TAX TREATMENT OF TRUSTS AND FIDUCIARY CONTRACTS UNDER LUXEMBOURG LAW[1]

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Under the Law of 27th July 2003 relating to trusts and fiduciary contracts[3] the Grand Duchy of Luxembourg ratified the Hague Convention on the Law Applicable to Trusts and their Recognition of 1st July 1985 (the Hague Trusts Convention) and introduced a new regulation of the domestic trust-like device, the fiduciary contract. When the mentioned statute came into force on 1st January 2004, Luxembourg could by no means boast a primacy among civil law jurisdictions recognising Anglo-Saxon trusts under the Hague Trusts Convention. Indeed, the same move had been previously made by Italy (as at 1992), the Netherlands and Malta (both as at 1996). Nonetheless this development is particularly significant insofar as the French Civil Code of 1804 (*Code Napoléon*) is still in force in the Grand Duchy. A received view, at least among French scholars and lawyers, that trusts and fiduciary arrangements would be incompatible with the foundations of civil law (as prescribed under the *Code Napoléon*) clashes here with a noteworthy exception, which might possibly be followed by France itself in the future[4].

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3 *Loi du 27 juillet relative au trust et aux contrats fiduciaries*.

4 To be sure, the Canadian province of Québec enacted a new civil code in 1994 and introduced an ingenious regulation of *fiducie* (trust in the official English translation). Québec lawyers have apparently been instrumental in the rounds of consultations carried out by the French Government in 2005 with a view to submitting a new "*fiducie* bill" before the next Presidential elections of 2007.

To be sure, a domestic trust-like device known as fiduciary contract or *fiducie* had been practised under Luxembourg law for two decades. The Grand Ducal Regulation of 19th July 1983, repealed by the new statute of 2003, had introduced an early regulation of a fiduciary arrangement, yet its application was restricted to the cases where a bank would act in a fiduciary capacity[5]. On the other hand, the Law of 1st August 2001 on transfer of title by way of security established a financial security arrangement based on the transfer of title to movable assets and claims either in a fiduciary or even in a beneficiary capacity[6]. Finally, the Law of 22nd March 2004 on securitisation allowed securitisation vehicles to be organised in the form of "fiduciary estates" and introduced a new category of financial intermediary, known as fiduciary representative and meant to perform the same functions as a security trustee in a securitisation transaction[7].

To some extent, the tax treatment of fiduciary arrangements in Luxembourg pre-dated the consolidation of a comprehensive civil law regime. Indeed, some provisions relating to the income tax treatment of fiduciary set-ups were contained in the tax laws enacted by the German invaders during World War II, most of which are still in force. On the other hand, the application of gift and inheritance tax as well as stamp duties to trusts and fiduciary contracts is accurately regulated under Title III of the Law of 27th July 2003.

Due to the international propensity of the Luxembourg financial industry, it is quite likely that fiduciary relationships governed by Luxembourg law may involve foreign residents in a fiduciary or a beneficiary capacity. In such cases the application of bilateral tax treaties may be in order, even though a restricted number of those stipulated by the Grand Duchy of Luxembourg include provisions expressly relating to trusts.

The coming into force of the EU Council Directive 2003/48/EC of 3rd June 2003 on taxation of savings income in the form of interest payments (European Savings Directive) as of 1st July 2005 may bring about some additional issues with respect to trusts the beneficiaries of which are individuals resident in the EU.

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5 Art. 4 of the Law of 27th July 2003 relating to trusts and fiduciary contracts expands the category of entities admitted to act in a fiduciary capacity and includes, inter alia, investment companies, investment management firms, securitisation vehicles and insurance companies. The scope of fiduciary arrangements is restricted to the financial sphere however. A ubiquitous resort to these arrangements, as is the case with the English trust, is therefore quite unlikely in Luxembourg, at least in the near future.

6 *Loi du 1er août 2001 sur le transfert de propriété à titre de garantie*.

7 *Loi du 22 mars 2004 sur la titrisation*. The tax treatment of securitisation transactions is not covered in this article.

Fiduciary arrangements and the Luxembourg tax system: an introductory overview

Trusts and fiduciary contracts are treated differently in Luxembourg for the purposes of indirect and direct taxes.

Indirect taxes, in particular registration duties, are levied on the grounds of the transfer of title to the trustee or the fiduciary and subsequently to the ultimate beneficiaries or back to the *fiduciant*, as the case may be. As a fiduciary set-up involves two subsequent transfers of title, the corresponding duties are applied at each step accordingly.

On the other hand, the title vested in the fiduciary or trustee is disregarded for the purposes of income tax. Insofar as the *fiduciant* retains a power of control – and hence the so-called "economic" or "beneficial ownership" of the assets transferred – it is liable to income tax as if such assets had not been transferred out of its personal patrimony.

This apparent inconsistency is in part due to the history of the Luxembourg tax system.

Indirect taxes were the bulk of government revenues up to modern times. Accordingly, those currently in force in the Grand Duchy of Luxembourg are based on the legal tradition of the foreign occupants that ruled the country from time to time. In particular, inheritance duties are based on the Dutch system in existence since the Grand Duchy was declared independent as a personal possession of the King of the Netherlands pursuant to the Treaties of Vienna of 1815[8]. Registration duties are based on the French system introduced at the time of the second French conquest of Luxembourg that converted a significant portion of the former Duchy into the French Department of Forests (*Département des Forêts*) and lasted from 1795 to the demise of Napoleon in 1814. Indeed, the current registration system and duties are still based on the Law of 22nd *Frimaire* of the year VII, as amended over time[9]. Stamp and mortgage duties are in turn regulated by two statutes of the same period, as amended from time to time, viz. the Law of

8 In fact, Luxembourg had been linked to a various degree to the historical and legal traditions of the Low Countries, and hence the Habsburg Empire, since it became part of the Kingdom of Burgundy in 1443.

