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Informal translation June, 2009

Dr. Ineke A. Koele: Fears and fantasies about trusts and other special-purpose funds[1]

The legislative proposal for amending the Inheritance Tax Act and certain other tax laws that was published on 20 April 2009 will shortly be debated in parliament. It is worth asking whether the part of the legislative proposal that addresses the approach to trusts and other special-purpose funds has not been overtaken by events in the financial world. One important development is that offshore planning is no longer fashionable in the international estate planning world. A conscientious global search is now under way to identify more sustainable onshore structures. If even Switzerland is falling out of favour because of its nebulous ways, billions are bound to beat a path to other jurisdictions. It is vital for an internationally minded small trading nation like the Netherlands to anticipate this trend. Is the Netherlands still in a position to offer wealth and wealthy families a safe and attractive haven? A constructive approach on this point is probably also the best way for the Dutch banking system to quickly regain its feet.

The legislative proposal takes a comprehensive new approach to trusts and other special-purpose funds.

The intention, starting in 2010, is to impute 'floating' assets held in special-purpose funds (trust, Anstalt, stichting, or otherwise), usually based in offshore jurisdictions where no tax is payable, to the individuals that set up the special-purpose funds, or, if the person concerned has died, to the heirs. A substantial part of the legislative proposal is designed to disregard what are known as *discretionary trusts* for the purpose of both income tax and inheritance tax. The usual purpose of this legal concept is to enable wealthy families permanently to relinquish their wealth to the trust, while leaving informal instructions to the trustees. The Supreme Court views legal concepts of this kind as an independent instrument for the application of Dutch tax law, and gifts to a trust of this kind are consequently subject to Dutch gift tax at the high third-party rate, while payments from these trusts are normally untaxed, since they are based outside the Netherlands.

Practice has adapted to this situation (with use being made mainly of trusts set up outside the legal sphere of Dutch taxation) and it is therefore high time for legislation, according to the explanatory notes to the legislative proposal. However, the legislative proposal is not restricted to trusts. The legislative proposal would apply a concept of nonexistence to any situation with an element of 'ring-fenced assets with which a more than incidental private interest is envisaged'. These assets are deemed to pass to the

[1] Published in Dutch in Fiscaal Tijdschrift Vermogen Juni 2009

heirs of whoever segregated their wealth, while payments from the ring-fenced assets are deemed to be paid by the same heirs.

Although it is understandable that the Dutch parliament wishes to introduce anti-abuse legislation that covers use of *discretionary trusts*, I am of the opinion that parliament has overshot the mark with the proposals on this point. The Explanatory Memorandum furthermore shows no evidence of any supporting analysis of the kinds of alternative anti-abuse regulations that have since been introduced in many (both Anglo-Saxon and 'civil law') jurisdictions.

The legislative proposal will bring about at least the following altogether undesirable consequences.

a) In Anglo-American legal practice, the trust is the workhorse of asset planning towards succeeding generations, and an average will and testament is likely to spawn one or more trusts. In practice trusts come in hundreds of different kinds, of which only the *discretionary trust* mentioned above causes any irritation. Although the Explanatory Memorandum says the intention of the new scheme is not to include other types of trust with different types of entitlement, nothing in the wording of the Act bears this out. In other words, it is a question of massive overkill.

b) Because imputing a special-purpose fund to beneficiaries creates substantial problems in practice (as has also transpired in Germany), a fiction has been created that the heirs are deemed to possess equal shares of the special-purpose fund assets. This fiction is entirely divorced from legal reality, and the profession will have no difficulty in adapting to the legislation. Precisely the people to whom the new legislation is addressed will then be able to avoid its application.

c) Foreign special-purpose funds will often be created for motives of pure *asset protection* (to protect assets against intrusive claims from ex-spouses and other family members). It will be commonplace in these cases for Dutch family members to be heirs and therefore notional owners of assets that in practice will never – to this degree – accrue to these 'heirs' (the inheritance will have been 'stripped'). The wording of the legislative proposal has an exception to the allocation to these heirs only if they are able to demonstrate that they will never be *able* to receive payment from the foreign special-purpose fund, which will generally be impossible in practice. The result will be a completely unreasonable imposition of tax.

d) The proposed legislation has to be 'EU proof'. Because no distinction is allowed between foreign and domestic legal forms and effective places of establishment, the wording of the Act is equally

applicable to foundations based in the Netherlands that satisfy the definition of ring-fenced private assets with a more than incidental private interest.

