EUROPEAN REGISTRATION & FRENCH TAX LAW CREATE PITFALLS FOR U.S. TRUSTS

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INTRODUCTION

Events that have taken place in the European Union during July confirm that a U.S. person who establishes a U.S. domestic or foreign trust for the benefit of a European resident, may face significant pitfalls regarding confidentiality and tax.

While trusts historically constitute a testamentary dispositive tool in common law countries, the recent UBS and Panama Papers scandals have shed a harsh light on these instruments. Add in the E.U.'s economic stagnation and the existence of terrorist threats, and it is not surprising that a massive, hasty crack-down on the use of trusts by high net worth individuals has ensued.

In an era of country-by-country reporting, the trust mechanism is no longer considered an estate planning or charitable giving tool. Rather, it is viewed as a tax evasion mechanism only available to a sophisticated elite who are either interested in concealing income and committing tax fraud, or possibly in financing terrorism. This view ignores the fact that high net worth individuals commonly use trusts to provide for future generations. Individuals who move internationally or have family members in multiple jurisdictions will undoubtedly suffer from the crack-down.

In light of the Panama Papers scandal, the European commissioner for economic and financial affairs, taxation and customs, Pierre Moscovici, has announced proposed changes to the existing ownership disclosure rules. This is not Mr. Moscovici's first foray into transparency legislation, having served as France's Minister of Economy and Finance when, in 2013, French legislation providing for a public trust registry was enacted. Now, in his role with the European Commission, Mr. Moscovici has brought forth a proposal for a Directive of the European Parliament and of the Council (the "Proposed Directive") to amend Directive (E.U.) 2015/849 On the Prevention of the Use of the Financial System for the Purposes of Money Laundering or Terrorist Financing and Directive 2009/101/E.C.

The Proposed Directive was announced at a July 5, 2016 press conference, where Mr. Moscovici emphasized the necessity for transparency and fair taxation, and pointed to increased need for scrutiny of trusts, tax advisors, and lenient countries. We have learned from experience that when a politician uses terms like "fair taxation" and "transparency," taxpayers must take heed, as those terms frequently precede a tax grab.

As referenced above, ownership disclosure rules already exist with regard to trusts in France. This article will first address the proposal for modification of the European Directive on the registration of trust beneficiaries that is currently under consideration by the European Parliament. It will also address French income, gift, inheritance, and wealth tax rules designed to ensure that no tax revenue is ever lost in France when a French individual is a settlor or beneficiary of a trust.

EUROPE'S BENEFICIAL OWNERSHIP HUNT

The Proposed Directive amends the recently enacted Fourth Anti-Money Laundering Directive[1] (the "4A.M.L.D.") and "fight[s] against tax evasion and money laundering, with the aim of ensuring both social justice and fighting organised crime and terrorism."[2] It is aligned with recent E.U. legislation and discussions with regard to transparency of information in the tax field,[3] including the B.E.P.S. Project. It aims at preventing "the large-scale concealment of funds which can hinder the effective fight against financial crime" and ensuring "corporate transparency so that true beneficial owners of companies or other legal arrangements cannot hide behind undisclosed entities."[4]

As a consequence, the Proposed Directive wishes to improve transparency with regard to ultimate beneficial ownership information, which must be available to competent tax authorities, financial institutions, and persons with a "legitimate interest." Among the entities targeted for improved disclosure are trusts and similar entities, such as foundations, *treuhands*, *fiducies*, or *fideicomisos*.

The 4A.M.L.D. already contains disclosure rules with regard to corporate entities, as well as trusts and comparable arrangements. The Proposed Directive now intends to harmonize the beneficial ownership disclosure rules applicable to corporate entities with those applicable to trusts. To that end, the explanatory memorandum to the Proposed Directive states:

> Rules regarding the registration of the beneficial ownership information of trusts by their trustees should be consistent with those in place in respect of the registration of beneficial ownership information of companies.

With this in mind, the Proposed Directive draws a distinction between "business-related trusts" and other trusts. For this purpose, business-related trusts are defined as follows:

> [T]rusts which consist of any property held by or on behalf of a person carrying on a business which consists of or includes the management of trusts, and acting as trustee of a trust in the course of that business with a view to gain profit.

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1 Directive (E.U.) 2015/849.

2 European Commission, "Remarks by Commissioner Moscovici at the Press Conference at the Launch of the New Transparency Rules to Tackle Terrorism Financing, Tax Avoidance and Money Laundering," news release, July 5, 2016.