9 As of 5th September 1793, calendar years were renumbered and months were renamed according to the "new era" following the French Revolution. The Law under consideration was therefore enacted in December 1799. Of course, the "Revolutionary Calendar" was adopted in France only and it was eventually repealed in 1806.

18th *Brumaire* of the year VII and the Law of 21st *Ventôse* of the same year, respectively[10].

During World War II Luxembourg was occupied by the German army on 10th May 1940 and subject to Nazi rule up to liberation on 9th to 13th September 1944. The current income tax regime is still based on the German legislation introduced at that time, in particular the General Tax Law or *Abgabenordnung* (*AO*) which closely reproduces the German *Reichsabgabenordnung* of 13th December 1919 as well as the Tax Adaptation Law or *Steueranpassungsgesetz* (*StAnpG*). All the legislation enacted during German rule was repealed after liberation, though income tax laws were upheld by the Grand Ducal Decree (*Arrêté grand-ducal*) of 26th October 1944 and further ratified by the Law of 27th February 1946. A major reform of the income tax system both of natural persons and corporations was enacted with the Law on Income Tax (*Loi de l'impôt sur le revenu*, *LIR*) of 4th December 1967.

The existence of two distinct cultural backgrounds based on two different legal traditions and principles justifies an impression that Luxembourg tax law would lack systematic consistency, as expressed by some leading scholars in the field.

Indeed, as far as trusts and fiduciary contracts are concerned, the same economic and legal facts are considered from two opposite angles for the purposes of the two different tax regimes. The provisions under Article 12 of the Law of 27th July 2003 relating to trusts and fiduciary contracts introduced a favourable and flexible system and removed some uncertainties still in existence at the time of the Grand Ducal Regulation of 19th July 1983 on fiduciary contracts with credit institutions, which contained no provisions with respect to tax treatment.

Accordingly, the indirect tax regime will be analysed first in this article. The provisions under Section 164 of the *Abgabenordnung* and Section 11 of the *Steueranpassungsgesetz* will be considered subsequently and their application to fiduciary contracts and trusts will be discussed. International tax issues and the European Savings Directive will be dealt with at the end of this article.

Registration and inheritance duties

Article 12(1) of the Law of 27th July 2003 relating to trusts and fiduciary contracts derogates from a provision under Article 23 of the Law of 22nd *Frimaire* of the year VII, which required prior registration of any documents to be produced

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10 It is fascinating to note that, whereas the English language adopts the taxpayer's standpoint in the phrase "registration duties", its French equivalent "*droits d'enregistrement*" (registration "rights") takes the point of view of the government

before the courts or any other public authorities. The Law of 27th July 2003 specifies that the registration of trusts and fiduciary contracts – or the documents modifying them – is now elective for any purposes, those mentioned above included, unless the instruments concern immovable property, aircraft, ships or inland navigation vessels located in Luxembourg. In other words, registration is compulsory on the grounds of the assets transferred to a trustee or a fiduciary, insofar as they undergo a specific registration regime *per se*. In any event, trusts and fiduciary contracts may be registered voluntarily if the parties so determine.

Registration, whether it is compulsory on the grounds of the categories of assets concerned or it is voluntary, brings about a liability to duties with respect to two events taking place in the context of a fiduciary transaction, i.e. the initial transfer by the settlor/*fiduciant* to the trustee/fiduciary and then by the latter to the beneficiaries or back to the *fiduciant*. In both cases title is transferred from an entity to another and hence the corresponding duties are applicable. Should they be levied on both passages at ordinary rates, an incentive would exist not to make use of fiduciary arrangements when registration is required. A special favourable regime was therefore introduced under Article 12(3) of the Law of 27th July 2003 relating to trusts and fiduciary contracts. Any instruments creating or amending a fiduciary contract or a trust and relating to property or rights which the fiduciary or the trustee is not required to hold for more than 30 years are subject to a fixed duty when they are presented for registration. The same fixed duty applies to the registration of any instruments by which property is retransferred to the *fiduciant* or the settlor within the same time span from the execution of the fiduciary contract or trust. A fixed duty is currently EUR 12, corresponding to the former LUF 500. Registration is thus symbolic in nature insofar as a fiduciary transfer is perceived as transitory, a limit conventionally set at 30 years.

Consistently enough, the same favourable regime applies to any instruments executing a transfer of title by way of security. Article 3(5) of the respective Law of 1st August 2001 specifies that registration is not compulsory and it is subject to a fixed duty when it is carried out voluntarily or for the purpose of court proceedings.

When the assets are definitively transferred by the trustee/fiduciary to third-party beneficiaries, or in the event that they are definitively assigned to the trustee/fiduciary – for instance by reason of a fiduciary transfer by way of security or of a security trust in case of default – if registration is required, it takes place at the ordinary rates. Article 12(4) of the Law of 27th July 2003 relating to trusts and fiduciary contracts specifies that, when assets are definitively transferred to third party beneficiaries by a fiduciary or a trustee, gift tax is applicable with respect to the degree of the relationship between the settlor or *fiduciant* and the beneficiaries.

Accordingly, should assets be transferred to beneficiaries on death, the same rule applies for the calculation of inheritance duties. To be sure, a fiduciary contract under Luxembourg law may be concluded *inter vivos* only, though it may include clauses requesting the fiduciary to transfer certain assets to certain beneficiaries on the death of the *fiduciant*.

