Analysis of New Law

TRUSTS UNDER ATTACK IN THE NETHERLANDS: THE NEW 2010 DUTCH TAX LEGISLATION ON TRUSTS

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INTRODUCTION

On 1 January 2010 new legislation on gift and inheritance tax entered into force in the Netherlands, which reformed the existing Inheritance Tax Act 1956. A number of important changes have been made, such as those concerning rates and exemptions, and in addition some tax avoidance schemes have been tackled, including the trust.

In this article I will elaborate on the changes in Dutch tax legislation regarding trusts, how trusts were taxed before 2010, why the legislation was introduced and the consequences of the new legislation.

AMENDMENTS TO THE INHERITANCE TAX ACT 1956 – GENERAL

First and foremost, the rates in the Dutch Inheritance Act 1956 have been substantially reduced and the exemptions have been extended in 2010. Where formerly there were 28 different rates applicable, a graded tax system applied with seven different rates and four categories depending on the taxable amount and the relationship between the donor or deceased and the acquirer, under the new 2010 legislation, there are only six rates. The maximum rate before 2010 was 68%. As of 2010 an acquisition of up to €125,000 is taxable at 10% for partners and children, at 18% for grandchildren and at 30% for all other acquirers. An acquisition of €125,000 or more is taxable at 20%, 36% and 40% for these groups of acquirers. Furthermore, the exemptions have been extended, with the exemption of €600,000 inheritance tax for partners and the exemption of €24,000 to €50,000 gift tax for children under specific circumstances, being the most important exemptions.

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In addition, so-called 'tax avoidance schemes' have been tackled. These include usufruct constructions, the 'grandfather clause' in wills, immediately due and payable interest-free loans, revocable gifts and certain life assurance schemes.

In order to finance the rate reductions and extended exemptions, trusts have been examined as well. In the view of the State Secretary of Finance, a trust is a specific form of a tax avoidance scheme.

REASON FOR THE NEW LEGISLATION

The Anglo-American trust is a legal concept unknown to Dutch law, as it is for many other continental legal systems. Even though the Netherlands signed the Hague Convention on the Law Applicable to Trusts and on their Recognition 1985 (the Hague Convention), the trust is generally not a part of our legal system.

Having said that, in the past many trusts and foundations were set up in practice involving Dutch taxpayers. Either they were the 'settlor' (contributor) or the beneficiary. Often foreign trusts and structures were used.

According to the State Secretary of Finance, a sum of more than €250 million in taxes would be involved with only a very few trusts belonging to residents in the Netherlands, especially in the Caribbean. This implies that it involves assets running into several billions, and would affect only a few dozen families. The State Secretary of Finance succeeded in convincing the Lower House that these assets do exist and are taxable, and received approval to introduce new legislation governing trusts.

TRUSTS UNDER THE OLD DUTCH REGIME UP TO AND INCLUDING 2009

In the past, many trusts and foundations were set up in practice involving Dutch taxpayers as settlor or beneficiary. Up to and including 2009, there was no legislation on trusts in the Netherlands. There was only case-law. To be more specific, most importantly there was the trust case-law of November 1998 regarding the inheritance tax consequences of an irrevocable discretionary trust, there was case-law for income tax purposes of 2006 and 2007 and there were cases in lower courts about when a trust could be qualified as irrevocable and discretionary. This case-law will be discussed below.

Case-law of November 1998 Regarding the Inheritance Tax Consequences of Irrevocable Discretionary Trusts

In the Netherlands, an individual is liable for inheritance and gift tax in case the deceased or donor was a resident of the Netherlands at the time of death or the donation. The tax is payable by the acquirers (heirs, donees) regardless of their place of residence.

Under old trust rules, in the case of irrevocable and discretionary trusts, the assets put into a trust were regarded as floating assets, not taxable with the settlor nor the beneficiaries. The basis could be found in the trust case-law of the Supreme Court of November 1998.[1] The specific features of the trusts in this case were that the settlor of the assets had irrevocably surrendered his assets and it was entirely at the discretion of the trustee to designate the beneficiaries of the assets. These are known as irrevocable discretionary trusts.

The following was decided by the Dutch Supreme Court:

– The settlor had irrevocably surrendered his assets and lost all authority to dispose of these assets.

– The beneficiaries did not have a right to a distribution from the trust, but only a bare expectation.

– Even though the trustees were legally the owners of the trust assets and they had the management and control over them, the trust assets formed a separate fund and the trustees could only exercise their authorities for the benefit of the beneficiaries.

– The protector that was involved in these cases did have some authority, but this authority only consisted of appointing or excluding the beneficiaries.

