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Introduction

This book examines the principles by which countries exert international taxing claims over income derived by, through or from a trust and the interaction of those taxing claims in treaty and non-treaty situations. It derives an initial set of principles, policies and tax settings by examining the national tax laws of Australia, the United States, the United Kingdom and New Zealand. It then considers the interaction of national tax laws more broadly, in light of the work of the OECD/G20 BEPS project[2] and by reference to the OECD Model tax treaty.[3]

This introductory chapter begins by outlining the aims and significance of the present work and its methodology. It goes on to identify the phenomenon of the trust as a legal institution and an economic entity and briefly to outline the tax design options and challenges that these features present, including distinctions between transparent and opaque taxing paradigms, between single and dual taxing points, and between the entity and its participants as potential taxpayers. It next identifies the range of international taxing perspectives that different countries may apply to the same factual arrangements and establishes terminology that will be used in later chapters. This is followed by an outline of the scope of coverage of the present study and an abbreviated summary of the trust rules in the tax systems of the surveyed countries. The chapter concludes with an outline of the structure of the book and a summary of following chapters.

[2] The joint project of the OECD and G20 on base erosion and profit shifting (BEPS), described in Section 7.1.5. For a summary explanation of the BEPS project and its 15 Actions, see OECD/G20 BEPS Project, *Explanatory Statement: 2015 Final Reports* (2015).

[3] OECD, 'Model Convention with Respect to Taxes on Income and on Capital' in OECD, *Model Tax Convention on Income and on Capital: Condensed Version 2017* (2017). See Section 7.1.1. References to the OECD Model in this book in an historical context relate to the version that was current at the relevant time.

1.1 Aims, Significance and Methodology

The goals of this book are to identify the principles by which countries tax income derived by, through or from a trust in an international context where more than one country has a potential taxing claim, to identify situations of double- or non-taxation that can arise from the interaction of national tax systems in treaty and non-treaty situations and to postulate principles of tax and treaty design to avoid inappropriate double- or non-taxation.

Trusts are legally, economically and socially significant and serve legitimate non-tax purposes in jurisdictions where they are recognized by the general law. The features that make trusts useful also make them attractive vehicles for tax arbitrage and avoidance. It is important that countries understand and address the international taxation of trust-related income in a coherent and principled way. Globalization has increased the importance of developing an international tax architecture that responds to cross-border arrangements. The BEPS project has shed light on the international significance of hybrids and other fiscally transparent entities. Trusts are probably the most challenging class of such entities because of their fundamental flexibility, the potential indeterminacy of interests in income and capital, the role of the grantor as an extra participant and the difficulty that some countries experience in conceptualizing an entity without separate legal personality as a subject of taxation or a fiscal resident. Conversely, if tax systems and the international tax order can rise to that challenge and get the international fiscal treatment of trusts right, the solutions they develop may also provide answers to problems concerning the treatment of other hybrid and transparent entities.

The first stage of the project is based on analysis of trust rules in the national tax systems of Australia, the United States, the United Kingdom and New Zealand. These countries have been chosen as a representative sample of jurisdictions that recognize the trust as part of their general law, have advanced economies and stable, highly developed legal systems and follow the general residence/source paradigm of international taxation but that differ sufficiently in their trust rules and related international settings to demonstrate potential mismatches and to enable conclusions to be drawn about the interaction of divergent rules and settings more generally. The survey has been limited to four countries in order to keep the project within manageable bounds. The text also includes a small number of references to particular Canadian trust tax rules which diverge from those in the surveyed countries in ways that are conceptually significant,

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although no general survey of that country's trust rules is attempted. The present work is conceived as foundational: it provides a basis for similar analysis to be extended and applied to other jurisdictions, including those which do not recognize the trust in their general law.