The combined tax provisions under Articles 12(1), 12(3) and 12(4) of the Law of 27th July 2003 relating to trusts and fiduciary contracts aim at a level playing field, i.e. neutrality with respect to the tax treatment of fiduciary contracts and trusts. On the one hand, the fixed duty regime applicable to transfers not exceeding 30 years is meant to set aside the risk that unnecessarily heavy registration duties might thwart the use of *fiducie* with respect to the categories of assets subject to registration in Luxembourg. On the other hand, gift tax and inheritance duties are applicable when the outcome of a fiduciary transaction is in fact a gift or a bequest to certain beneficiaries. Ordinary registration rates – as well as gift tax if appropriate – apply accordingly when a fiduciary is definitively released from the obligation to transfer the assets back to the *fiduciant* or to beneficiaries.

Income tax and "beneficial ownership"

Indirect taxes are levied by reason of the actual transfer of title taking place via a fiduciary contract or a trust. On the other hand, the circumstance that legal title is vested in the fiduciary or in the trustee for the whole duration of the fiduciary contract or the trust is in fact ignored for the purposes of Luxembourg income tax. Indeed, the German income tax statutes that are currently in force in Luxembourg include some provisions expressly relating to a fiduciary agreement known in German as *Treuhand*.

The underlying principle is that income tax is due by the entity enjoying "economic" or "beneficial ownership" of the assets transferred to a fiduciary or *Treuhänder*. The notion of "beneficial ownership" for Luxembourg tax purposes is indeed slightly different from the corresponding notion at Equity. The received idea is that "beneficial ownership" rests with the *fiduciant*, or rather the *Treugeber* in German, in spite of the legal title vested in the fiduciary and the actual stipulations of the fiduciary agreement or trust. In other words, this "economic" approach equates the trustee/fiduciary to a mere nominee for income tax purposes.

Accordingly, Sections 11(2) and 11(3) of the *Steueranpassungsgesetz* (§ 11(2) and § 11(3) *StAnpG*) specify that the assets transferred to a fiduciary (either for a consideration or for free) as well as those acquired by a fiduciary in its capacity and for the benefit of a *fiduciant* are deemed to belong to the *fiduciant* for tax purposes.

With the same respect, Section 164(1) of the *Abgabenordnung* (§ 164(1) *AO*) prescribes that a fiduciary may have to specify on request who is the "beneficial owner" of the rights or assets it holds in such capacity, otherwise it shall be deemed to be the beneficial owner thereof and taxed accordingly. The same rule applies to administrators and pledgees. Indeed, the German phrase literally specifies that the fiduciary is due to disclose "to whom the rights or assets belong" (*wem die Rechte oder Wertsachen gehören*). The verb *gehören* implies full title to the assets concerned, as opposed to the mere possession (*Besitz*) enjoyed by the fiduciary. With this respect, the rule under § 164(1) *AO* disregards the circumstance that full title is vested in the fiduciary under the "full title theory" (indeed *Vollrechtstheorie*) applying to fiduciary contracts under Luxembourg law.

The fact that a fiduciary (*Treuhänder*) is compared to an administrator or a pledgee under that rule is but a confirmation of this state of things. In fact, § 164(1) *AO* is related to Article 2230 of the Civil Code, suggesting that everyone is deemed to have title to the assets he or she possesses, though evidence may be brought that he or she holds them for the benefit of someone else.

In order to assess the actual bearing of the rules under § 11(2) and § 11(3) *StAnpG* and § 164(1) *AO* on Luxembourg fiduciary contracts, a brief theoretical discussion may be in order.

A scholarly distinction is sometimes made between the so-called "*fiducie-gestion*" and "*fiducie-sûreté*". The latter is the collateral arrangement regulated under Article 8 of the Law of 27th July 2003 relating to trusts and fiduciary contracts as well as the Law of 1st August 2001 on transfer of title by way of security[11]. The former notion is quite vague as it includes a number of different cases ranging from regular asset management services offered by Luxembourg professionals in a fiduciary capacity to a number of set-ups involving an entity acting as a fiduciary with a view to performing certain activities (incorporating a company, organising a take-over, extending a fiduciary loan, etc.). The distinction between "*fiducie-sûreté*" and "*fiducie-gestion*" may sound attractive to civil law scholars as it echoes the famous Roman law categories of "*fiducia cum creditore*" and "*fiducia cum amico*", respectively, as specified by Gaius. Yet the notion of *fiducie-gestion* is so vague to provide but little assistance to both the interpreter and the practitioner. For this reason the notion is not used in this article.

Nevertheless, a principle may be mentioned for income tax purposes, that has to do with *fiducia cum amico*. The rules under § 11(2) and § 11(3) *StAnpG* and § 164(1) *AO* are applicable whenever the following sentence applies: *contrahitur cum amico quo tutius nostrae res apud eum essent*, i.e. we deal with a friend in

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11 discussed in detail in Chapter 4 of the book

order to place our assets more safely with him. The sentence qualifies the assets transferred as still *nostrae*, viz. our own, as if no title had been transferred to the friend acting in a fiduciary capacity. In fact, a further maxim best defines *fiducia* under Roman law: *mancipio dare ea lege ut remancipietur*, that may be loosely rendered as "to give in order to take back".

In all instances where the *fiduciant* is in a position to "give in order to take back", the rules under § 11(2) and § 11(3) *StAnpG* are applicable. In such cases, indeed, the *fiduciant* does not give up its claims to the assets transferred, as the same are due to go back to its own personal patrimony at maturity or on the occurrence of a certain event. This is true with all instances of *fiducie-sûreté* (if there is no default) as well as in many situations that may fall under the *fiducie-gestion* label. Wherever fiduciary contracts meet the specifications above, the *fiduciant* shall be liable for income tax. Of course, when the *fiduciant* happens not to be a Luxembourg resident, the actual assessment of its tax liability will be determined according to its country of residence.