3 See, *e.g.*, the Directive on Administrative Cooperation, accessible via "Enhanced Administrative Cooperation in the Field of (Direct) Taxation," European Commission; European Commission, *Proposal for a Council Laying Down Rules Against Tax Avoidance Practices that Directly Affect the Functioning of the Internal Market*, (Brussels: 2016); EU2016.nl, *Informal ECOFIN - Line to take NL Presidency*, (2016).

4 Directive (E.U.) 2015/849, Explanatory Memorandum.

In the case of a business-related trust, the disclosed beneficial ownership information will be made available to a range of persons that is broader than the range for other trusts. In cases related to other trusts, only persons holding a legitimate interest are to be granted access to the beneficial ownership information. A legitimate interest exists where there is a mission statement to combat money laundering, terrorist financing, and associated offenses. This can extend to governmental and nongovernmental organizations, provided that the latter demonstrates (i) previous activities relevant to the fight against money laundering and terrorist financing or associated predicate offences, or (ii) a track record of surveys and actions in that field.

While the reasons behind the trust distinction seem clear, the distinction itself could very well be fictitious in most cases. Indeed, individuals often retain professional trustees, whom they entrust with overseeing assets that are held for subsequent generations or for charitable purposes. Trusts with an institutional trustee will be considered to be business-related trusts and will fall under the broader disclosure rules. In effect, the distinction between the two types of trusts is meaningless.

Article 31 of the current 4A.M.L.D. provides that Member States must require trustees of any trust "governed under their law" to obtain and hold accurate and up-to-date information on beneficial ownership. The information to be disclosed is the following:

- The settlor
- The trustee(s)
- The protector (if any)
- The beneficiaries or class of beneficiaries
- Any other natural person exercising effective control over the trust

Article 31 further provides that when the trust "generates tax consequences," Member States must hold the above information in a central register.

The Proposed Directive attempts to clarify the phrases "governed under their law" and "generates tax consequences," and criticizes the previous lack of definition. The Proposed Directive points out that as a result, Member States may take the position that if they do not recognize trusts under their domestic laws, they are not required to monitor and register any trusts which may be administered from their territories.

To address the issue, the Proposed Directive suggests that governed under their law should be understood as the place of administration. With regard to the requirement that the trust must generate tax consequences before there is a filing requirement in a central register, the Proposed Directive points out that this limitation on the registration requirement is not compliant with another 4A.M.L.D. requirement regarding trust categorization. The 4A.M.L.D. provides that categorization of trusts is required prior to the time a business relationship is entered into with a trust. In addition, the Proposed Directive points out that existing rules create a loophole for trusts that do not pay taxes in any jurisdiction as a result of different rules regarding tax residence. These trusts would not be registered anywhere. Consequently, the Proposed Directive provides for an interconnection of national registers.

FRANCE'S ONE-SIZE-FITS-ALL TRUST ANALYSIS

Although the trust mechanism does not exist under French law, the French Tax Code defines a trust, for tax purposes, in the following terms:

> [T]he legal relationships created in a country other than France, *inter vivos* or upon death, by a person, the settlor, in order to place assets or rights under the control of a trustee for the benefit of one or more beneficiaries or to achieve a specific purpose.[5]

Under French tax law, a trust can trigger three main types of tax consequences: an income tax consequence, a gift and estate tax consequence, and a wealth tax consequence.[6] Disclosure requirements apply. In all cases, French tax law does not take into account the fundamental differences that exist between various trust instruments, such as differences between current or future, capital or income beneficiaries, fixed or discretionary entitlements, and revocable or irrevocable trusts. Instead, French tax law applies the same regime to all trusts under a one-size-fits-all approach.

U.S. Trusts and French Taxes on Distributions

French tax law provides for general tax rules, which are applicable to trusts. In certain cases, an unfavorable income tax regime applies.

General Tax Regime Applicable to Distributions

Under the general regime, trust distributions are subject to French ordinary income tax rates if the beneficiary of the distributions is a French resident for French income tax purposes.[7] The highest applicable marginal income tax rate is 45%. French law is unclear as to whether the tax applies to capital distributions or if it is limited to distributions of income. However, the approach taken by the French tax administration seems to indicate that income distributions are subject to French income tax and capital distributions are subject to French gift and estate tax.[8] Income distributions are taxed without regard to the nature of the underlying income.