The method of analysis of trust rules in the surveyed countries is functionally comparative.[4] The structural elements of the comparison reflect the logic of international taxation and the influence of tax treaties. The first division is between taxation of trust income by current attribution and taxation of trust distributions. The next division concerning trust income reflects the choice of taxpayer to whom trust income is currently attributed: grantor, beneficiary or trust. The grantor, beneficiary and trust chapters are then divided between general principles of attribution, inbound settings and outbound settings; the trust chapter also addresses the fiscal residence of trusts. Further functional subdivision of the attribution, inbound and outbound sections of these chapters varies according to the subject matter, the logic of international taxation and, in some cases, the historical background. The purpose of the analysis is to facilitate an understanding of the range of actual and possible international tax settings and their underlying logic.[5] For that reason, particular countries are not always discussed in the same order. In some contexts, the order is varied to facilitate the illustration of a spectrum of approaches or the historical development of fiscal strategies.

The second stage of the project is global in focus. It assesses the interaction of national tax systems generally, informed by conclusions based on the earlier analysis. It is largely framed by reference to work of the BEPS project on hybrid entities and preventing the abuse of tax treaties (Actions 2, 6 and 15). Analysis of treaty situations is principally framed by reference to the OECD Model treaty, the Partnership Report and corresponding elements of the BEPS project, supplemented by consideration of the US Model and selective elements of the treaty practice of other countries.

[4] A functional approach focuses on 'the functions of tax rules of different countries with the goal of identifying similarities and differences between domestic tax systems as well as potential alternative solutions to common problems' and thereby seeks to overcome the heterogeneity and apparent incomparability of tax concepts in different countries: Carlo Garbarino, 'An Evolutionary Approach to Comparative Taxation: Methods and Agenda for Research' (2009) 57 *American Journal of Comparative Law* 677, 681, 687–688.

[5] The comparison of trust rules is not a first-order objective but a necessary means to facilitate the identification and description of jurisdictional taxing principles and their interaction.

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The working normative hypothesis is that inappropriate non-taxation should be avoided by national tax systems selectively expanding their claim to tax in situations that would otherwise represent unintended lacunae due to mismatches between tax systems – principally, negative conflicts of attribution and double non-residence of trusts – in a way that avoids inappropriate double taxation. Inappropriate double taxation should be addressed by treaty and, more selectively, by unilateral credit, exemption or non-taxation by reference to the tax treatment of the other country. In both treaty and non-treaty situations, this implies the need to recognize overlapping tax claims and to develop model, bilateral or unilateral principles of taxing priority.

The present work does not seek to engage with fundamental economic critiques of income taxation. It takes the general system of international income taxation as given and addresses national tax systems, their mutual interactions and the global matrix of tax treaties in light of the body of scholarship that has grown up around the international tax work of the OECD, particularly but by no means exclusively focused on tax treaties, and which reflects an historically balanced combination of legal analysis, international relations and economic policy.[6]

Within that body of scholarship, relatively little attention has been devoted to a systematic consideration of international trust taxation. The most notable exceptions[7] are a 1989 study by the international tax group in response to the Hague Trusts Convention, which comprised a comparative account of taxation in a number of common law and civil

[6] See, e.g., H David Rosenbloom and Stanley I Langbein, 'United States Tax Treaty Policy: An Overview' (1981) 19 *Columbia Journal of Transnational Law* 359; Hugh J Ault, 'Corporate Integration and the Division of the International Tax Base' (1992) 47 *Tax Law Review* 565; Reuven S Avi-Yonah, 'All of a Piece Throughout: The Four Ages of US International Taxation' (2005) 25 *Virginia Tax Review* 313; C John Taylor, 'Twilight of the Neanderthals, or are Bilateral Double Taxation Treaty Networks Sustainable?' (2010) 34 *Melbourne University Law Review* 268; Richard J Vann, *Writing Tax Treaty History* (24 March 2011), Sydney Law School Research Paper No 10/19, available at SSRN: https://ssrn.com/abstract=1788603.

