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Commercial Uses of Trusts

The common law trust has long been a feature in many kinds of commercial arrangements. It has certain unique characteristics which set it apart from other contract-based relationships. This article sets out some of the many uses to which it has been, and may yet be possible, to put a trust.



Katharina Byrne *

1. Introduction

First, however, we shall review the core elements of a trust and why it lends itself to commercial applications.

1.1 What is a trust?

A basic definition is a legal arrangement which involves a person (the “**settlor**”) transferring legal title to assets to another person or body (the “**trustees**”) to hold for the benefit of one or more persons (the “**beneficiaries**”), which may include the settlor. The terms of the trust are usually set out in a written instrument, often in the form of a deed. The trust imposes onerous duties on the trustee; failure to fulfil those duties properly may result in the trustee being held personally liable.

In order to determine whether the settlor has created a trust, as opposed to another kind of obligation, the three certainties must be present: certainty of intention to create a trust; certain of subject matter; and certainty of beneficiaries (or objects). Although these concepts can sometimes raise difficult questions in the context of private trusts, they are usually less of a concern in a commercial arrangement, as the parties often will have decided in advance what form they want the venture to take and have recorded that in the trust deed.

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1.2 Advantages of a trust

Certain features of the trust make it a very useful vehicle for commercial purposes. First, the segregation of the trust fund so that it does not form part of the patrimony of either the trustee or the beneficiary is an extremely valuable feature for a number of reasons. For example, creditors of the trustee will have no claim to the trust fund; this is also broadly true in the case of creditors of the beneficiary.

Second, in certain circumstances it may not be possible for the beneficiary to hold property in his own name, whether because of a lack of legal capacity to do so, or because of fiscal or other regulatory reasons.

Another important feature is the inherent flexibility of a trust. As a general matter, the provisions of any trust can be whatever is agreed between the settlor and the trustee. Trusts, apart from certain exceptions, such as pension fund trusts, are subject to relatively little regulatory control. This is in stark contrast to other commercial vehicles, whose governance is externally controlled to a large extent by legislation. For example, the very creation of a trust involves very few formalities in comparison to the incorporation of a company.

A third advantage is the tax treatment of trusts. Because of the lack of legal personality, the beneficiaries are often treated as the direct owners of the underlying trust property and taxed accordingly. Such flow-through treatment for tax purposes is particularly important in commercial transactions; for example, where several independent parties pool their resources in order to undertake an investment and each wishes to share in the deductions for tax purposes, as well as the profits, of the venture.

A fourth benefit is the confidentiality inherent in both the creation and the operation of a trust.

Having reviewed some of the general advantages of trusts, what then of the specific commercial uses of trusts?

Commercial trusts can be divided into three broad categories: trusts for investment purposes, trusts acting as a security device, and trusts for other business purposes that do not fit neatly into one of the other two categories.

2. Investment Trusts

As an investment vehicle, trusts can take the form of unit trusts, and pension fund trusts. Unit trusts allow several persons to invest in the same assets by way of what is often a small contribution compared to the total value of the trust fund. The interests of the unit-holders in the trust are represented by units of beneficial interest, the value of which are directly related to the value of the assets in the trust fund. The terms of the trust instrument regulate the rights of the unit-holders, often providing that a unit-holder does not have a direct proprietary interest in the assets of the trust fund, but only a right to the income arising in respect of units held, as well as the proceeds of sale of units.

2.1 Pension schemes as trusts

Occupational pension schemes are also often established using trusts and here, too, the fiduciary nature of the trust and the segregation of trust assets provide a valuable mechanism for protecting the interests of the employee-beneficiaries. As with unit trusts, pension schemes are often subject to regulation in the interests of the beneficiaries.

3. Security Trusts

3.1 Debenture trusts

With respect to the second category of trust, security trusts, a typical example is the debenture trust, whereby multiple parties can participate in lending to a company through the medium of a trust. The lenders receive marketable securities issued by the trustee, which holds upon trust for the lenders the right to enforce repayment of the loan, as well as property provided by the borrower as security for the loan.