The Supreme Court of the Netherlands concluded that neither the settlor nor the beneficiary could be taxed on the assets contributed, and so they were not liable for inheritance tax. However, the trust was deemed to be a special purpose fund and the tax authorities could levy gift tax at the highest rate of 68% when establishing the trust.

Case Law Regarding Income Tax Consequences of Irrevocable Discretionary Trusts

According to the Dutch Personal Income Tax Act that became effective in 2001, Dutch individual residents are subject to income tax in three different so-called boxes. On their income from employment and housing in box I, a progressive rate with a maximum of 52% personal income tax is due. On income from a substantial shareholding in box II,[2] a flat rate of 25% is due on capital gains and dividends. Finally, in box III, income from savings and investments is taxable at a fictitious yield of 4%, taxable against 30% (1.2%).

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1 Supreme Court, HR 18 November 1998, 31 756, BNB 1999/35c, Supreme Court, HR 18 November 1998, 31 758, BNB 1999/36c and Supreme Court, HR 18 November 1998, 31 759, BNB 1999/37c.

2 A substantial shareholding is a shareholding of 5% or more of the issued and paid up capital in a company with a capital divided into shares.

For personal income tax purposes, case-law of 14 July 2006 was decisive with regard to trusts. In two proceedings[3] the Dutch Supreme Court decided that distributions by a trust can under certain circumstances be qualified as taxable periodic payments. This means that the payments are taxable for personal income tax purposes so far as the amount of paid premiums for this right to periodic payments is exceeded. Even though this case-law relates to the old Dutch Personal Income Tax Act of 1964, under the new legislation, the Personal Income Tax Act 2001, this case-law remained valid and the payments would be taxable in box I. Secondly, the Dutch Supreme Court[4] ruled that in case of a special life interest trust, namely the 'qualified domestic trust' the income from the trust should be qualified as taxable income from savings and investments, taxable in box III at 1.2%. The spouse of the deceased settlor had the right to 'the entire net income of the Qualified Trust'. During the life of the settlor, the trust was revocable, as a result of which he could dispose of the assets of the trust as if they were still his own. After the death of the settlor, the trust deed stated that the trust would become irrevocable. The widow was entitled to the income from the assets, but did not have the authority to dispose of the assets. She was taxable for her income from the trust in box III, the income was qualified as income from savings and investments.

Case-law of Lower Courts about Qualification of a Trust as Irrevocable and Discretionary

Whether a trust was regarded as irrevocable and non-discretionary, or if the assets could be attributed to settlors or heirs was decided in case-law as well. For the Dutch Personal Income Tax Act, The Court of Haarlem,[5] ruled that in case of an irrevocable discretionary BVI trust that, given the facts and circumstances, specifically the involvement of the settlor with the trust assets, there was more than a bare expectation and that the settlor would at a future time receive a distribution from the trust. She was taxed for assets with a market value according to the Dutch Personal Income Tax Act. The Court of Haarlem[6] also ruled that the settlor of assets into an Antillean Stichting Particulier Fonds (SPF) in fact still had the right to dispose of these assets, even though the board of directors of the SPF formally consisted of third parties. These assets were taxed as assets from savings and investments under the Dutch Personal Income Tax Act. However, in another case, the Court of The Hague[7] ruled that the settlor who had put assets into an irrevocable

3 Supreme Court, HR 14 July 2006, 39 262 and Supreme Court, HR 14 July 2006, 39 201.

4 Supreme Court, 26 October 2007, 42.53.

5 District Court Haarlem, 17 December 2009, 08/02773 and 08/02774.

6 District Court Haarlem, 17 December 2009, 09/1750 – 09/1753.

7 District Court The Hague, 16 December 2009, 09/02177.

discretionary Guernsey trust had irrevocably waived her rights to these assets. It was not found likely that the authority to dispose of the assets was in fact still with the settlor and neither that the settlor could expect a distribution from the trust that was determinable and had any market value.

In summary, whether a trust can be qualified as irrevocable and discretionary completely depends on the level of authority or power of disposal of the assets.

Opportunities in Tax Planning under the Old Dutch Regime

Even though the trust case-law of November 1998 seems restrictive at first sight, in practice it also offered opportunities for the active use of irrevocable discretionary trusts. Individuals living outside the Netherlands, and who did not fall within the scope of Dutch inheritance and gift tax,[8] could create a trust without any Dutch gift tax. In addition, the increase of value of assets with a potential for growth could remain untaxed by putting these assets into a trust in an early stage. Last but not least, the taxation of the increase of value of a substantial share interest in a company with a capital divided into shares, for example, an Ltd or a Dutch BV, could be prevented this way.