[7] See also Alexander Easson and Victor Thuronyi, 'Fiscal Transparency' in Victor Thuronyi (ed), *Tax Law Design and Drafting* (International Monetary Fund, 1998) vol 2, 925, 949–965. The object of that work and others in the same collection was to assist developing countries in the design of their tax systems. Another quite early contribution was Frans Sonneveldt and Harrie L van Mens (eds), *The Trust: Bridge or Abyss between Common and Civil Law Jurisdictions?* (Kluwer, 1992), a collection of essays focusing on the treatment of trusts in certain civil law countries and under the OECD Model.

law countries[8] and an account of corresponding international taxation including some treaty issues,[9] and the more recent work of Robert Danon on Swiss taxation of trusts with reference to the US, Canadian and New Zealand trust taxation[10] and on the impact of the Partnership Report on conflicts of attribution involving trusts.[11] The 1989 study did not consider grantor taxation, and, while it considered a matrix of international taxing situations, it did not attempt to construct a general or normative explanation of them or of their consequences. That study also preceded the Partnership Report, which fundamentally changed the discourse (even among its dissentients) on the international taxation of non-corporate entities and their income. Professor Danon's work continues to address trusts in treaty situations[12] but has not extended to a general consideration of international trust taxation. Each of those works has informed the analysis in this book at various points, but none has sought to develop a systematic understanding of international trust taxation or to achieve the goals outlined at the beginning of this section.

1.2 The Trust as Legal Institution and Economic Entity

Most jurisdictions that recognize the trust in their general law have inherited the common law of England, including the rules of equity. A small number with a mixed background of common and civil law recognize the trust as an institution of received or unwritten law without separate equity jurisprudence, such as Scotland and South Africa. Others that did not receive the trust have chosen to adopt it by statute, such as Louisiana, Japan and China.[13]

[8] John F Avery Jones et al., 'The Treatment of Trusts under the OECD Model Convention – I' [1989] *British Tax Review* 41.
[9] John F Avery Jones et al., 'The Treatment of Trusts under the OECD Model Convention – II' [1989] *British Tax Review* 65.
[10] Robert J Danon, *Switzerland's Direct and International Taxation of Private Express Trusts with Particular References to US, Canadian and New Zealand Trust Taxation* (Linde/Schulthess/Westlaw/Bruylant, 2004).
[11] Robert J Danon, 'Conflicts of Attribution of Income Involving Trusts under the OECD Model Convention: The Possible Impact of the OECD Partnership Report' (2004) 32 *Intertax* 210.
[12] Trusts are among the entities considered in Robert J Danon, 'Qualification of Taxable Entities and Treaty Protection' (2014) 68 *Bulletin for International Taxation* 192.
[13] There is a rich and growing literature dealing with the reception of the trust in countries of diverse legal backgrounds. See Madeleine Cantin Cumyn, 'Reflections Regarding the Diversity of Ways in Which the Trust Has Been Received or Adapted in Civil Law

Each trust jurisdiction is legally independent and has its own concept of the trust, and there is no international hierarchy of national definitions. Some local formulations also present difficulties in a comparative context because they are circular or self-referential.[14] There is nevertheless much common ground, and the Hague Trusts Convention provides a useful working definition that captures the essence of an express trust and reflects its understanding in common law jurisdictions:

> For the purposes of this Convention, the term 'trust' refers to the legal relationships created – inter vivos or on death – by a person, the settlor,[15] when assets have been placed under the control of a trustee for the benefit of a beneficiary or for a specified purpose.
>
> A trust has the following characteristics –
>
> a) the assets constitute a separate fund and are not a part of the trustee's own estate;
> b) title to the trust assets stands in the name of the trustee or in the name of another person on behalf of the trustee;
> c) the trustee has the power and the duty, in respect of which he is accountable, to manage, employ or dispose of the assets in accordance with the terms of the trust and the special duties imposed upon him by law.

Countries' in Lionel Smith (ed), *Re-Imagining the Trust: Trusts in Civil Law* (Cambridge University Press, 2012) 6 and other essays in that book; Tony Honoré, 'Obstacles to the Reception of the Trust: The Examples of South Africa and Scotland' in A M Rabello (ed), *Aequitas and Equity: Equity in Civil Law and Mixed Jurisdictions* (Hebrew University of Jerusalem, 1997) 793; George L Gretton, 'Scotland: The Evolution of the Trust in a Semi-Civilian System' in Richard Helmholz and Reinhard Zimmermann (eds), Itinera fiduciae: *Trust and Treuhand in Historical Perspective* (Duncker & Humblot, 1998) 507; George L Gretton, 'Trusts without Equity' (2000) 49 *International and Comparative Law Quarterly* 599; Lusina Ho and Rebecca Lee, 'Reception of the Trust in Asia: An Historical Perspective' in Lusina Ho and Rebecca Lee (eds), *Trust Law in Asian Civil Law Jurisdictions: A Comparative Analysis* (Cambridge University Press, 2013) 10; Adam Hofri-Winogradow, 'Zionist Settlers and the English Private Trust in Mandate Palestine' (2012) 30 *Law and History Review* 813. Particular differences in local conceptions of the trust will not be considered here.