Such an arrangement provides benefits for both the lender and the borrowers. For example, as far as the lender is concerned, the size or nature of the loan may be such that it is difficult to find willing lenders unless their individual participation is limited to a certain amount. In the case of a debenture trust, it is possible to have any number of lenders providing loans of varying amounts. Another advantage for an individual lender is that the trustee will be responsible for ensuring that the borrower complies

with the terms of the loan. A further advantage, which draws upon the trustee's inherent fiduciary office, is that the trustee will act even-handedly *vis-à-vis* all the bondholders, and not allow itself to be forced to take action by a small group of 'rogue' bondholders, which may be detrimental to the bondholders as a whole.

The centralisation of control of the debt in the hands of the trustee is also of benefit to the borrower, since it has to deal with only the trustee and not each of the bondholders.

This also ensures that the borrower's financial condition is kept confidential so that it is the trustee and not any one bondholder who decides whether action needs to be taken to protect the interests of the bondholders.

3.2 Employee benefit trusts

The security benefits of a trust are also important reasons why it is often used as the holding vehicle for shares or cash which is to be distributed to employees in accordance with a particular mechanism. By holding the property in such a separate vehicle, it is isolated from the risk of the employer becoming insolvent, or from claims of creditors of the employer. Such protection can be vitiated in certain circumstances; however, provided that proper advice is sought from the outset, the risk of attack can be minimised.

3.3 Sinking fund trusts

Another form of security trust is one which creates a sinking fund out of which potential claims can be settled over a fixed number of years. An actual example of such a trust is one that was established for the benefit of shareholders of a company whose business had involved the use of hazardous materials. The shareholders wished to place the company into liquidation, yet were concerned about possible claims being brought against them in respect of the company's products even after the company had ceased to exist.

Therefore, it was agreed that a sum of money would be placed into trust for the benefit of the shareholders and would be disbursed over a number of years according to a set formula to the shareholder - beneficiaries, provided no claim

was brought against them in respect of the company's products.

3.4 Trusts of insurance monies

Another example of a security trust involved an arrangement whereby the holders of policies issued by a particular insurance company agreed to the proration of payments made in respect of their policies. Such an arrangement was necessary to ensure the solvency of the insurance company and allow a scheme of arrangement to be put in place for the benefit of creditors of the company.

Pursuant to the trust, a percentage of claim payments were assigned to a trustee, to be disbursed according to the instructions of the insurance company.

In addition to ensuring the protection of creditors, a trust can also be used to protect rights of a more intangible nature. For example, the redomiciliation of a company from one jurisdiction to another may give rise to a conflict between the rights of shareholders under the laws of the home jurisdiction and those under the new jurisdiction. In some jurisdictions, changes to certain shareholder rights require unanimous shareholder consent. However, in other jurisdictions, only a specified majority is required. In such a situation, a possible solution would be to issue a special voting share to a trustee to hold on trust for those persons who are shareholders at the time of redomiciliation. The terms of the trust provide that the rights of those shareholders can only be amended if the trustee does not vote against the resolution. How the trustee will cast its vote will depend on the terms of the trust; for example, the trust may state that the trustee can veto such a resolution if not all of the shareholders agree to the amendment.

4. Business Purpose Trust

The third category of commercial trusts, the business purpose trust, is very broad and can encompass a myriad of arrangements.

4.1 Voting trusts

An example of a trust with a general business purpose is that of the voting trust. This is a device for separating the economic and control

aspects of share ownership. Although shareholder agreements are not uncommon, a voting trust strengthens such agreements by vesting the voting rights of the individual shareholders in a trustee who is to exercise those rights in accordance with the terms of the agreement. Whereas under a shareholder agreement one shareholder can choose not to abide by the terms of the agreement and thereby undermine its whole purpose, this is less likely to happen where voting rights are vested in a neutral party *i.e.*, the trustee, who is bound not only by the terms of the trust agreement, but also by the general principles of trust law. As a fiduciary, the trustee must act in the best interests of all the beneficiaries' shareholders, and cannot favour one over the other.