There are some situations that may be quite accurately classed as *fiducia cum amico*, though they hardly fit the scheme under § 11 *StAnpG*. A conspicuous case is the so-called "*fiducie-libéralité*", where a fiduciary is requested to transfer certain fiduciary assets to certain third-party beneficiaries at maturity or upon a certain event. Indeed, this set-up no longer qualifies as an instance of *mancipio dare ut remancipietur* insofar as fiduciary assets are bound to be transferred further to some third-party beneficiaries and as such they shall not be retransferred to the *fiduciant*.

The application of the rule under § 11 *StAnpG* and hence the assessment of an income tax liability by the *fiduciant* would be inappropriate to the extent that the fiduciary patrimony is no longer its own and the respective income is applied (from time to time or at maturity) to one or more third party beneficiaries.

A literal construction of the rule under § 164(1) *AO* may be helpful, as it specifies that the fiduciary is due to disclose "*wem*", i.e. to whom the fiduciary assets – and hence the income thereof – belong. Alas, the received construction of such rule hardly lends itself to a flexible interpretation. Luxembourg scholars view § 11 *StAnpG* and § 164 *AO* as if they stood in a hierarchical relationship, whereby the general principle is expounded under § 11 *StAnpG* whilst the rule under § 164 *AO* relates to disclosure and evidence only. For that reason the latter is related to the mentioned provision under Article 2230 of the Civil Code.

Nonetheless, a solution suggesting that the *fiduciant* should be liable to income tax in any case is not satisfactory in the event of *fiducie-libéralité*. In the event that the fiduciary contract expressly specified that income must be paid to a certain beneficiary, the latter should be liable to income tax. In the event that income were accumulated for the benefit of third-party beneficiaries up to maturity and eventually paid out to them, the application of the mentioned tax rules would imply that income tax would be paid by the *fiduciant* for the whole duration of the contract. In other words, the *fiduciant* would be deemed to retain possession of the assets – and hence to enjoy the income thereof – up to maturity, so that beneficiaries would eventually receive them net of income tax. Even in the absence of specific provisions to that effect, the construction suggested above should be upheld on the grounds of some general principles of Luxembourg tax law. More precisely, § 5 and § 6 *StAnpG* prescribe that the actual tax liabilities must be assessed irrespective of any civil law arrangements, most notably with a view to curbing any attempts at tax avoidance.

An imaginative though quite authoritative opinion with respect to *fiducie-libéralité* suggests that income tax should be levied based on an analysis of the actual beneficiaries of the income. In the event that the *fiduciant* and its family – a notion construed in an extensive meaning under § 10 *StAnpG* – received over 50% of the income deriving from the assets transferred under the fiduciary contract, § 11 *StAnpG* should apply so that income tax would be fully paid by the *fiduciant*. Such tax liability should exist as long as the respective income accrues, irrespective of its actual receipt by the *fiduciant*, in order to prevent any undue deferral of tax liabilities by means of a fiduciary shelter. On the other hand, should the *fiduciant* and its family have right to less than 50% of the income deriving from the fiduciary assets, a "patrimony by appropriation" (*patrimoine d'affectation*) i.e. a dedicated fund would be deemed to be in place and as such qualify as an entity liable to corporate income tax (but not to municipal commercial tax) under Article 159, first paragraph, nr.7 of the Law on Income Tax. This construction is compatible with the rules on family foundations (*Stiftungen*) under § 12 *StAnpG*, an institution enjoying varying degrees of application in the countries of German legal tradition (Austria, Switzerland and Liechtenstein in particular) but virtually unknown under Luxembourg civil law.

The extension of such principles to fiduciary contracts – and the more so to trusts – may give rise to an unfavourable tax treatment of such devices in some circumstances.

Equating a *fiducie* or a trust to a family foundation for tax purposes does not appear to be a correct and desirable approach however. A technical as well as an economic argument need to be laid down to this effect.

From a purely technical point of view, Article 99 of the Luxembourg Constitution prescribes that no tax may be levied unless it is expressly established by statute.

This is indeed an instance of the glorious principle of "no taxation without representation" dating back from Chapter 12 of the Magna Carta. A consequence of it is that no analogous reasoning is admitted with respect to tax law, i.e. if a certain species is taxed according to a valid provision under tax law, the same tax may not be levied to an "analogous" case.

Undoubtedly, a fiduciary contract or a trust may be functionally equivalent to a family foundation in some circumstances. On the other hand, it goes without saying that a contract, a trust and a foundation are completely different legal institutions. In the light of this, the constitutional grounding for the extension of a rule expressly conceived for family foundations to fiduciary contracts and trusts appears to be questionable[12].

A more mundane argument, though quite a significant one in economic terms, should be allowed for as well. If the rule under § 12 *StAnpG* were to be followed, some *fiducies* and trusts would happen to be taxed in Luxembourg irrespective of the country of residence of their beneficiaries and in addition to the taxes levied in such jurisdiction. More precisely, this would be the case if the *fiduciant*/settlor and its family retained the right to less than 50% of the income generated by the fiduciary patrimony or trust fund. In such instance a patrimony by appropriation (*patrimoine d'affectation*) would be deemed to be in existence and it would be subject to Luxembourg corporate income tax. The current rate is 22%. Only 78% of the fiduciary/trust income would therefore be available for distribution to the intended beneficiaries, who would then pay the marginal income tax rate applicable to it in their country of residence. Economic double taxation would quite likely be the result, as a trust or a fiduciary contract are seldom included in double taxation treaties.