[14] J D Heydon and M J Leeming, *Jacobs' Law of Trusts in Australia* (LexisNexis Butterworths, 8th edn, 2016) [1.01], make the points that definition is elusive, if not impossible, and that those definitions which have been attempted are merely descriptive. An attempt to define the trust is inevitably circular. Thus, at [1.03]: 'If definition is demanded, then the trust may be defined as the whole relationship which arises between the parties in respect of the property the subject of the trust, and the obligation of the trustee to the beneficiary and the interest of the beneficiary in the property may be regarded as flowing from the existence of that relationship'.

[15] Generally referred to in this book as the grantor – see n 18.

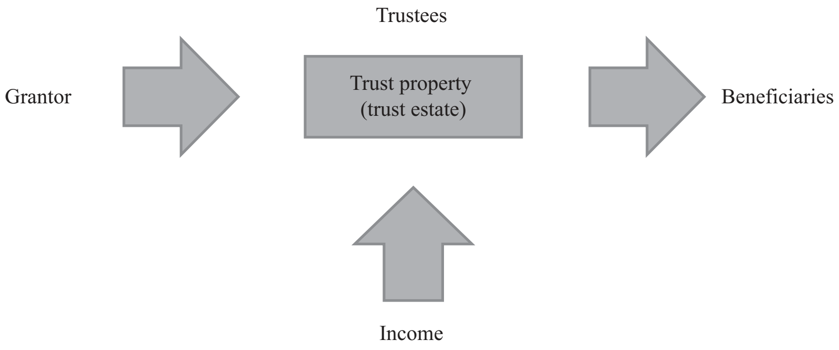

Figure 1.1 The Trust, Its Participants, Property and Income

> The reservation by the settlor of certain rights and powers, and the fact that the trustee may himself have rights as a beneficiary, are not necessarily inconsistent with the existence of a trust.[16]

In an international tax context, express trusts for beneficiaries are the main focus of attention. A corresponding limitation applies to the scope of this book.

The trust is essentially a relationship between property and persons (Figure 1.1). The body of trust property is administered as an economic entity without its own legal personality.[17] It is available to meet liabilities incurred by trustees in carrying out the trust, but not their other or personal liabilities. The trust is legally enforceable by or on behalf of the beneficiaries.

In a tax context, it is usual to refer to the economic entity constituted by the trust property as a whole under the administration of its trustees or the trustees acting in that capacity simply as a trust. Equity purists

[16] *Convention on the Law Applicable to Trusts and on Their Recognition*, opened for signature 1 July 1985, Hague Conference on Private International Law, 1664 UNTS 311, [1992] ATS 2 (entered into force 1 January 1992) Art 2. The function of the Convention is to provide for the recognition of trusts and their proper law by contracting states (Art 1). It does not affect the fiscal powers of such states (Art 19). Of the four surveyed countries, Australia and the United Kingdom have signed and ratified the Convention while the United States has signed but not ratified. New Zealand has not signed. See Hague Conference on Private International Law, 'Status Table for the Convention of 1 July 1985 on the Law Applicable to Trusts and on their Recognition' www.hcch.net/en/instruments/conventions/status-table/?cid=59 (at 14 December 2017).

[17] See Gretton, *Trusts without Equity*, n 13, arguing that the trust should be seen as a special patrimony or *Sondervermögen*.

may object that a trust is none of these things, but there is no other convenient term. Brevity and common usage dictate that the same term is used to refer to the trust property and/or the trustees in that capacity as that which in equity discourse designates the relationship between property, trustees and beneficiaries.