A voting trust can also be an integral part of a dual-listed company ("DLC") structure, whereby two companies merge their economic interests while at the same time remaining separate entities. Both companies also continue to remain listed on their respective stock exchanges. DLC structures have a long history: the Royal Dutch Petroleum and Shell DLC dates back to 1903 whereas the Unilever DLC was created in 1930. Other examples of DLC structures include Rio Tinto Limited/Rio Tinto PLC, and BHP Billiton Limited and BHP Billiton PLC, and Reed Elsevier.

A DLC may involve special voting shares in one of the participant companies being held in a trust for the benefit of the shareholders of the other company. The terms of the trust set out how the trustee will vote in particular circumstances. In essence, the purpose of the arrangement is to ensure that the voting rights attached to the special voting shares are cast in such a way as to replicate the voting that has taken place at the general meeting of shareholders of the other company.

A trust which holds shares can also be used to meet regulatory requirements. The author has advised on a structure where a major airline established a trust to hold the shares in its subsidiary which ran the airline's frequent flyer programme. The trust enabled the airline to comply with certain EU competition law obligations. In another case, using a voting trust allowed a party to

acquire a regulated business despite the fact that the regulator did not consider the purchaser to be a suitable person to operate the regulated business. The regulator allowed the transaction to proceed on condition that voting control of the regulated business was placed in the hands of an independent professional trustee. The economic rights associated with the business remained with the new owner.

Another type of business purpose trust concerns the use of a trust as a holding and distribution mechanism of monies for several parties representing payment for services rendered by those parties to each other. A simplified structure involves the trustee receiving monies representing advance payment for services. Provided that certain conditions are met, the trustee makes payments out of the trust account to contractors of the named beneficiary, as well as to the beneficiary itself. In certain cases, however, payments represent refunds of the prepaid sums.

Because the trustee only pays funds out of the trust when certain conditions are met, such an arrangement can, as noted above, mitigate the insolvency risk of a party. However, using a trust in this way can also have practical benefits: for example, administration is centralised in the hands of the trustee. In addition, the trust can create a "level playing field" where the parties are not otherwise equal in terms of financial strength, for example.

4.2 Purpose trusts

Although many commercial arrangements can be analysed from a beneficiary trust perspective, it can be difficult to identify where the beneficial interest in the trust fund lies at any given time. For example, it is arguable that the beneficiaries of the sums paid into the above kind of trust include not only the party which will render the relevant services but also the payers of those sums. Would the creditors of those payers also have a claim to those paid sums in the event of a payer becoming bankrupt? Furthermore, do the contractors of a beneficiary have an interest in the monies held in the trust? Unfortunately, these issues tend to be overlooked unless and until a dispute arises among the parties, or one or more of them experiences financial difficulties.

Such an arrangement could also be characterised as a purpose trust, on the basis that its key feature is the mode of application of the trust fund, not the identity of the ultimate recipients of the trust fund. As a purpose trust, the arrangement still retains the advantage of creating a pool of assets which is kept separate from the property of the individual parties. Moreover, this feature is enhanced by the fact that there are no beneficiaries. As indicated above, in a beneficiary trust, it could be argued that the trustee holds the trust fund on a bare trust, so that each beneficiary has a clearly discernible interest in the underlying assets of the trust fund. Consequently, a creditor of the beneficiary could also lay claim to that interest in bankruptcy proceedings.

Although English law recognises purpose trusts (other than those for exclusively charitable purposes) only to a limited extent, several jurisdictions¹ have introduced legislation that allow for the creation of trusts for purposes, or in some cases, trusts with both beneficiaries and purposes.

Key features of a purpose trust

Most of the jurisdictions which have passed purpose trust legislation have taken a similar approach in defining the parameters of the purpose trust, based on the interpretation of the reported English cases in which such trusts have been considered.

