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**TRANSFORMATION AND TRANSPARENCY – THE CURRENT STATE OF
THE OFFSHORE TRUST**

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**DIFFICULTIES OF OFFSHORE TRUSTS – DOMESTICATION OF
OFFSHORE TRUSTS – EU MONEY LAUNDERING DIRECTIVES – NEW
FRENCH “FIDUCIE” LAW**

This paper addresses the following four subject matters:

1. The difficulties facing offshore trusts (namely, trusts settled in low tax jurisdictions)
2. The resulting domestication of offshore trusts
3. Money laundering directives as they apply to professionals in the area of trusts
4. The advent of the trust concept in French law: the "fiducie"

1. The difficulties facing offshore trusts

The Organization for Economic Co-operation and Development (in other words the "OECD") many years ago launched an all out attack against offshore financial centres.

Other organizations such as the Financial Action Task Force (or "FATF") set out to combat offshore financial centres.

Their objective is to fight the modern criminal world, principally terrorism and drugs, as well as the resulting crime of money laundering, which naturally must be applauded.

Bona fide wealth however had been invested over the years in offshore financial centers, notably after World War II and also as a result of the development of international commerce and individual mobility. Much of that wealth was settled in trusts.

In this situation the trend in the modern tax laws of high tax jurisdictions has been to enact long-arm statutes to include the so-called offshore wealth in the tax nets of those jurisdictions.

In France, the relevant statute is Article 123 Bis of the French tax code, which, in substance, provides that if a French resident beneficiary controls an offshore vehicle (including specifically a trust), that person must file a special tax return in accordance with French-GAAP and must include the vehicle's income in his own income. It is also generally accepted that a French taxpayer who is subject to Article 123 Bis is also subject to French wealth tax on the fair market value of the trust fund. I have attached to the hand-out in your file a translation of Article 123 Bis (Annex I).

This has naturally resulted in difficulties for offshore trusts

Another difficulty for offshore financial centres is that high tax jurisdictions have begun to understand the benefits of attracting the bona fide wealth that is currently invested in offshore financial centres. This aspect will be discussed in the next section.

Yet another phenomenon which also results in difficulties for offshore financial centres is the position taken by new generations of beneficiaries. Indeed, they do not want to be confronted with the problems that their parents or grandparents have had to face especially in an environment where high tax jurisdictions are offering less confiscatory tax packages than they did in the past.

2. The domestication of offshore trusts

The first condition for domestication set by all high tax jurisdictions is naturally that the assets should be bona fide, in other words lawfully acquired by the settlor. That is generally obtained through stringent KYC rules that must be respected by all concerned in the jurisdiction of destination. The customer due diligence measures as they are called in the third EU money laundering directive are set out in Annex III to this presentation.

The second condition is generally that the settlor and the beneficiaries should not be residents of the jurisdiction of destination (the question of citizenship also comes into play in the case of the United States).

The third condition is often that the assets should not be located in the high tax jurisdiction of destination.

If the above conditions are satisfied, several jurisdictions will allow the resettlement of trust assets previously settled in low tax jurisdictions. The United States, Ireland, Israel assets are examples of jurisdictions that will allow a variant or another of the domestication process.

It is essential in order for domestication to be a reasonable proposition that the settlor clearly has no control whatsoever, in law or in fact, on the trustees of the offshore trust or on the trust fund.

If all the conditions are satisfied, then the next issue is to analyze whether latent gains will be taxed on realization on the basis of historical value in the "old" trust or by reference to the value of the assets on the date of domestication.

Finally it is necessary to determine:

- how the newly domesticated trust will be taxed in the host jurisdiction,
- how distributions will be taxed (which depends on whether the jurisdiction of residence of the distribution beneficiary characterizes the distribution in accordance with its own laws or with the tax law of the jurisdiction wherein the trust is established;
- whether undistributed income are taxed.

3. The EU money laundering directives as they apply to professionals in the area of trusts

Under the EU legal system, a directive is an EU-level statute that each of the 27 Member States must within a set period of time integrate in their respective domestic legal systems. Directives are opposed to so-called "EU regulations", which are also EU-level statutes, but which are directly applicable as law in each of the 27 Member States.

Two successive money laundering directives were enacted in the past. The third version was enacted on 26 October 2005 and should now be integrated by all Member States. Article 2 of the latter provides that the directive applies notably:

- to tax advisors (unrestrictedly) and
- to independent legal advisors when assisting in the planning or execution of transactions for their clients in a wide range of activities and notably in "the creation, operation or management of trusts, companies or similar structures".

In France, the reporting obligation is to TracFin, the arm of the Ministry of Finance in charge of tracking money laundering activities.

At this juncture, France has only implemented the second money laundering directive. Under the French statute implementing that directive, the reporting obligation for attorneys-at-law (avocats) is to the chief of the local bar association (Bâtonnier), who decides, considering the circumstances of fact, whether the report should go to TracFin or whether the avocat was acting erroneously in making the report. This method will probably disappear under the third money laundering directive so that the avocat will be directly faced with the responsibility to report or not to report.

The third money laundering directive provides that reporting obligations will however not apply in certain cases, notably, as regards tax advisors and independent legal professionals, when they are:

- in the course of ascertaining the legal position for their client, or
- performing their task of defending or representing that client in relation to judicial proceedings, including advice on instituting or avoiding proceedings.

In other words, adhesion to the rules is more than ever a must despite the fact that compliance has become a more and more technical and bureaucratic process.