Besides policy measures from the State Secretary of Finance and transparency agreements between the tax authorities and taxpayers involved in a trust in specific individual cases, there was never an adequate legal system for trusts. In particular, since 1994, in the personal income tax return forms the question is asked whether the taxpayer is somehow involved in a trust. Not answering this question or answering it incorrectly leads to filing an incorrect tax return with many negative consequences, such as penalties.

As stated, under old trust rules, in the case of irrevocable and discretionary trusts, the assets put into a trust were regarded as floating assets, not taxable against the settlor or the beneficiaries. The presence of these floating assets was a frustration for the Dutch tax authorities.

TRUSTS UNDER THE NEW DUTCH LEGISLATION WITH EFFECT FROM 2010

The term introduced in 2010 for trusts and similar vehicles is the 'Afgezonderd Particulier Vermogen', or APV (Separate Private Fund). This is defined as a fund with an intended private interest that is more than secondary, unless certain

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[8] Residents of the Netherlands fall within the scope of Dutch inheritance and gift tax, as well as individuals with Dutch nationality who have been a resident of the Netherlands in the 10 years prior to the donation or death.

economic rights are obtained in respect of this separation. If, for example, certificates or shares have been issued related to the separation, these qualify as economic rights. More than secondary means more than 10%. Separating funds is described as the direct or indirect, legal or factual segregation of assets, with no payment or a payment that is unusual in social and economic life. Segregation also means the legal or factual, direct or indirect transfer of assets in the interest of the transferor, his or her partner or certain family members. These definitions are very broad, also to be able to capture future developments into these definitions. In practice, this leads to many uncertainties, for example, the question whether a pension foundation can qualify as an APV.

National and foreign foundations such as the 'Anstalt', 'Stiftung' and 'Treuhand', as well as the *Antilliaanse Stichting Particulier Fonds* (SPF) in the Netherlands Antilles, also fall within the scope of the definition of an APV.

Trusts are Considered Transparent for Tax Purposes From 2010

Under the new legislation, trusts are regarded as transparent for tax purposes, and as a consequence the assets contributed to the trust are deemed to be part of the settlor's assets. This means that from a Dutch perspective the assets may no longer be regarded as floating assets for tax purposes. The trust is transparent. As stated before, Dutch gift and inheritance tax is due if the donor or deceased was a resident of the Netherlands at the time of the gift or death. As a consequence of the new transparency, a gift originating from the trust is deemed to originate from the assets of the settlor and gift tax is payable if the settlor lives in the Netherlands, or if the settlor has lived in the Netherlands in the past 10 years if he has Dutch nationality. In the event of an acquisition from the trust following the death of a settlor, the assets are also deemed to have been obtained from the settlor and inheritance tax is payable if the settlor lived in the Netherlands, or if the settlor has lived in the Netherlands in the 10 years prior to the donation or death if he has Dutch nationality.

In respect of establishing the trust itself, ie when assets are transferred to the trust, gift tax is now no longer payable.

Taxation of Beneficiaries in Certain Cases

In case the settlor, his or her partner or heirs cannot be determined, the law provides for a safety net, stating that in this situation the assets are deemed assets of the beneficiaries.

The law contains a rule for evidence to the contrary, which can be provided by heirs who can prove that they are not the beneficiaries of the trust or APV. What this evidence should contain is unclear. Moreover, there is no payment facility, as a result of which for gift and inheritance tax purposes, heirs or beneficiaries may be taxable, whereas in the event that the trust has not made any distributions yet, there might be a liquidity problem.

In case of a non-discretionary trust (a fixed trust) where an individual has a legally enforceable claim or right towards the trust, he or she will in principle be taxable for that right according to the regular Dutch Personal Income Tax Act 2001.

Collection of Taxes

The collection of taxation takes place on three different levels. First, the settlor will be liable for the taxes. If collection with the settlor is impossible, the trust itself will be liable for the collection of the taxes. Last but not least, if the collection is also impossible with the trust itself, collection can take place with Dutch assets of the trust, more specifically 5% or more shareholdings of the trust. This collection takes place proportionally, depending on the level of shareholding of the trust.

Very Limited Transitional Law

These new rules, which dramatically changed the Dutch system of taxation of trusts, apply regardless of the moment of the establishment of the trust. There is only a very limited transitional rule applicable to the legislation introduced in 2010. An acquisition as a consequence of the death of a person who, for example, has been living outside the Netherlands for 15 years and gave away his assets to a trust 14 years ago, would be taxed if he came back to live in the Netherlands. After all, the trust is transparent for tax purposes and his beneficiaries receive an inheritance from someone who was resident in the Netherlands at the time of his death. Dutch inheritance tax is therefore payable on this acquisition by the acquirers. Only if an existing trust was of very limited size in 2009 (less than €5,000) and did not contain any substantial interest shares of 5% or more (*aanmerkelijkbelangaandelen*) will the new trust legislation not be applicable. In addition, a transitional law is applicable to trusts which already existed in 2009 if a transparency agreement was entered into with the tax authorities, on the basis of which there was an allocation of assets to certain persons. These agreements remain in force. Finally, there is a transitional law for situations where inheritance or gift tax was levied when establishing the trust. This tax can be reclaimed.

