be missed even in the financial sphere are the geographical location of the island, being a "bridge" between three continents, the European lifestyle and the English-based legal system make the island a prosperous region where inward investment especially through international trusts can easily flourish[117].

4.03 Cyprus International Trusts legislation

The relevant legislation in Cyprus in respect to international trusts is the International Trusts Act 1992 (hereinafter as the "Act"). Under clause 2 of the Act a trust qualifies as a Cyprus international trust if:

(i) the settlor is not a permanent resident of Cyprus;

(ii) at least one trustee is a permanent resident of Cyprus;

(iii) no beneficiaries are permanent residents of Cyprus; and

(iv) the trust property does not include any immovable property in Cyprus.

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115 Christiana HJI Panayi, Double Taxation, Tax Treaties, Treaty Shopping and the European Community, (Kluwer Law International, 2007) ch.1

116 No.69(I) of 1992

117 Andreas Neokleous 'Cyprus – An ideal jurisdiction for trusts' [1987] CLR Issue 20 at 5667

A quick outline of the Act can simply reveal that the trust can remain in force for 100 years and the Cyprus courts have jurisdiction to vary the trusts pursuant to the English Variation of Trusts Act 1958. The property of the trust is not subject to any estate duty so any trust income, which can be accumulated any time in the life of a trust, in the form of royalties, interests and dividends are exempt in the hands of the trustees and beneficiaries as well. Furthermore, any gains on the disposal of assets are not taxable in Cyprus. The only charge arising on creation of the trust may seem to be under clause 12(2) of the Act, where the instrument creating the international trust is subject to stamp duty of €427,00.

4.04 Planning Ideas

In an attempt to apply the already discussed principles through decided case law from international courts the next section provides ideas on how trusts can be used tax efficiently in the field of investment, project financing and management and asset partitioning.

(a) Unit trust scheme

The International Collective Investment Schemes Act 1999[118] (hereinafter as "ICIS") lies down guidance under s.76 of ICIS for international trusts created and recognized to operate as international unit trust schemes being exempt from any tax. To establish such trusts though the prior approval from the Central Bank of Cyprus, which acts as the supervisory and regulatory authority, is needed which in order to be granted it has to be satisfied the requirements that the manager and trustee are experienced and experts of good standing in the field[119].

The *JP Morgan* case[120] case in the CJEU gave some footing to this type of unit trusts which were accepted to be exempt from VAT. In proceedings in the VAT Tribunal, the UK managers asserted that the services received by international trusts companies should be VAT exempt following the same treatment of other types of investment funds. Since "special investment funds" are not defined in the Directive, it was held that in principle international trust companies are capable of being classified as such[121] since as Advocate-General Kokott stipulates there is really no substantial difference between the two schemes[122] since it would be

118 N.47(I)/1999 as amended

119 Clause 18(1) of ICIS 1999

120 Case C-363/05 JP Morgan Fleming Claverhouse Investment Trust plc v Commissioners of HM Revenue and Customs [2007] ECR I-4027

121 ibid para 24

122 ibid para 30

contrary to fiscal neutrality and tax competition[123]. The CJEU pointed out that '*that the purpose of the exemption [...] is, particularly, to facilitate investment in securities by means of investment undertakings by excluding the cost of VAT'* so any discretion MS have on defining the fund structures is limited[124].

This is an important point to make: the ability to get "qualified" as a special investment fund. Hence it can be argued based on this authority that if the Cyprus international trust classified and recognised under the ICIS as an international unit trust scheme, then the road to being qualified as a special investment fund eligible for VAT exemption has been opened by the CJEU. Nonetheless, it should be carefully noted that this is not an easy going process. For instant, the Federal Court of Australia issued recently its decision in relation to the long awaited *Colonial First State*[125] trust case. The issue was a retail unit trust investment fund which held units in another unit trust fund, that sought to amend its constitution so that the proceeds of the redemption could include capital and income amounts. The purpose of such an amendment was to stream appropriate capital gains to specific unit holders and to distribute income to the same unit holder resulting in a more just and fair allocation of amounts amongst beneficiaries of the unit trusts. It was held by the Federal Court that such amendments were ineffective due to the terms laid down in the trust deed not enabling the unit trust being a fixed trust. Therefore, careful analysis and prior planning should be the priority in establishing such structures.