According to the Explanatory Memorandum, Dutch foundations with *'no, or only an incidental'* public service function are also used for tax evasion. There is nothing to clarify what kinds of foundations might then be involved. The only kinds that I can imagine would be involved are those that move their actual seat to offshore jurisdictions before making payments directly, or to family members of the people who segregated their assets in the foundation.

Foundations based in the Netherlands can operate in a tax-efficient way only if they qualify as a charity, which is referred to in the law as a public benefit organisation (PBO). A PBO organization of this kind happens to be subject to the highest gift tax rate for any payments it makes that have no public service objective.

The legislative proposal also provides for a substantial tightening of the requirements on a PBO: whereas under the current law a PBO may serve private interests to approximately 50%, the permissible proportion is to be reduced to 10%.

The Explanatory Memorandum draws no distinction between foundations that are PBOs and others. The distinguishing criterion for tax evasion given in the explanatory notes is whether it can be established that the ring fenced assets were envisaged as having a '*more than incidental'* private interest. It is completely unclear how this is to be interpreted. It is perfectly possible for a charitable foundation that its activities pursue entirely its charitable objective, whilst at the same the philanthropist concerned to have envisaged a 'more than incidental' private interest in segregating these assets (e.g. by linking the gift to an instruction to, or condition on, one or more third parties). According to the legislative proposal this would be reason to impute the entire assets of the charitable foundation to the philanthropist who created it, or to his or her heirs. The same applies fairly generally to the new gift-tax-exempt class of organizations that promote a social interest while also serving a private interest (referred to as SBBIs in the Netherlands). The result is completely unreasonable and contrary to the principles of Dutch tax law. The wealthy foundation has its own legal personality and is not subject to corporate income tax if it does not conduct a business. It is conceptually unsound to allocate these assets 'at random' to philanthropic individuals who created them.

e) The legislative proposal has an accumulation of legal fictions, which leads to extremely unfair results. If someone ring-fences assets in a purely foreign family foundation and names the Red

> Cross as beneficiary, any payments from 'his' foundation after his death will be deemed notionally to be payments by the Red Cross. Although no one will doubt that the Red Cross only makes payments that are 'deemed to be made as a public service', one has to wonder what the consequences of this fiction would be for the Red Cross…! It might be held liable for the gift tax that is considered due by the recipient of this gift, whilst it is absolutely innocent and not involved in this.

The 'fear' of floating assets has prompted quite a few 'fantasies' at the ministry. However, precious little fantasy is needed to arouse an uneasy feeling that this proposal will fail to affect the people it is aimed at, while unintentionally posing considerable problems for many others (including charities and philanthropic family foundations).

In my view, it would be much more effective, and would meet with far less resistance, to introduce a fiction into the law that special-purpose funds are deemed to be based in the Netherlands in certain circumstances, if both those who contribute assets, and at least some of the beneficiaries, are resident in the Netherlands. This would acknowledge the legal reality of the special-purpose funds and do justice to the Netherlands' ratification of the Hague Trust Convention, while covering both the 'doomed' *irrevocable discretionary trusts* and the foundations that have emigrated to distant shores to escape Dutch gift taxation. The Italian parliament introduced just such a fiction in 2007, and on this point it may be a source of inspiration to the Dutch parliament. Little fantasy is needed to see that the introduction of a fictional place of establishment of this kind would make all the money flows to and through these special-purpose funds subject to the highest gift tax rate, while parliament need have no fear of ineffectiveness through incompatibility with the 'freedoms' of the EU Convention.

If parliament were finally to dare to accompany a fictional establishment of this kind with an effectively formulated exit provision, according to which special-purpose funds would be deemed to be based in this country if they had been based in the Netherlands in the past ten years, it would become possible to levy gift tax on payments from foundations that emigrated in this period. This would appear to me to be the only way for parliament to achieve its objective of about 70% of budgetary cover of the legislative proposal (including substantial gift and inheritance tax rate reductions and higher exemptions of business assets) in the just fight against trusts and other 'shadowy' foreign special-purpose funds.

However, the greatest threat for parliament goes much further than the budget for this legislative proposal. The irritations created by unjust legislation among wealthy individuals leads to emigration and other evasive action. It would be advisable to address the fantasy again, and to consider how we, as a

small trading nation, might offer a home to assets seeking their way from offshore locations to flexible legal forms in ‘high tax’ countries.

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