For income tax purposes too, the trust is transparent. The assets and liabilities as well as the income and expenditure from the trust will be assigned to the settlor of the assets. If the settlor lives in the Netherlands, this will usually result in an annual tax on imputed return on investment of 1.2% in box III on the trust assets. If the settlor lives abroad and Dutch immovable property belongs to the trust assets, the settlor will in principle be liable for income tax in the Netherlands for this property.

In case of a substantial shareholding of 5% or more in a company factually managed in the Netherlands, income tax in box II will in principle be due. The applicable rate to dividends and capital gains would in that case be 25%.

Exception in the Case of 10% Profits Tax

There is an exception with respect to the transparency: if the trust is subject to a profits tax of at least 10% by Dutch standards, the trust is no longer transparent for income tax purposes. However, this exception only applies for income tax purposes, not for inheritance and gift tax purposes.

This 10% benchmark may have the unwanted consequence that trusts are being established in jurisdictions with profits tax rates approaching this 10%. Substantial savings could be the result. The 10% tax rate is considered a reasonable tax rate in the Netherlands, and is used as a benchmark in other kinds of taxes, such as Dutch corporate income tax.[9]

Opportunities in Tax Planning under the New 2010 Dutch Legislation

The Netherlands has a unique view on trusts with this new legislation. Where the Netherlands has introduced transparency, many other countries have different rules with regard to the taxation of trusts, often not including transparency. These mismatches can offer good tax planning possibilities.

One of the advantages of the present trust laws could be that if someone is intending to emigrate to a country that does not have tax transparency, but levies tax on the contribution of assets and therefore not on the income or assets during the existence of the trust (as was the case with the system in the Netherlands before 2010), tax can be avoided. After all, during residency in the Netherlands assets can be contributed tax-free to the trust, and then once abroad, the assets held in the trust will no longer be taxed. So the Netherlands can be used as an (interim) country of residence in order to benefit from the new legislation containing the transparency of trusts. Transferring the assets into a trust is not a taxable event in the Netherlands (any more). Generally speaking however, the measures introduced in relation to trusts will have an adverse effect.

Trusts Recognised in the Netherlands now?

One can argue that the explicit mentioning of the trust, or rather the APV,[10] in Dutch tax law implicitly means a further recognition of the concept of trust in Dutch law.

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9 The Dutch corporate income tax rate however, is much higher and amounts to 20–25% in 2011.

10 Afgezonderd Particulier Vermogen (Separate Private Fund).

This may be the case. As said, trusts were recognised officially under the Hague Convention, but the tax legislator and the tax authorities have always seemed and still seem to be very suspicious about trusts. This will not change any time soon, also in the light of the reason for introducing this legislation, being that only a few dozen Dutch residents were presumed to hold €250 million in trusts in the Caribbean.

CONCLUSION

Many American and UK trusts in particular will now be subject to the new legislation in the Netherlands regarding trusts. Although these trusts have generally been established for non-tax reasons, such as managing the inheritance process, for philanthropic reasons or to protect minors, nevertheless these trusts will fall within the scope of the new legislation. Gift or inheritance tax will therefore be payable if at the time of a gift or death the settlor was living in the Netherlands (or was deemed resident of the Netherlands). Income tax will be payable on the funds held in the trust as well. Unfortunately, there is hardly any transitional law.

Commentators argue that the new Dutch rules on taxation of trusts are inconsistent and unclear. The main reason is that all kinds of trusts seem to be included in the new legislation, in principle even fixed trusts (non-discretionary) and revocable trusts. The fact that the transitional law is so very limited has also provoked comments as well. It seems that the State Secretary for Finance was eager to clamp down on a number of foreign trusts and, as a consequence, the legislator very rapidly introduced a completely new system of taxation of trusts. Where the trusts used to be separate funds, these are now considered completely transparent for Dutch tax purposes. Future case-law and explanatory notes to the legislation should bring more clarity.

Action

It is vital that the tax consequences of the amended Dutch legislation introduced in 2010 are identified and analysed in respect of existing trusts. If foreign advisers or their clients as (former) residents of the Netherlands are involved in a trust, they would be encouraged to contact a Dutch tax adviser.

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