(b) Trusts used as Special Purpose Vehicles

Secondly, the Special Purpose Vehicle (hereinafter as "SPV") trust structuring can also be used in circumstances where treaty-shopping has been used as tax avoidance as has been demonstrated by the *Indofood*[126] case. An Indonesian company incorporated a Mauritian SPV to issue loan notes. These contained provisions of a gross-up clause, early redemption in case of treaty changes with an aim to benefit from the withholding tax rates under the Indonesia-Mauritius DTC. JP Morgan Chase was the trustee and the paying agent for the bondholders. However, Indonesia subsequently terminated the DTC with Mauritius and Indofood was advised to establish a SPV in the Netherlands to perform the same function as the Mauritian one and continue benefiting from the favourable 10% withholding tax on interest. The Court of Appeal held that this was not a

123 ibid para 46

124 ibid para 45

125 Colonial First State Investment Limited v Commissioner of Taxation [2011]FCA 16

126 Indofood International Finance Ltd v JP Morgan Chase Bank NA London Branch [2006]EWCA Civ158

reasonable measure than Indofood should have taken as no direct beneficial ownership of either the Mauritian or Durch SPVs could be proved[127].

This principle was consistently applied by the Canadian Court in *Prevost*[128] case where, a Netherlands holding company - B.V., was established by Swedish and UK resident corporations to hold shares of a Canadian corporation. The residency of B.V. was in the Netherlands. From 1996 to 2001, Prévost Car made 12 dividend payments totalling $90 million. Withholding tax of 5% was paid pursuant to the Canada-Netherlands DTC. On receiving such dividends from Prévost Car, B.V. would distribute them to its UK and Swedish shareholders, as dividends on the shares of B.V. It was argued that B.V. was not the "beneficial owner" of the dividends paid by Prévost Car and the tax authorities levied 15% and 10% withholding tax pursuant to the Sweden-Canada DTC and UK-Canada DTC. The Tax Court of Canada found in favour of Prevost Car. There was no evidence that the BV was a conduit used to funnel dividends from Prevost Car to the Swedish and UK corporations.

The Cyprus international trust legislation as it stands now poses no obstacle for an international trust to be used in Cyprus in the same way its analogous STAR and VISTA trusts are being used in the Cayman Islands and in the British Virgin Islands as SPVs for project managing companies[129]. Nonetheless, Cyprus' tendency to abide to the general anti-avoidance provisions put forward by the EU and international community may give some strength to the Inland Revenue Authority to tackle such a structure and/or it may just be a matter of time for an SPV – even a government established and controlled one – to follow upon the experience of its corresponding competitors in the exotic islands.

(c) Asset protection trusts

Thirdly, an asset protection trust is a trust with main purpose of 'ring-fencing' the settlor's assets, from creditors who may have a claim against their assets, since the trust property is in fact separated assets from the rest of the settlor's wealth. In large building projects and/or ship financing, aircraft leasing etc an SPV is usually established for the purposes of protecting the shareholders from potential insolvency of the project and at the same time insulating creditors from shareholders insolvency[130]. Ideally SPVs are located in favourable tax jurisdictions

127 HJI Panayi, supra n.111

128 The Queen-v-Prévost Car Inc.[2009]FCA 57

129 Glasson supra n.53

130 Philip Wood, Law and Practice of International Finance (University edition, Sweet&Maxwell,2010)ch.13

which can facilitate transfers of intangibles with no withholding tax, good network of DTCs, and no capital gains tax on any realised profits and so on. An illustrative example of such a practice is the STAR trusts in the Cayman Islands[131].