To be sure, the above-mentioned tax regime is based on some purely academic reasoning only. If it were to really apply to trusts and fiduciary contracts established in Luxembourg (i.e. featuring a Luxembourg *fiduciaire* or trustee), it would cause the Grand Duchy to be an unviable alternative to a number of

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12 A. Steichen, "Droit comptable et fiscal du "Trust" et de la fiducie luxembourgeoise" in Trust et Fiducie, Luxembourg (2005) provides a vivid example of analogy under tax law: if access to buses were prohibited to dogs, it would be quite easily accepted that, by way of analogy, the same prohibition should apply to "pet crocodiles" (*sic*) if its rationale were to protect human passengers' safety. On the other hand, even though dogs and pet crocodiles would probably be kept at home for the same reasons, nobody would accept that a tax on the owners of dogs would be immediately extended to the owners of crocodiles unless an express statutory provision prescribes it. Under these premises, it is surprising that the same writer spells out the mentioned argument aiming at subjecting trusts and fiduciary contracts to § 12 *StAnpG*, which relates to family foundations. After all, a trust and a foundation appear as different in nature as a dog and a crocodile!

international financial centres. It is quite unlikely that the Luxembourg authorities would tolerate such an unfavourable competitive outcome.

To be sure, the principles under § 11 *StAnpG* and § 164 *AO* may be applied to many fiduciary contracts concluded under the Law of 27th July 2003, even though some difficulties may arise in certain cases as specified above.

The application of the same categories to trusts recognised in Luxembourg under the Hague Trusts Convention pursuant to the same Law of 27th July 2003 may be even more complicated. Of course, in case of interest in possession trusts it would be quite often possible to establish "to whom" assets belong for the purposes of § 164 *AO*. Nonetheless, this is not always the case. An accurate analysis must be carried out based on the actual features of each individual trust. With no pretension to comprehensiveness, a few categories may be singled out under the following headings:

(a) trusts with beneficiaries.

- revocable
- irrevocable
    - (i) fixed-interest
    - (ii) discretionary

(b) purpose trusts

- commercial (security)
- charitable

Revocable trusts meet the requirements of *mancipio dare ut remancipietur* insofar as the settlor reserves the right to set aside the settlement and claim back the assets. The principles under § 11 *StAnpG* are thus fully applicable. The same is true for *purpose trusts* concluded for commercial purposes such as *security trusts* and in all cases where assets are transferred to a trustee in a temporary way, with a view to transferring them back to the settlor.

Bare trusts may be considered in this context as well, irrespective of their revocable or irrevocable nature. Such trusts are functionally equivalent to fiduciary contracts insofar as the settlor (or a beneficiary) retains significant powers and prerogatives, so that the trustee is in the same position as a nominee or an agent.

Of course, because of such prerogatives the settlor (or the beneficiary) shall be deemed as the beneficial owner of the trust assets and shall be liable to income tax accordingly.

Fixed interest trusts should be analysed case by case according to the nature of the beneficiary interests. Incomes regularly payable to beneficiaries should be taxed at the recipients' level as long as they accrue. In fact, a number of fixed interest trusts may be viewed as functionally equivalent to *fiducie-libéralité*. Accumulation and maintenance, protective or spendthrift trusts should be duly allowed for though, as in such cases the intended beneficiaries are deliberately denied access to the trust assets and the income thereof, at least over a specified period of time. Income tax may thus be deferred up to the time of actual income distribution. As argued above, the alternative argument recognising a patrimony by appropriation (*patrimoine d'affectation*) is hardly convincing in these cases.

Any arguments suggesting that the settlor should be liable to income tax on the income generated by the assets it has irrevocably transferred to a trustee is not acceptable, except to the extent that some incomes are applied to the settlor *qua* beneficiary and irrespective of their proportion of the overall trust income.

Under the present statutory provisions, taxation should be deferred up to the actual distribution to the ultimate beneficiaries of *discretionary trusts*. No beneficial owner can be ascertained until a definitive determination to that effect is irrevocably carried out by the trustee.

The same should be true with respect to *charitable* trusts, a favourable tax treatment of which would obviously be desirable.

In fact the notion of residual entities as defined under the European Savings Directive – details on which are provided below – appear to indicate that trusts are not subject to corporate income tax. Such residual entities are neither legal persons (*personnes morales*) nor undertakings for the collective investment in traded securities (UCITS) according to the Directive 85/611/EEC, nor is their income taxed under the general arrangements of business taxation (i.e. they are not subject to corporate income tax in Luxembourg). A complete, official list of such entities is not available, yet some leading Luxembourg scholars quite convincingly contend that an "Anglo-Saxon trust" may easily fit such definition. Based on this notion the application of Luxembourg corporate income tax to trusts is in principle excluded.
In conclusion, a case-by-case approach is therefore necessary in order to ascertain the underlying economic facts of each transaction – including the categories of income concerned – and the related tax outcomes (*wirtschaftliche Betrachtungsweise* according to German theory). In the absence of a general statutory rule, an analytical approach must thus be adopted with a view to

assessing the ultimate taxpayers with respect to each individual transaction or category of transactions.

International tax issues

The discussions carried out so far have often assumed that all the entities involved in case of a trust or of a fiduciary contract are Luxembourg residents or otherwise subject to Luxembourg tax. In fact, it is quite likely that at least some of the parties are foreign residents. International tax issues are then likely to arise, that double taxation treaties may seldom help determine.

The case is quite different with respect to fiduciary contracts on the one hand and trusts on the other.

Double taxation treaties following the OECD model apply to the beneficial owners of income only. This notion partially overlaps with that of "beneficial owner" under the income tax statutes in force in Luxembourg, such as § 11 *StAnpG* in particular. To that purpose, as far as fiduciary contracts are concerned, in most cases double taxation treaties should be applied with reference to the place of residence of the *fiduciant*. A fiduciary would seldom – if at all – qualify as the ultimate beneficial owner of dividend, interest or royalty income and thus command the application of the reduced tax rates prescribed under a double taxation treaty. Of course, such rates – if any – may apply between the country where the respective income is produced and that where the *fiduciant* has established its residence. Any attempt to interpose a Luxembourg fiduciary with a view to benefiting from one of the bilateral tax treaties concluded by the Grand Duchy is thus illegitimate and it should not produce the intended effects under a careful and conscious conduct.