A trust may be capitalized by the owner of property declaring a trust over it, and so becoming the trustee, or transferring property to another to hold it on trust. The terms of the trust are customarily set out in a deed executed by the person who provides the property and (if they are different persons) the trustees. An existing trust can be augmented or 'fed' by a person, not necessarily the original settlor, voluntarily transferring property to the trustees in that capacity. De facto capitalization can be achieved by providing value in any form gratis or at an undervalue. In order to avoid semantic arguments about the meaning of 'settlor', a person who capitalizes a trust in any of these ways will generally be referred to as a **grantor**.[18]

As a legal institution, the trust is characterized by extreme flexibility and private control.[19] Every trust has its own charter, the terms of which are stipulated or adopted by the grantor. Decisions about the investment and management of trust property can be made or constrained in the trust deed or left to the discretion and future decision of the trustees and/ or others stipulated in the deed. The same is true of decisions about the duration of the trust, the ultimate beneficial enjoyment of trust property and the beneficial enjoyment of income derived from it in the meantime. Few constraints apply to the terms of a trust, and trusts are typically not required to be registered or approved in order to take effect. In most

[18] The term is borrowed from US tax law, where it is well understood. The US concept of a grantor refers to a real or economic settlor of a trust in respect of that person's contribution (*Buhl* v *Kavanagh*, 118 F 2d 315 (6th Cir, 1941); *Estate of Kanter* v *CIR*, 337 F 3d 833 (7th Cir, 2003)), including one who feeds an existing trust. It is defined to include a gratuitous transferor of cash or other property and a transferor for undervalue to the extent of the undervalue (26 CFR s 1.671-2(e)). Compare the UK and New Zealand terms 'settlor' (ITTOIA s 620; ITA NZ s HC 27) and the Australian 'attributable taxpayer' (ITAA 1936 s 102AAT) or 'transferor' (a colloquial synonym – cf 'eligible transferor' in ss 347, 348).

[19] See, e.g., John H Langbein, 'The Contractarian Basis of the Law of Trusts' (1995) 105 *Yale Law Journal* 625; Stewart E Sterk, 'Asset Protection Trusts: Trust Law's Race to the Bottom?' (2000) 85 *Cornell Law Review* 1035, 1040–1041; Nuncio D'Angelo, *The Trust: From Guardian to Entrepreneur: Why the Changing Role of the Trust Demands a Better Legal Framework for Allocating Stakeholder Risk* (PhD Thesis, University of Sydney, 2012) ch 1; see also n 23.

circumstances, a trust can effectively insulate assets from claims made by creditors of the grantor,[20] the trustees (in their personal capacities) and the beneficiaries,[21] and beneficiaries are either immune to trust liabilities or can readily be made so.[22]

Reflecting these features, trusts are used for very diverse purposes, and have historically been used where otherwise available legal forms presented impediments or failed to accommodate to a new economic purpose.[23] Trusts today are variously used as vehicles for collective investment, both retail and wholesale; for special purposes and joint ventures in industry and commerce; to reward or remunerate employees; for pension or superannuation funds; for the holding, management or intergenerational transfer and distribution of family or personal wealth

[20] The main general constraint is the rule for setting aside fraudulent conveyances derived from the *Statute of Elizabeth 1571*, 13 Eliz 1, c 5 and represented in most modern common law jurisdictions that are not also tax havens (e.g. *Conveyancing Act 1919* (NSW) s 37A). Family law and succession law may also constrain the efficacy of dispositions by a spouse or by a person whose deceased estate is in issue. Such rules are not specific to trusts.

[21] A beneficiary's interest in a trust can be insulated from execution or bankruptcy of the beneficiary by making that interest discretionary or defeasible. Even if the interest is available to creditors, the trust assets themselves cannot generally be reached unless the exacting conditions of the rule in *Saunders* v *Vautier* (1841) 4 Beav 115; 49 ER 282 are satisfied, which require a finite group of legally competent beneficiaries to hold exhaustive beneficial interests in trust property and to concur in requiring distribution. This is the strong form of affirmative asset partitioning or (as it has later been called) entity shielding identified by Henry Hansmann and Reiner Kraakman, 'The Essential Role of Organizational Law' (2000) 110 *Yale Law Journal* 387, 395.

