Luxembourg tax treatment of trusts and fiduciary operations

Jean Schaffner, Allen & Overy Luxembourg

While the *fiducie* exists in Luxembourg for some time already, Luxembourg has ratified the Hague Convention only in 2003, thereby formally recognising foreign trusts.

The fiducie contract is a contract whereby a person, the principal (*fiduciant*), confers ownership rights over fiduciary assets to a credit institution or similar regulated entity (*fiduciaire*) under certain obligations, i.e. the fiduciary liabilities agreed upon in the fiduciary contract. The fiduciary agent obtains legal title over the assets designated in the fiduciary contract. There is a transfer of ownership and, from a civil law perspective, the fiduciary agent is the legal owner of these assets. Upon termination of the agreement, the assets are transferred back to the principal or to a third party.

The law of 27 July 2003, which amends the fiducie and ratifies the Hague Convention, only addresses fiduciary operations where banks and certain professionals of the financial sector, such as investment firms, investment funds set up as a *société d'investissement à capital variable* or as a *société d'investissement à capital fixe*, management companies of collective investment funds (*fonds commun de placement*), pension funds, insurance or reinsurance companies and finally securitisation vehicles act as agents.

However, various mandate and similar agreements are also commonly referred to as "*contrats fiduciaries*" by Luxembourg practitioners. These agreements do not benefit from the protection of the law of 27 July 2003 in the case of bankruptcy of the fiduciary agent. Indeed, if a bank or similar entity which has entered into a fiduciary agreement as a *fiduciaire* goes into bankruptcy, the assets managed on a fiduciary basis are isolated and may not be seized by the general creditors of the bank. In the presence of a fiduciary contract not governed by the law of 2003, creditors of the principal do not enjoy the protection guaranteed by the law. This is particularly true for domiciliation companies (so-called "trust companies"). The law of 2003 has not included the domiciliation companies in the list of entities, which may act as fiduciary agents. To incorporate a Luxembourg company, the principal frequently entrusts the share capital to a domiciliation company, with an obligation to contribute this money to a company to be set up and to act as incorporator of this company in the notarial meeting, which has to be held to that effect in Luxembourg. The shares of the company may then be converted into bearer shares or be transferred back to the principal by the fiduciary agent after the incorporation meeting. Such arrangement is often referred to as "*fiducie*" but does not benefit from the law of 2003.

Banks use the fiduciary contract mainly for credit or guarantee purposes. For example, under the *fiducie crédit*, the client of a bank transfers to the bank assets, which he holds on deposit with the bank and requests the bank to make a loan to a designated person by using these assets. This loan will be made in the bank's name, but for the risk of the principal. Similarly, the bank may also issue securities to the public on behalf of the principal. The *fiducie* in this instance also serves to facilitate the issuance of depository receipts.

Under the *fiducie sûreté*, the principal transfers title to various assets to the fiduciary agent as security in respect of a loan or other obligation. The purpose is to enable the fiduciary agent to sell these assets at the maturity of the guaranteed obligation if the principal is in default.

Of course, the *fiducie* may also be used for gift and inheritance purposes.

The law of 27 July 2003 recognises foreign trusts, but it does not provide for the possibility to set up Luxembourg trusts. It does also not address the direct tax treatment of trust and fiduciary contracts. Although the

fiduciary contract is an agreement between the *fiduciaire* and the *fiduciant* (contrary to a trust) without a division between equitable and legal ownership in respect of these assets, as is the case for a trust. which is not based on a contractual relationship, their tax treatment is largely comparable.

The Luxembourg tax treatment on trust and fiduciary operations is based on general tax principles. The basis of income taxation of both the *fiducie* and the trust may be found in a rather old legislation of German origin, paragraph 11 of the tax adaptation law (*Steueranpassungsgesetz*) and paragraph 164 of the general tax law (*Abgabenordnung*).

According to paragraph 11 of the tax adaptation law, assets transferred to a fiduciary agent or acquired by a fiduciary agent from a principal are attributable to the principal for tax purposes. Therefore, from a tax point of view, the principal will be considered to hold the fiduciary assets and be the beneficiary of the income derived from these assets for purposes of Luxembourg wealth tax, income tax and municipal business tax. The fiduciary agent or trustee will in principle not be subject to taxation in Luxembourg on fiduciary assets held or on the income made on the transfer of the fiduciary assets back to the principal. Neither the fiduciary assets nor the income generated by them are reflected in the tax balance sheet of the fiduciary agent. To benefit from this favourable tax-neutral treatment, the fiduciary agent has to be prepared to provide, upon request by the Luxembourg tax authorities, the identity of the principal or beneficiary and the details of the operations performed by the fiduciary agent on their behalf. Indeed, paragraph 164 of the general tax law provides that where a taxpayer claims to derive income as a fiduciary agent or representative, he has to demonstrate for whose benefit he acts. This provision slightly contradicts paragraph 11 of the tax adaptation law, according to which assets transferred on a fiduciary basis have to be allocated for tax purposes to the principal. However, historically paragraph 11 merely intended to cover scenarios where the *fiducie* served for purposes of a donation. Both provisions confirm the economic analysis which prevails in Luxembourg tax law. It is the economic beneficiary of the trust or the *fiducie*, who is subject to taxation on income and gains derived from the trustee or the fiduciary agent.