Although nothing to that effect is mentioned in the French-U.S. Income Tax Treaty, an outdated French administrative notice should still be applicable to trust distributions in the French-U.S. context.[9] The notice, issued in the context of the terminated 1967 France-U.S. income tax treaty, was extended in 1999[10] to a prior version of the current income tax treaty,[11] which came into effect in 1994 and has been amended twice since then. Nonetheless, the notice has not been published in the official

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5 Article 792-0 *bis* of the French Tax Code.

6 When dealing with French tax exposure, it must always be kept in mind that substantial social charges generally apply on passive-type income.

7 Article 120, 9 of the French Tax Code.

8 BOI-ENR-DMTG-30, Oct. 16, 2012, No. 170.

9 BOI-14B-2-81, Mar. 25, 1981.

10 BOI-14B-33-99, May 6, 1999.

11 Convention with Respect to Taxes on Income and Property of 1967, U.S.-Fra., Jan. 1, 1967. TIAS 6518.

administrative regulations database, which is available online, and the continuing validity of the notice may be subject to challenge.

Under this notice, the U.S. trust mechanism is taken into account for tax purposes to a certain extent:

- In the presence of a "simple trust," France treats the trust instrument as fiscally transparent. The underlying income will flow through to the beneficiaries. Thus, depending on the underlying nature of the trust income, the applicable treaty article should be referred to in order to determine the right to tax that income under the treaty.

- In the case of a "complex trust" (*i.e.*, a trust that accumulates income without distributing it automatically), France also treats the trust instrument as tax transparent. However, France grants foreign tax credits on trust distributions only to the extent that U.S. tax was incurred by the beneficiaries and not by the trust itself.

- France retains the right to analyze every trust instrument on a case-by-case basis in order to determine whether a given trust is a "grantor trust." In that case, the grantor is treated as the taxpayer and the beneficiaries are not.

> ***"French tax law does not take into account the fundamental differences that exist between various trust instruments. . . . [It] applies the same regime to all trusts under a one-size-fits-all approach."***

Distributions of the trust assets are subject to French gift or inheritance tax upon transfer, if the trust beneficiary or the settlor is a French resident at the time of the transfer or death.[12] The applicable exemption amounts and rates generally depend on the relationship between the settlor and the beneficiary.[13] However, the highest (*i.e.*, 60%) rate applies when either (i) the trustee is subject to the laws of a non-cooperating state or (ii) the trust instrument was formed after May 11, 2011, and the settlor was a French tax resident at the time of formation.[14]

Unfavorable Income Tax Regime

French tax law provides for an unfavorable regime, which applies to French residents who directly or indirectly hold at least 10% of the shares, interest, economic rights, or voting rights in an entity (whether it be a legal entity, organization, French *fiducie*, or similar institution) that meets all of the following criteria:[15]

- It is established or formed outside of France.

- It is subject to a beneficial tax regime. (For this purpose, a tax regime is considered beneficial when the tax burden is at least 1/3 lower than the French corporate tax rate that would apply if the income were held by a French corporation.[16])

- It directly or indirectly holds securities, debt instruments, deposits, or accounts.

Should this regime apply to a trust, 125% of the income distributions would be subject

[12] Article 750 *ter* of the French Tax Code.

[13] Article 792-0 *bis* of the French Tax Code.

[14] Article 792-0 *bis*, 2, last paragraph of the French Tax Code.

[15] Article 123 *bis* of the French Tax Code.

[16] BOI-RPPM-RCM-10-30-20-10, Sept. 12, 2012, No. 300.

to French income tax at the beneficiary level.[17] If the trust is formed in a non-cooperating country or in a country that has not entered into an administrative assistance agreement with France, the beneficiary's taxable distribution will be multiplied by 125% and by an annual interest rate published by the French administration.

This provision disregards the underlying trust instrument. The determination of who, for instance, has a 10% interest in a discretionary, irrevocable, and transgenerational trust instrument is unclear, to say the least. In this context, the applicability of Article 123 *bis* of the French Tax Code may be subject to challenge, but no tax planner likely wishes to be the first to raise that challenge.

Under U.S. tax law, the income of a U.S. trust may be taxable at the trust level, at the beneficiary level, or at the settlor level. In virtually none of these cases would the U.S. tax rate be at least 1/3 lower than the French corporate tax rate (*i.e.*, less than 22%), and the application of Article 123 *bis* in the French-U.S. context could be challenged under this approach as well.

French social charges generally apply to trust distributions under both the general and unfavorable regimes.