The situation may be quite different with respect to trusts. If on the one hand revocable trusts as well as many instances of security trusts would be considered as transparent, i.e. pass-through devices for international tax purposes, the opposite should be true for discretionary trusts. So long as a discretionary trust is in existence, no beneficiary has an actual claim to the trust fund or its income. Each beneficiary has but a potential expectation to be included among those who will share the trust assets and their cumulated income at maturity. Accordingly, a fairly broad consensus exists that double taxation conventions should apply with reference to the residence of the trustee. In other words, a discretionary trust should be considered as if the trustee were – at least temporarily – the "beneficial owner" of the respective income. An analytical, case-by-case approach should be adopted with respect to interest in possession trusts, allowing for the specific provisions concerning income.

The main difficulty with the application of double taxation treaties is that trusts seldom allow a straightforward identification of beneficial owners, as specified above.

On the other hand, the cases of bilateral tax treaties expressly containing provisions relating to trusts are quite rare.

The double taxation treaty between Luxembourg and the United States specifies that all income earned by a trust is deemed to be received by a resident of the state where it may be taxed at the level of the trust itself, its settlor or its beneficiaries, as the case may be.

The treaty between Luxembourg and Canada includes trusts under the definition of "persons" for the purposes of the convention, though it reserves the application of lower tax rates to the cases where income (e.g. dividends) is actually paid to its ultimate beneficial owner. For that matter, a trust may qualify or not according to its actual purpose and features. Article 21 of the treaty – as is generally the case following the OECD model – indicates that income failing to fall under any of the categories specified thereunder is taxed in the state where the recipient is resident, unless such income is produced in the other contracting state. In that case, provided the income concerned is fully taxable in the state of its recipient, a withholding tax not exceeding 15% of the gross income may be levied by the latter state.

A similar provision is not included under the double taxation treaty between Luxembourg and the United Kingdom. Article 22 specifies that items of income of a resident of a contracting state, that are not covered by any of the categories contemplated in the convention, shall be taxable only in that state. The only express exception refers to the income paid out of trusts. Its rationale appears to be a general reservation expressed by the United Kingdom with respect to Article 21 of the OECD model convention, with a view *inter alia* to retaining the authority to tax incomes paid out of UK trusts to non resident beneficiaries. To be sure, the bilateral tax treaty between the United Kingdom and Luxembourg was signed in 1967, at a time when the latter instance was by far the most likely with reference to trusts. The application of Article 21(1) in its current redaction may in due course lend itself to a more balanced state of things, insofar as it is not unthinkable that a Luxembourg trust may pay income to some beneficiaries resident in the United Kingdom, yet it is not clear how Luxembourg would tax the income paid out of such trust.

Interest income and the European Savings Directive

The Law of 21st June 2005, transposing the EU Council Directive 2003/48/EC of 3rd June 2003 on taxation of savings income in the form of interest payments – known as the European Savings Directive – has introduced a further category of income tax previously unknown under Luxembourg tax law, viz. a withholding tax on interest payments. The German tax statutes of the 1940s were adopted in Luxembourg in a virtually unchanged form. As they did not provide for a withholding tax on interest payments, the same was never introduced into the tax system of the Grand Duchy. In the context of the political negotiations on harmonisation of the European tax system, which eventually led to the adoption of the Savings Directive, Luxembourg as well as Belgium and Austria opted for its application in the form of a withholding tax on interest payments in alternative to the automatic exchange of information with the other Member States.

Pursuant to a bilateral agreement between the European Union and Switzerland, signed on 26th October 2004 and purporting to adopt the same regime as in the EU member countries, as well as to similar agreements with Liechtenstein, Andorra, Monaco and San Marino, the European Savings Directive eventually came into force all over the EU member states and their dependent territories on the 1st July 2005. A general overview of the contents of such Directive as transposed into Luxembourg law will therefore be provided. Some specific remarks on the application of the Directive to trusts and fiduciary arrangements will then conclude this article.

The European Savings Directive (hereinafter, unless otherwise specified, the Directive) contains some deviations from the main principles of Luxembourg tax law. Accordingly, its transposition into the domestic legal system took place by means of a specific statute introducing the required amendments and references. The Bill n. 5297 transposing the Directive into Luxembourg law was filed with the local Parliament (*Chambre des Députés*) on 9th February 2004. Based on the recommendations expressed by the State Council, seeking *inter alia* to rule out any possible inconsistencies between the provisions in the Directive and the general principle of Luxembourg banking secrecy, a modified text was submitted to Parliament on 3rd February 2005 and definitively approved as the Law of 21st June 2005.

The scope of the Directive, as carefully reproduced under Article 1 of the Law of 21st June 2005, covers interest payments made in a Member State to beneficial owners (*bénéficiaires effectifs*, i.e. actual beneficiaries) who are individuals resident for tax purposes in another Member State. The “actual beneficiaries” of income for the purposes of the Directive are individuals resident in a Member State other than the one where interest is paid. Individuals resident in the same

Member State and companies of whatever nature and irrespective of their place of residence are therefore excluded from the scope of the Directive.

Even though interest payments are defined as a fairly wide category under Article 6 of the Law of 21st June 2005, which closely reflects the corresponding Article of the Directive, no other categories of income, such as dividends, royalties or the proceeds resulting from insurance policies, are concerned. Four notions are considered with respect to interest payments however, i.e. (a) interest related to debt claims of whatever nature, including in particular income from debentures, bonds or government securities (b) interest accrued or capitalised on the transfer of a debt claim of whatever nature, (c) income distributed by undertakings for the collecting investment (UCI), whether qualifying as "European-passport" UCITS under the Directive 85/611/EEC or established outside the territory of the European Union, to the extent that such income results from interest payments and with a *de minimis* exception of 15% (i.e. if the interest-bearing component does not exceed 15% of the total assets, income payments are exempt), and (d) income realised upon the sale, refund or redemption of shares or units of UCI, whether qualifying as "European-passport" UCITS under the Directive 85/611/EEC or established outside the territory of the European Union, investing more than 40% of their assets in debt claims of whatever nature[13].