For example, if the *fiducie* is used for estate planning purposes, income of the assets transfers to the *fiduciaire* is taxable in the hands of the beneficiary, as soon as he is entitled thereto. Otherwise income is taxable with the *fiduciant*. The *fiducie* may also be used for example to grant a loan. The *fiduciant* entrusts cash to a bank, and requests the bank to grant a loan to a certain beneficiary. Interest on this loan is then taxable with the *fiduciant*.

Thus, from a Luxembourg tax perspective, the fiduciary assets are beneficially attributed to the economic beneficiary. Accordingly, the fiduciary agent may *a priori* not claim treaty protection under the Luxembourg tax treaties on income produced by these assets or on capital gains realised on their disposal. This tax treatment is applicable regardless of whether the law of 2003 applies to the fiduciary contract at hand or not, i.e. without taking into account the identity of the fiduciary agent.

A trust is usually taxed along the same principles. A trust may however follow a more complex pattern, for example in the case of a discretionary trust. If no beneficiary of the income and the assets of the trust may be isolated, Luxembourg income tax law comes to the conclusion that the trust itself is the taxable entity. Indeed, article 159. 1 (A) 7 of the Luxembourg income tax law considers as corporate income taxpayers entities whose income is not taxable in the hands of another taxpayer. This could apply to certain discretionary and charitable trusts.

If the taxpayer in the presence of a *fiducie* or a trust is a non-resident of Luxembourg, not having a permanent establishment or permanent representative in Luxembourg, solely Luxembourg source income is taxable. This covers, for example, rental income and capital gains on the sale of Luxembourg real estate, capital gains on the sale of shares in a Luxembourg company, under the condition that the seller had a substantial participation of more than 10% in the share capital of the Luxembourg company, and the shares are sold within six months of their acquisition, or dividend distributions by a Luxembourg company. In the latter case, taxation is applied via

withholding, while the two first categories are subject to taxation via general assessment. Such profits are however not subject to municipal business tax.

Under the EU savings directive 2003/48, as implemented into Luxembourg tax law, interest payments to a *fiduciaire* or trustee do not fall within the scope of the interest withholding tax, but the *fiduciaire* or trustee, if based in Luxembourg, may become paying agent when paying on interest to the beneficiary and, in that capacity, would have to apply withholding tax.

Luxembourg has further entered into certain double tax treaties, for example the double tax treaty with Canada, where a trust may be considered as a resident for treaty purposes. Income of a trust falls within the other income article, and may (in most cases) be subject to taxation via withholding at source at a rate not exceeding 15%. Under the Luxembourg-US double tax treaty of 3 April 1996, a trust is considered a person for purposes of the treaty and qualifies as a resident if its income is directly taxed at its level or in the hands of resident beneficiaries of the trust.

No VAT is usually levied on the transfer of assets to a trustee or a *fiduciaire*. Indeed, this transfer is not made for valuable consideration, so that it should not be within the scope of value-added tax.

Under the law of 27 July 2003, an *ad valorem* registration duty may only be required upon the transfer of assets to a trustee or a *fiduciaire* where this transfer of assets to a trustee or *fiduciaire* is supposed to stay in place for more than thirty years. This transfer duty may for example apply on Luxembourg real estate or on ships or aircrafts registered in Luxembourg. These particular tax rules may apply also if the fiduciary agent does not qualify under the law of 27 July 2003.

In respect of the timing of application of gift duties and inheritance taxes, the law of 27 July 2003 confirms that such taxes and duties are due at the moment of the actual transfer of the relevant asset (other than real estate) to the heir or donee. This transfer materialises the donation or legacy.

No gift tax is indeed due on the transfer of assets to a trustee or a *fiduciaire*. Gift tax and estate tax may be due only upon transfer to the beneficiary, but not at the time the *fiducie* or trust is set up. The tax rate applicable depends on the relationship between the principal and the beneficiary.