Consequently, many of the statutes provide that non-charitable purpose trusts are valid, provided that the purpose is specific, reasonable, and capable of being fulfilled. Moreover, the purpose must not be immoral, unlawful, or contrary to public policy. In some jurisdictions, the definition of "charitable purpose" has been extended to allow the creation of trusts for philanthropic (but not necessarily charitable) purposes or for the mixed benefit of worthy causes and individuals.

Many of the jurisdictions have also done away with the common law principles against inalienability, thereby allowing for the creation of trusts whose purpose is very long term.

Since a purpose trust has, by definition, no beneficiaries to enforce it, the relevant jurisdictions have included enforcement mechanisms in their trust legislation. In some cases, the trust must

provide for the appointment of a person to act as enforcer of the trust. The enforcer is under a duty to ensure that the trustee carries out the terms of the trust in connection with the specified purposes.

5. Other commercial uses of purpose trusts

5.1 Off balance sheet arrangements

Another example, albeit a simple one, of a trust for commercial purposes is in off-balance sheet arrangements where the trust holds the shares of a "quasi-subsiary". The reasons for such arrangements include circumventing of controlled foreign company taxation rules, asset protection by isolating speculative economic activities from the assets of the 'parent', and off-balance sheet treatment for accounting purposes.

For example, the finance subsidiary of a corporate group may have issued some form of debt instrument supported by a guarantee from its parent company. By transferring the obligation of the subsidiary to a purpose trust, it may be possible to release the parent company from its guarantee and remove the liability from the consolidated balance sheet liabilities of the group. Such a restructuring may be desirable in order to improve the group's credit rating with a view to putting in place another financing transaction, or to facilitate a sale of the parent.

5.2 Future reserves or provision

Purpose trusts are ideal vehicles for creating a fund to pay the present and future creditors of the settlor. Without the need to satisfy one of the three certainties, that is, having an ascertainable beneficiary in existence at the time of the creation of the trust, a purpose trust could even be for the future creditors only.

Such a trust is less vulnerable to attack under insolvency law principles², for the following reasons:

- ◆ there is no 'gift' to another person, since it is a trust for purposes, not persons;
- ◆ there is no transaction at an undervalue, since the trustee is not benefiting personally from the transaction; and
- ◆ no one creditor is preferred.

Such a trust could be used in a situation similar to that discussed earlier where a company which had engaged in a hazardous business was to be put into liquidation, but shareholders were concerned about possible claims being brought against them personally once the company had been liquidated. As an alternative to a beneficiary trust, the company could set aside funds to cover potential claims in a purpose trust which would last for a specific number of years. The company could then be put into liquidation. Once the trust period has expired, the balance of the trust fund can be paid out in the manner specified in the trust deed. The ultimate recipients could be the former shareholders, or perhaps a charitable purpose related to the business of the company. Such a trust would not require an identifiable beneficiary on the day that it is created; this requirement is often overlooked, yet is crucial to ensuring the validity of a beneficiary trust. Secondly, the trustee need not concern itself about the nature of the interest of any beneficiaries and the duties which it may owe to them; instead, enforcement of the purposes of the trust is the responsibility of the person designated in the trust deed or under the relevant legislation. If the trust deed provides that the former shareholders are to receive any balance left in the trust fund at the end of the trust period, such a right is arguably not a contingent equitable interest as might otherwise be the case with a beneficiary trust.

5.3 Quistclose Trusts

A purpose trust also appears to offer a solution to the legal problems which arise in connection with so-called Quistclose trusts.

A Quistclose trust arises when A makes a transfer to B for a specific purpose and **for no other purpose**. The significance of the Quistclose trust is that the funds transferred remain the property of the **transferor** unless the recipient applies them for the specified purpose. If the recipient becomes insolvent before applying the funds for that purpose, those funds cannot be used to satisfy its creditors. For this reason, cases involving Quistclose trusts are often insolvency cases where it is necessary to establish who is the beneficial owner of the funds: the creditors of A or B, or the persons to whom B was to make payment?

