Administrative doctrine on the tax implications of a trust

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The Spanish Directorate-General for Taxation (abbrev. DGT), in its 8 April formal binding answer 2016V1495-16 to a taxpayer's query, addresses the tax implications, especially for the purposes of the inheritance and gift tax, of creating a trust, a subject on which the DGT has issued statements on other occasions and which gives rise to interpretation problems on account of the lack of recognition of such an arrangement in our legal system.

1. The position of the DGT

As is known, a trust is a device regulated in common law countries, by means of which one or more persons (settlors) provide for, inter vivos or mortis causa, the establishment of a separate fund (trust), assigning it to a fiduciary (trustee) who is required to manage and administer the same in accordance with the instructions received and for the benefit of another person or persons (the beneficiaries).

In this regard, the DGT has had to analyse a case where a US citizen, resident in Spain since 2015, was previously designated as beneficiary of trusts into which her parents (settlors), US residents, transferred various movable and immovable properties they owned, appointing different managers as trustees. In the description of the circumstances of the case, it is noted that the querier has no powers over the trusts or the assets transferred thereinto, the management and maintenance of which falls to the trustees.

Following the above statement of facts, the querier essentially asks whether she would have to pay inheritance and gift tax in Spain if, on the death of her parents, the assets managed by the trusts are acquired by an American company wholly owned by her.

The DGT begins its line of reasoning by repeating a criterion expressed in all its binding answers on matters concerning the tax implications in Spain of establishing a trust: it is a legal mechanism that has not been recognised in our country, a country which is not even among the signatories to The Hague Convention of 1 July 1985 on the Law Applicable to Trusts and on their Recognition, which aims to eliminate or at least simplify the problems arising from the unfamiliarity of many legal systems with this arrangement. Therefore, according to the DGT, "the treatment of a trust in our tax system posits that such a legal device is not recognised by the Spanish legal system and, therefore, for the purposes of such legal system, the relations between the transferors of property or property rights and their recipients or beneficiaries through a trust are regarded as existing directly between each other, as if the trust were non-existent ('tax transparency of trusts')".

Pursuant to the above, and taking into account the legislation governing the inheritance and gift tax, the DGT notes that in the circumstances in question, the establishment of trusts by the parents of the querier of which she is a beneficiary "means an increase for profit in a natural person's estate. That is, the taxable event of the tax is present". Then, the DGT states that it is necessary to distinguish between those cases where the taxable event is understood to have occurred on the death of the bequeather (an acquisition by reason of death) or when an act or contract is caused or concluded as in the case of the creation of trusts (an acquisition between living people).

In this specific case, the DGT concludes that "the creation of several trusts in favour of the querier by her parents is a taxable event as regulated in article 3(1)(b) of the Inheritance and Gift Tax Act (abbrev. LISD), as it constitutes an acquisition of property or property rights by way of a gift or by any other inter vivos legal transaction without consideration", specifying that, "as the relationship between the questioner and her parents through trusts is regarded as existing directly between each other", the tax liability accrues at the time of creating the trusts.

Thus, according to the above, it should be construed that the beneficiary has received a gift at the time of the establishment of the trusts, something which in this case removes her from the obligation of paying the inheritance and gift tax in our country, because when the trusts were established and, therefore, when the taxable event took place that gave rise to the accrual of liability for the same, the querier was not yet a resident in Spain.

Notwithstanding the foregoing, the DGT cautions the querier that she would be liable to pay personal income tax in Spain on any income earned from the assets acquired by way of gift.

Next, the DGT addresses tax implications for the querier if, on the death of her parents, it is a non-Spanish resident company wholly owned by her which acquires the settled property of the trust. In this case, the DGT states that "the querier, in her capacity as beneficiary, will never be subject to the Inheritance and Gift Tax, since the same only taxes increases for profit in a natural person's estate. Those of legal persons are subject to Corporate Income Tax".

2. Final commentary

The main difficulty in analysing the implications of creating a trust in our tax system derives from the fact that such a mechanism, under common law, allows for the fragmentation of the powers inherent in the right of ownership between the trustee and the beneficiary. In this regard, as noted by the DGT in its binding answer V0989-14, the existence of a trust makes it necessary to differentiate between 'legal or nominal ownership' (that of the trustee) and 'beneficial ownership' (that of the beneficiary), a separation in the right of ownership that, as recalled by the DGT, "is not possible under Spanish law".

Nonetheless, as the previously discussed answer makes clear, as do other earlier answers (vide V1003-14 of 8 April 2014), the DGT seems to circumvent this difficulty by construing that from the creation of a trust stems for the beneficiary a transfer of property akin to that which, according to civil law, applies in our legal system to gifts or, where appropriate, to transmissions on death. Otherwise, a 'partial' or 'limited' transfer of such a right would not meet the necessary conditions to conclude, as the DGT does, that the transaction performed fits the taxable event of the inheritance and gift tax, an essential element of the tax that, as construed by the DGT, would take place with the establishment of the trust, if inter vivos, or on the death of the bequeather (the settlor), if it is provided that the status of beneficiary takes effect as from the latter's demise.

However, although the DGT does not expressly refer to this distinction in the answer under review, we believe that its conclusions should be limited, taking into account the classification of trusts, to those having an irrevocable nature, leaving aside 'discretionary' trusts, where the trustee has the freedom to decide when, how and to whom income is distributed or assets transferred. In that sense, in answers of the DGT, such as V1226-14 of 7 May 2014, which addressed certain tax implications of a discretionary trust, it is clear that the mere designation of beneficiaries at the time

of establishment does not generate here the specific effects of a gift on such date.

What is more, and in addition to considering that the DGT's conclusions in the discussed answer (V1495-16) should be initially limited to the scope of irrevocable trusts – a characteristic of the trusts of which the querier was a beneficiary, according to her description of the facts – we submit that the foregoing can always be affirmed provided that it can be construed under applicable Spanish civil legislation that ownership of the property or property rights has been transferred to the beneficiary. In this regard, we cannot forget that civil legislation underpins both the tax on gifts and the inheritance mechanisms. From this point of view, we believe that the DGT has oversimplified a matter which, strictly speaking, requires not only paying attention to the type of trust that has formally been created, i.e. discretionary or irrevocable, but also, if the latter, to the clauses stipulated in the trust deed and which may result in important limitations to the powers which, in our civil law, must be vested on the person to which the ownership of property or property rights is attached.

In our view, it is only under this light that the position adopted by the DGT can be understood, a position by virtue of which we shall have to conclude that a gift will have taken place if the status of beneficiary takes effect in the settlor's life, while if it is provided that such a status takes effect on the settlor's death, property or property rights received will be taxed by inheritance tax. In any case, once the gift or inheritance has occurred, we can only but construe that the beneficiaries are regarded by our legal system as owners of such assets, as only as such can it be understood, as mentioned by the DGT, that in the event that these individuals later receive income from the trust, such must be taxed by personal income tax. If this ownership is not recognised, we are of the opinion that any income distributed by the trust to the beneficiaries cannot be placed but in the scope of gift tax.