The Directive leaves it open to each Member State to determine whether to apply its provisions equally to interest accruals that have not yet been paid or credited to an account. Article 6.5 of the Directive establishing such option for the Member States was not included in the Law of 21st June 2005. Accordingly, the Directive applies in Luxembourg with respect to interest actually paid or credited to an account only, not to annuities or accruals. In other words, in the event of a "zero coupon" bond with a maturity date exceeding one year, interest is considered for the purposes of the Directive when it is realised by means of the sale, refund or redemption of the security and not on the grounds of annual accruals.

A central notion in the Directive is that of paying agent. According to the definition under Article 4.1 of the Directive, literally reproduced in the same Article of the Law of 21st June 2005, a paying agent is the economic operator who pays interest to or secures a payment of interest for the immediate benefit of the "actual beneficiary", be it the actual debtor of the debt claim giving rise to an interest payment or simply an operator charged by the debtor or the actual beneficiary with the task of paying interest or securing the payment. The phrase

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13 UCITS investing more than 15% but less than 40% of their assets in interest-bearing securities are deemed to execute interest payments insofar as they distribute their proceeds. Capital gains on the sale of the shares of a capital fund which does not make distributions are therefore excluded.

"for the immediate benefit" (*au profit immédiat*) of the actual beneficiary refers to the case of a chain of payments leading from the actual debtor to the ultimate beneficial owner. In such case the last entity in the chain, which executes an interest payment directly to the beneficial owner, is deemed to be the paying agent of that transaction for the purposes of the Directive.

The notion of paying agent introduces an important deviation from a generally received principle of tax law. Indeed, the entity liable with respect to the obligations established under the Directive, i.e. disclosure of information or the application of a withholding tax is the paying agent as defined above, not necessarily the actual debtor.

A related notion introduced under Article 4.2 of the Directive, and transposed as such into the corresponding Article of the Law of 21st June 2005, is that of paying agent on receipt or "residual entity". This category includes any entity meeting either of the three following requirements: (i) it is not a legal person (*personne morale*), (ii) its income is not taxed under the general arrangements for business taxation (i.e. in Luxembourg it is not subject to corporate income tax), (iii) it is not a UCITS according to the Directive 85/611/EEC.

Any entity which does not correspond to any of the categories above is deemed to be a paying agent on receipt. Any interest payment to such an entity, provided it is resident in a Member State other than the one where the payment is made, is therefore subject to exchange of information or the application of a withholding tax as if such residual entity were the ultimate beneficial owner. Of course, such measures apply to the extent that the beneficial owners of such residual entity are individuals resident in another Member State. Article 7.4 of the Law of 21st June 2005, which has no equivalent in the Directive, prescribes that a withholding tax is levied by reason of the "members" (*membres* in French) of such residual entity that are individuals resident in another Member State. In other words, a withholding tax is levied on the proportion of interest payments ultimately belonging to individuals resident in another EU Member State. Failing such breakdown of information, the withholding tax shall be levied on all interest payments to the concerned residual entity.

The latter provision is in fact quite unlikely to be applied in Luxembourg however. Article 4.3 of the Directive specifies that residual entities may apply for a treatment equal to that of UCITS. If residual entities are treated as if they were UCITS, no exchange of information or withholding tax applies to interest payments at their level. It will be the residual entities' duty to perform the corresponding activities with respect to the payments they will make to the beneficial owners. Under the Directive residual entities are required to apply for a specific certificate granting the same treatment as UCITS. On the other hand, Article 4.3 of the Law of 21st June 2005 specifies that all residual entities that are resident in Luxembourg shall be treated as UCITS with no need for a certificate to that effect. Accordingly, Luxembourg-based residual entities are not treated as paying agents on receipt and the withholding tax is thus deferred until the actual payment to the beneficial owner.

The fact that Luxembourg-based residual entities are treated as if they were UCITS provides a useful guidance for the application of the Directive in the Grand Duchy, though it does not help identify such entities. An official list of all the eligible residual entities is not available either at the national or at the European level.

Some examples may be identified however. Article 4.5 of the Directive expressly mentions some kinds of limited partnerships under Swedish and Finnish law. On the other hand, the explanatory document accompanying the Law of 21st June 2005 indicates that Luxembourg temporary associations, societies or joint-ventures (*associations momentanées*, *associations en participation*) do not fall under the definition of residual entities insofar as they are subject to corporate income tax.

Some further examples may be UCI not qualifying as EU-passport UCITS and organised in the form of mutual funds as well as trusts. With respect to the former category, UCI organised as investment companies (SICAV or SICAF) would not qualify as residual entities to the extent that they are legal persons under corporate form. On the other hand, the inclusion of trusts within the residual entity category is an indirect confirmation that corporate income tax is not applicable to their case.
For all Member States other than Luxembourg, Belgium and Austria, including the ten countries that acceded to the EU on 1st May 2004, the Directive prescribes an automatic exchange of information with respect to interest payments to individuals resident in other Member States. Each paying agent is required to communicate some details of the beneficial owner of interest payments to the tax authorities of its own country. The latter shall forward such information to their counterparts in the country of residence of the beneficial owner. To that purpose, paying agents are required to obtain certain mandatory information on their clients, including in particular their exact address of residence.