The House of Lords attempted to elucidate the situation first in *Barclays Bank Ltd. v. Quistclose Investments Ltd.*³ and then in *Twinsectra Ltd. v. Yardley and others*⁴. However, views differ widely on the extent to which the House of Lords has succeeded in doing so. In contrast, if a purpose trust were used, problems such as the situs of the beneficial interest at any given time fall away. Furthermore, the monies are secure from the creditors of both A and B.

The classic Quistclose trust arises when a loan is made for a specific and exclusive purpose. However, the basic principle is derived from earlier case law and the courts have also found that Quistclose trusts apply in the following situations:

- ◆ A company paid funds to its advertising agency for the sole purpose of paying third parties for work on behalf of the company (*Carreras Rothmans Ltd. v. Freeman Matthews Treasure Ltd* [1985] Ch 207).
- ◆ A company that was a debtor of a second company paid funds to the administrator of the second company for the sole purpose of allowing the administrator to pay a subcontractor for further work on behalf of the first company (*Re Niagara Mechanical Services International Ltd.* [2000] 2 BCLC 425).
- ◆ A firm of solicitors gave an undertaking to use funds only to complete the purchase of a specified property. The firm could not use the funds for other purposes such as paying disbursements (*Templeton Insurance Ltd v. Penningtons Solicitors LLP* [2006] EWHC 685 (Ch)).
- ◆ Individuals paid funds to the promoter of a film tax relief scheme, while the funds were held in a client account before investment (*Bieber and others v. Teathers Ltd* [2012] EWHC 190 (Ch)).

It is clear from the preceding overview that trusts have wide applications in the commercial as well as the private sphere. The inherent flexibility of a trust makes it an ideal vehicle for various kinds of business transactions. Moreover, where the trust used takes the form of a purpose trust, the advantages can be even greater.

6. Taxation

The taxation of a commercial trust will often depend on a number of factors, including the residence of the settlor, beneficiaries and trustee, the nature of the beneficiaries' interests in the trust assets, where the activities of the trust are undertaken, and the location of the trust assets. In the UK, the general thrust of the income tax and capital gains tax regimes is to exempt trusts that form part of *bona fide* commercial arrangements. However, this is not the case with inheritance tax, despite the fact that the main purpose of the inheritance tax legislation is to charge individuals or their estates to tax when they die, or when they make certain kinds of gifts.

There are very few UK cases which consider the taxation of trusts for genuine commercial purposes, where mitigation of IHT is not in issue. Nor has HMRC produced very much public guidance on the matter. Clarification from the courts, if not the legislature, would therefore be welcome.

The taxation of commercial trusts is less complicated if the trust is a bare trust⁵, as it will be taxed as if the trust assets belong to the beneficiary absolutely. However, a bare trust is much less robust in terms of protecting the trust assets from the claims of creditors of the settlor. As noted above, a non-charitable purpose trust is arguably less vulnerable to attack from the creditors of the settlor than a traditional trust. However, it is not clear how the UK revenue authorities would characterise such a trust for tax purposes.



1 For example, international financial centres such as Bermuda, Jersey, Guernsey, the Isle of Man, the Cayman Islands, the British Virgin Islands, Belize, the Cook Islands, Cyprus and Labuan. However, onshore jurisdictions, including the US state of Delaware and the Canadian province of Quebec also permit purpose trusts under domestic law.

2 For example, as a preference, or a transaction at an undervalue. See UK insolvency Act, 1986, sections 339,340 and 423.

3. [1968] UKHL 4

4. [2002] UKHL 12

5. Broadly, a bare trust is a trust where the beneficiary (or beneficiaries) has an immediate and absolute right to both the capital and income of the trust. The property is held in the name of the trustee (or trustees), but the trustee has no discretion over the assets held in trust.