The Cyprus international trust has been used quite often in the respect of asset protection due to the further advantage provided for in clause 3(2) of the Act. This delineates a strong presumption against avoidance of an international trust unless it is proven to the court that the trust was made with an intent to defraud persons who were creditors of the settlor at the time when the payment or transfer of assets was made to the trust, the burden of proof being on the person who is seeking to annul the transfer. As it seems the provision, and particularly the requirement to prove intent to defraud on the part of the settlor, set the threshold high for the claimant trying to set aside a transfer to a Cyprus international trust. As Mr Neocleous argues in his recent article[132] even though the standard of proof is the balance of probabilities, rather than the criminal standard, the claimant must still establish that the trust was more likely than not a fraud; this being a difficult standard to meet in practice as strong evidence has to be adduced to illustrate fraud.

If one were to apply the thinking of the European level tax point of view, if the creditors are the tax authorities of the trust resident MS the burden of proof will be on them claiming an avoidance of the trust or restriction one of the fundamental freedoms with the justification of “prevention of tax avoidance”. This resembles the ‘wholly artificial arrangements test’ applied by the CJEU in the *Cadbury Schweppes*[133] case.

4.05 Amendments to Cyprus International Trusts Law

The importance and significant role the international trust plays in the economic life of the island and particularly in the tax system is shown through the willingness and effort to further amend and refine the existing law relating to it. There has been in the streamline, since February 2011[134] a new amendment to the Act with a number of significant issues being raised. The Technical Explanation to the Amendment specifies the need of increasing competitiveness in view of the recent developments of other international trusts laws in several jurisdictions, such as Jersey and British Virgin Islands. The proposal anticipates and recommends for the setup of a more economically attractive and competitive environment for

131 Glasson, supra n.53

132 Elias Neocleous ‘Cyprus’ [2010] Trusts&Trustees, Vol.16, No.3, pp.128-133

133 Supra n.25

134 Published in the Official Gazette of the Government on 25 February 2011, Issue 4111, No.7

prospective settlors in Cyprus preserving at the same time Cyprus' tax respecting stance in the EU[135].

One of the major issues for the amendment of the existing Act is the fact that a number of important terms used in the Act are not defined. For example, there is no definition of the terms 'creditor' and 'intent to defraud', which are crucial in applying and understanding the clause 3(2) of the Act; one of the most relevant clause for the asset protection feature of a Cyprus international trust. The proposals bring into the existing clauses, definitions for all important terms which clearly will minimize the uncertainty that may have been faced by international clients and/or tax authorities. For example, the inclusion of definition to terms such as "object", "decision", "creditor", "disposition", "beneficiary", "settlor", "protector", "intent to defraud", "obligation" sound more than essential terms that need to have already been defined.

Following an analysis on the proposed amendments[136] it is apparent that a new section, adopted by the Jersey and Guernsey international laws, is to be inserted, permitting the settlor to reserve powers to himself, to retain a beneficial interest in trust property, and/or to act as the protector or enforcer of the trust. The impact this may have on the tax treatment and classification of the trust may be an issue since by giving powers to the settlor would not amount to their alienation from the trust property. An authority from Jersey reaffirms this in the case of *Rahman v Chase Bank (CI) Trust Co Ltd*[137] where the settlor retaining the power to appoint capital of the trust to anyone including himself, being himself one of the beneficiaries and any transfer the trustee was willing to make should have been 'exclusively to the interests of the settlor'. The Royal Court of Jersey held that the settlor was administrating and managing the trust property as his own so 'the settlement was made to appear to be what it was not'. Thus, how wide the powers the settlor should be retained and how much discretion should be accepted in the ambit of this provision should be carefully considered and is quite controversial.

Moreover, in the proposals there is emphasis added to Articles 6 and 7 of the Hague Convention providing as such for the choice of law for the trusts. The proposed new clauses 12A, 12B and 12C give guidance as to the choice of law rules and make clear that a choice of the law of Cyprus to govern an international trust is valid and effective and also establishing choice of law rules for identifying the governing law of the trust in the absence of choice; and make it clear that

135 As proposed and outlined by Maria Kyriakou, Nicholas Papadopoulos, Angelos Votsis.

136 Elias Neocleous and Toby Graham, 'Cyprus international trusts – a leap forward: the proposed amendments to the International Trusts Law 1992' [2011] Trusts & Trustees, Vol.17, No.5, p.382-392

137 Rahman supra n. 52

where the law of closest connection to the trust in the absence of choice is the law of Cyprus, the application of the law of Cyprus is entirely effective.