[22] See *Hardoon* v *Belilios* [1901] AC 118.

[23] A striking example is the development of the joint stock company.

> 'And so we came by our English *Anstalt* or *Stiftung* without troubling the State to concede or deny the mysterious boon of personality. That was not an inconsiderable feat of jurisprudence. But a greater than that was performed. In truth and in deed we made corporations without troubling king or parliament though perhaps we said that we were doing nothing of the kind'. (Maitland, F W, *The Unincorporated Body*, 3 Maitland, Collected Papers [Bristol University, 1911] www.efm.bris.ac.uk/het/maitland/unincor.mai).

See also n 19. For other illustrations of the trust's propensity to colonize a desirable but unoccupied niche in the fiscal or commercial world, see Erik Röder, 'Combining Limited Liability and Transparent Taxation: Lessons from the Convergent Evolution of GmbH & Co. KGs, S Corporations, LLCs, and Other Functionally Equivalent Entities' (2018) 21 Florida Tax Review 762. Dale Pinto and Stewart Karlinsky, 'Darwinian Evolution of the Taxation of Trusts: A Comparative Analysis' (2007) 10 *Journal of Australian Taxation* 251.

(family trusts, testamentary trusts);[24] for the conduct of active business or investment; for indirect participation in other businesses such as partnerships; as holding entities; for the holding of particular business assets and to secure assets for the benefit of lenders, creditors or other parties to commercial transactions.[25] The list is not exhaustive, and some of its items are more or less common in particular jurisdictions.

The reasons why people choose the trust form are equally varied. The trust allows separation between decision-making and beneficial enjoyment; a trusted decision-maker can be appointed where beneficiaries are vulnerable or their needs and characteristics are not yet known. It allows beneficial enjoyment to be determined by future events, whether objective (birth, death, marriage) or based on discretionary judgment of a trusted decision maker. It allows a grantor to influence events after death. It allows assets to be protected against adverse claims or ventured commercially with limited liability for an investor. It allows access to professional management expertise and economies of scale. Tax considerations are always important, though not necessarily determinative. The trust is not inherently a tax avoidance vehicle, but its characteristics lend themselves to that purpose, and the historical use of particular types of trusts for avoidance in particular fiscal contexts has been significant.

Trust participants and designers do not have a completely free hand. Where privacy of design and flexibility of the trust are perceived as prone to abuse relative to particular public or social norms, the courts or the legislature may constrain a trust-related dealing or some of its intended effects.[26] In a fiscal context, this is particularly seen in the treatment of

[24] Particularly in Australia and New Zealand, it is common to find such trusts used for the conduct of active business as well as more passive holdings and investments, typically with a high degree of discretion vested in the trustees and/or others associated with the grantor over the beneficial destination of trust income and capital.

[25] See, e.g., Graeme Cooper, 'Reforming the Taxation of Trusts: Piecing Together the Mosaic' (2013) 35 *Sydney Law Review* 187; Charles M Bruce, *United States Taxation of Foreign Trusts* (Kluwer, 2000) 43–48; Charles M Bruce, Lewis D Solomon and Lewis J Saret, 'Foreign Trusts – Continuing Uses' (2004) 7(6) *Journal of Retirement Planning* 39; New Zealand, Law Commission, *Review of Trust Law in New Zealand: Introductory Issues Paper*, NZLC IP19 (2010) [1.15]–[1.18], [2.37]–[2.45]; New Zealand, Law Commission, *Court Jurisdiction, Trading Trusts and Other Issues: Review of the Law of Trusts Fifth Issues Paper,* NZLC IP28 (2011) [2.2]–[2.20]; New Zealand, Law Commission, *Review of the Law of Trusts: A Trusts Act for New Zealand*, NZLC R130 (2013) [2.3].

[26] Prevention of fiscal abuse is not the only instance. A transfer system should also ideally be based on an individual's real economic situation, and special provisions are commonly made in pension or social welfare legislation for the recognition of voluntary