U.S. Trusts and French Wealth Tax

A French resident is generally subject to French wealth tax on worldwide assets if his/her worldwide estate exceeds €1.3 million on January 1, 2016.[18]

French wealth tax is computed as follows:

Net Taxable Estate	Applicable Rate
Not exceeding €800,000	0
In excess of €800,000 but less than €1,300,000	0.50%
In excess of €1,300,000 but less than €2,570,000	0.70%
In excess of €2,570,000 but less than €5,000,000	1.00%
In excess of €5,000,000 but less than €10,000,000	1.25%
In excess of €10,000,000	1.50%

Settlors must include trust assets in their taxable estates for wealth tax purposes.[19] When assets remain in a trust after the conclusion of a settlor's life and the assets are held for the benefit of beneficiaries, the beneficiaries must include the trust assets in their estates for French wealth tax purposes.

Here again, this provision applies without further analysis of the trust instrument. A

[17] Article 158, 7, 2 of the French Tax Code.

[18] Article 885 of the French Tax Code.

[19] Article 885 G *ter* of the French Tax Code.

French-resident settlor of an irrevocable discretionary trust must still include trust assets in the tax base for purposes of the French wealth tax during the balance of the settlor's life, even though no control is retained over the assets held in trust.

U.S. TRUSTS & THE FRENCH TRUST REGISTRY

French Disclosure Obligations

"A French-resident settlor of an irrevocable discretionary trust must still include trust assets in the tax base for purposes of the French wealth tax during the balance of the settlor's life."

Disclosure obligations exist in France with regard to trusts.[20] These obligations apply in the following set of circumstances:

- If either (i) the settlor, one of the beneficiaries, or the trustee is a French resident for French tax purposes or (ii) an asset owned by the trust is located in France, the trustee must file Form 2181-Trust 1, disclosing
  - the creation of the trust instrument,
  - the names of the settlor and the beneficiaries,
  - amendments that have been made to the trust instrument,
  - the dissolution of the trust instrument if applicable, and
  - the terms of the trust instrument.
- If the settlor or one of the beneficiaries is a French resident for French tax purposes, the trustee must file Form 2181-Trust 2, disclosing the value of all the trust assets.[21]
- If neither the settlor nor any of the beneficiaries is a French resident, but some of the trust assets are located in France, the trustee must file Form 2181-Trust 2, disclosing the value of the French situs trust assets.

Failure to file the appropriate forms results in a failure-to-file penalty, which is the greater of 12.5% of the value of the trust assets and capitalized trust income, or €20,000. In addition, failure to subject trust assets to French wealth tax, or failure to file Form 2181-Trust 1 or Form 2181-Trust 2, will trigger a 1.5% tax on the worldwide trust assets, should the settlor or a beneficiary be a French tax resident. If the obligation is triggered only because French situs assets are owned by the trust, the penalty is imposed on assets located in France.[22]

French Public Trust Registry

The law requires that a public trust registry must be maintained. It must contain information regarding the name of the trustee, the name of the settlor(s), the names of the beneficiaries, and the date the trust was created. On July 5, 2016, this public registry became available online.

Initially, the only requirement to access the registry was a French tax identification number. This essentially resulted in all French taxpayers being able to access the

[20] Article 1649 AB of the French Tax Code.

[21] This disclosure obligation is in addition to the foregoing.

[22] Article 990 J of the French Tax Code.

register. However, this open access was short lived. In a July 22, 2016, emergency hearing of the highest French administrative court, the *Conseil d'Etat* suspended access to the public registry.[23]

The petitioner in the deciding case was a 89-year-old French resident who had established U.S. trusts in order to plan for the distribution of her estate at the conclusion of her lifetime. The petitioner claimed that, by disclosing particularly private information regarding her estate plan, which included the identity of the trust beneficiaries, the public register had subjected her to pressures from her entourage regarding her succession plan and violated her constitutionally protected right to privacy. The *Conseil d'Etat* deemed the public access to constitute a potential non-apportioned violation of the right to privacy, as guaranteed by Article 2 of the Declaration of Human Rights, and referred the question to the French Constitutional Court. The latter is required to render a decision within a three-month period.

CONCLUSION

While this article focuses mainly on disclosure and tax issues under French tax law, the Proposed Directive signifies the ever-increasing complexity of compliance obligations in the European Union. Advisers to global families should plan for difficult times when drafting estate plans involving trust instruments for high net worth families.

23 Conseil d'Etat, *juge des referes*, July 22, 2016, No. 400913.