It is obvious that some aspects of this Amendment may be well-received and if passed by the House of Representatives it will result in better clarity and predictability in a modern trust law environment. However, it should be reckoned carefully whether in this way some of the hesitancies and reluctances of investors in respect to establishing and utilising Cyprus international trusts for tax planning will fade away amounting to a successive and profitable structuring or whether it may lead to a complete alienation from the Cyprus international trust. The new Bill is in the pipeline and is due to be passed soon. The implications it will have on the Cyprus International Trust from both a domestic and an EU perspective is an interesting issue to follow further.

Conclusion

Tax mitigation has discovered, innovated, attempted, explored and is still developing. Reasons vary according to the initial purpose, the motive, the result, the experience and the stance of the party involved in tax planning. The only fact that can be stated is that: it is a reality. Offshore tax planning is one of the "next steps" dared to be taken by exploring the benefits of tax mitigation off the territorial limits of one's own state. The risk involved is compensated by the gain return. Efficient tax planning can be said to be the minimisation of tax residence liability without incurring any significant source tax liability in the other jurisdiction[138].

What should be emphasised and never neglected is the full disclosure of any intention, structure, attempt and success of this. After all, the benefit from increased competition, efficient business structuring and profitable returns is not only to be enjoyed by taxpayers and wealthy individuals against the government but also by governments themselves. There is no implication or assertions in any of the prudent tax planning structures and tax mitigation processes that the revenue authorities should be deceived and reasonably if not necessarily any fraudulent attempt to do so amounts to the criminal offence of tax evasion which is penalised. As Prof. Philip Baker stresses that there are countries where there are different degrees of tax fraud and suggests that possibly different degrees of penalties '*dependent upon the degree of culpability*' might be acceptable. What seems to be almost basic if not compulsory nowadays is for countries to adopt a statutory

138 Clarke supra n. 57

offence of tax fraud defining such as '*taxpayers are entitled to a clear, statutory definition of what is regarded as criminal conduct*'[139].

A sham is an attempt to deceive, to pretend thing are otherwise than they seem[140]. This is not what should planners are aiming at. The EU through the TFEU and the CJEU provides a great deal of opportunities to a person to structure their fiscal affairs. The trust concept being "alive" from the time of the Crusades proved to be an intelligent way to take advantage of benefits that are available and actually provided for. The Hague Trusts Convention is a reaffirmation of this in the sense that it respects this "common law principle" and gives the chance to civil law countries to recognise it and make use of its merits by ratifying the Convention. Structuring using trusts as shown in this study could be complex, multipart, influenced and dependent of quite a few factors but beneficial and as shown in practice these "barriers" tend to be ignored when it comes to the profits realised. After all, they were initially created under equity as the 'just and equitable' decision to be taken to those '*who come to equity with clean hands*'[141].

Cyprus is a small island with big opportunities. Being for many years as one of the 'blacklisted' countries of the OECD in respect to harmful tax competition and having the tag of a tax haven was an incentive for aiming at better cooperation, and achievement of international standards and approval. Today Cyprus is one of the financial centres of the Mediterranean and the evolution tax has brings economic development. Cyprus legislators revise the tax system with a purpose of keeping up with the transformation from a tax haven threatened with imminent sanctions to a tax regime with enhanced appeal for international tax planning[142].

Quoting Bertolt Brech seems the ultimate conclusion that can be drawn in respect to international tax avoidance through trusts: professional, lucrative, risky. Cyprus can be the legal avenue to get there or escape from.[143]

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139 Baker supra n. 5

140 Douglas v Baldwyn [1953] NZLR 313 at 321

141 Hanbury supra n. 49

142 Demetra Pipinga, 'The Continuing Advantages of Cyprus in International Tax Planning' [2008] IBFD European Taxation 21.

143 Glasson, supra n. 53