Luxembourg, Austria and Belgium are entitled to apply an alternative regime, consisting of a withholding tax of 15% on all interest payments. Such withholding tax rate shall be in force for three years to be increased to 20% as of 1st July 2008 and 35% from 1st July 2011 onwards. The revenue from such withholding tax shall be shared between the tax authorities of the Member State collecting it and those of the Member State where the beneficial owner is resident at the rates of 25% and 75% respectively. The same withholding tax regime shall be applied by Switzerland, Liechtenstein, Andorra, Monaco and San Marino by virtue of their respective bilateral agreements with the European Union to that effect, as well as by the dependent and associated territories of some Member States such as the United Kingdom and the Netherlands (i.e. the Channel Islands, the Isle of Man and a number of Caribbean jurisdictions). Of course, this regime concerns exclusively interest payments by paying agents based in the countries above for the benefit of individuals resident in the EU. From the standpoint of the Directive a level playing field is thus established among the financial centres of the EU, such as notably Luxembourg, and those not belonging to a Member State.

The withholding tax regime shall come to an end in Luxembourg, Belgium and Austria once the United States, Switzerland, Liechtenstein, Andorra, Monaco and San Marino will have agreed to a regime of exchange of information on request with the European Union based on the corresponding OECD model agreement. At that stage Switzerland and the other European financial centres mentioned under the Directive will continue to apply a withholding tax at the rate of 35% however.
Luxembourg, Belgian and Austrian paying agents, as well as those based in the countries governed by a bilateral agreement with the EU to the effect of the Directive, may opt for the exchange of information instead of applying a withholding tax if their clients so require. This exception to the withholding tax regime may take place in two different forms: (a) the beneficial owner authorising its paying agent to disclose the related information to its tax authorities, (b) a certificate drawn up by the competent tax authorities in the name of the beneficial owner evidencing that the foreign assets producing interest payments are officially known to such authorities (*Freistellungsbescheinigung*).

As far as the former case is concerned, the previous redaction of Article 9 of the Bill n. 5297 used to reproduce the corresponding text of Article 13 of the Directive and provided for a simple authorisation by the beneficial owner. The definitive version of Article 9.1.(a) of the Law of 21st June 2005 specifies that the actual beneficiary must specifically instruct its paying agent (*donne mandat special*) to proceed to the exchange of information in lieu of the withholding tax. Far from being a subtlety of style, this modified wording has to do with the Luxembourg rules on banking secrecy. Based on an analysis by both the State Council and the Luxembourg financial regulator, the CSSF (*Commission de Surveillance du Secteur Financier*), the new redaction is consistent with banking secrecy insofar as title to the information concerned is vested in the client, who may therefore direct a paying agent to make it available at his or her behest. A general treatment of banking secrecy in Luxembourg is provided at Chapter 6.

Another exception to the application of the withholding tax as well as to the exchange of information is based on a grand-fathering rule concerning negotiable debt securities issued before 1st March 2001. Such exemption is based on certain conditions and limited in time up to 31st December 2010.

The withholding tax regime in force in Luxembourg under the Directive has a bearing on the tax treatment of fiduciary contracts and trusts established with or for the benefit of foreign clients.

Any of the entities authorised to act as fiduciaries under Title II of the Law of 27th July 2003 relating to trusts and fiduciary contracts may be treated as a paying agent under the Directive. It is quite likely that a fiduciary will be the last in a chain of paying agents leading to the ultimate beneficial owner of an interest payment. Of course, a withholding tax of 15% (20% or 35% as the case may be) shall be applicable to interest payments only in the event that the beneficial owner under a fiduciary agreement, i.e. the *fiduciant*, is an individual resident in a Member State other than Luxembourg.

As far as trusts are concerned, it may be appropriate to consider them as residual entities under article 4.2 of the Directive. Accordingly, an interest payment by a Luxembourg paying agent (e.g. a UCITS or a bank) to a trustee resident in another Member State, or in a country or territory applying an equivalent withholding tax regime, shall be considered as a payment to a paying agent on receipt. A withholding tax shall thus be levied to the extent that the "beneficial owners" under such trust are individuals resident in another Member State and provided that the trustee or the trust have not obtained a certificate granting that they may be treated as UCITS in their State of residence.

In the event of an interest payment to a Luxembourg trustee by a paying agent based in another Member State, on the other hand, the UCITS treatment shall automatically apply to the Luxembourg payee. Accordingly, no withholding tax shall be levied at that stage: its collection will be deferred until the final payment to the ultimate "beneficial owner", however defined, and provided that the latter is an individual resident in another Member State. Of course, the withholding tax shall be collected under the responsibility of the Luxembourg trustee.

Finally, the case of an interest payment by a Luxembourg paying agent to a Luxembourg trustee does not fall under the scope of the Directive. Of course, the Luxembourg trustee may be due to apply a withholding tax if its role can be construed as that of a mere paying agent for the benefit of one or more individuals resident in another Member State (e.g. a bare trust where the trust fund consists of some debt securities only). To be sure, whether the Directive does not apply as in the present example, or the payee qualifies for a UCITS treatment as it is always the case for Luxembourg-based residual entities, the withholding tax may be effectively deferred by a substantial time span thanks to the circumstance that no annualised interest accruals are considered for the application of the Directive in the Grand Duchy.

In general terms, however, the application of the Directive to trusts – irrespective of the place of residence of the trustee – is by no means straightforward. If a trust can be construed as a pass-through device by which some “beneficial owners” – which may include the settlor – earns interest income, then exchange of information or the withholding tax shall apply based on the residual entity notion. In a number of cases though, as it is discussed above, the identification of the “beneficial owners” or “members” of a trust for tax purposes is not obvious, if at all possible, and it requires an accurate, case-by-case analysis of the actual features of every single trust.

It goes without saying, by way of conclusion, that the Directive is applied only to the extent that the trust fund includes debt securities or other assets giving rise to interest payments.