4. The new French law adopting the concept of fiducie

When the program for this Conference was printed it was less than certain that the draft bill instituting in the civil code a concept analogous to trusts would be voted into law.

As a consequence of a decisive effort on the part of the Government, the Senate and the General Assembly, the law was finally enacted on 19 February 2007.

"La fiducie" is born. A translation into English of the new civil code sections is attached as Annex III.

However, to the distress of many, it will not be possible in its present form to use the fiducie for objectives other than business law (substitute for pledging assets, defeasance, nominee relationships, etc).

However, a majority of the participants in the effort to introduce the concept in the civil code are confident that the law will be changed in the coming years to allow for private wealth transfer planning uses.

One central question is whether the fiducie is a trust.

Under the civil code definition (in Article 2011) a fiducie is the transaction whereby one or several settlors transfer assets, present or future, to one or several trustees who, holding the same separate from their own estate, act for a specific purpose for the benefit of one or more beneficiaries. This looks like the description of a trust.

However France does not recognise the distinction between legal and equitable ownership.

Hence the question.

One approach is to look to the Hague Convention on the law applicable to trusts and their recognition¹ of 1985. Under that convention it is not necessary for a relationship to distinguish between legal and equitable title to have a trust. It is sufficient under Article 2 that:

- the assets constitute a separate fund and are not part of the trustee's own estate (Article 2 a));
- title to the trust assets stand in the name of the trustee or in the name of another person on behalf of the trustee (Article 2 b));
- 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. (Article 2 c)).

The fiducie law appears to meet all the above tests. This is important not only as an academic point to make but also to determine whether the other signatories of the Hague convention of 1985 will admit the French fiducie in the club of trusts, which I hope will be the case!

It will be for the courts to say, eventually.

¹ Concluded on 1 July 1985 and entered into force on 1 January 1992. Ratified by Australia, Canada, Cyprus, Italy, Luxembourg, The Netherlands, United Kingdom of Great Britain and Switzerland. France and the United States of America are signatories of the Convention but have not ratified it. Xavier de Roux (see footnote 4), wrote in his report to the National Assembly on the fiducie bill: "... France, which has signed the Hague Convention of 1 July 1985, relating to the law applicable to trusts and their recognition, will not be able eternally to postpone the moment for ratifying this international legal instrument".

Annex I

Article 123 Bis of the French General Tax Code

1. When an individual domiciled in France directly or indirectly holds ten percent at least of the shares, quotas, financial rights or voting rights of a juridical entity, an organisation, a trust or a similar institution, established or organised outside of France enjoying a privileged tax regime, the profits or positive income of such juridical entity, organisation, trust, or similar institution are deemed to constitute revenue from securities for such individual in the proportion of the shares, quotas or financial rights which he or she holds directly or indirectly, when the assets or chattels of the juridical entity, organisation, trust or comparable institution are mainly made up all of securities, receivables, deposits or current accounts.

For the implementation of the first paragraph, the privileged nature of a tax regime is determined in compliance with the provisions of section 238 A by comparing with the tax regime applicable to a corporation or an organisation mentioned in 1 of article 206.

2. The shares, quotas, financial rights or voting rights held indirectly by the individual mentioned in 1, refer to those shares, quotas, financial rights or voting rights held through a chain of shares, quotas, financial rights or voting rights; the computation of the percentage of the shares, quotas, financial rights or voting rights thus held is made by multiplying between themselves the successive holding percentages relating to such shares or quotas, to such financial rights or voting rights.

Indirect holding also exists with regard to the shares, quotas, financial rights or voting rights held directly or indirectly by the spouse of the individual, or their ascendants or descendants. However, such shares, quotas, financial rights or voting rights are not taken into account for the computation of the revenue from securities of the individual mentioned in 1.

3. The profits or positive income mentioned in 1 are deemed to accrue on the first day of the month which follows the end of the fiscal year of the juridical entity, organisation, trust or similar institution established or incorporated outside of France or, if no fiscal year is closed during a year, December 31st. They are determined in accordance with the rules under this code as if the juridical entities, organisations, trusts or comparable institutions were subject to corporate income tax in France. The tax paid locally on profits or positive income in question by the juridical entity, organisation, trust or comparable institution is deductible from the income deemed to form a revenue of securities for the individual, in the proportion mentioned in 1, subject to the condition that the same are comparable to corporate income tax.

However, whenever the juridical entity, organisation, trust or comparable institution is established or organised in a state or territory which has not signed an administrative assistance treaty with France, the taxable income of the individual may not be less than

the result of the multiplication of the net assets or net value of the assets of the juridical entity, organisation, trust or comparable institution, computed under the conditions set in 1, by a rate equal to that mentioned in 3° of 1 of article 39.

4. The income distributed or paid to an individual mentioned in 1 by a juridical entity, organisation, trust or comparable institution do not constitute taxable income within the meaning of article 120, except for that part which exceeds the taxable income mentioned in 3.

5. A decree approved by the Council of State sets the conditions of implementation of the preceding provisions, notably the reporting obligations of the individuals.

Annex II

Article 8

Third EU Money Laundering Directive

1. Customer due diligence measures shall comprise:

(a) identifying the customer and verifying the customer's identity on the basis of documents, data or information obtained from a reliable and independent source;

(b) identifying, where applicable, the beneficial owner and taking risk-based and adequate measures to verify his identity so that the institution or person covered by this Directive is satisfied that it knows who the beneficial owner is, including, as regards legal persons, trusts and similar legal arrangements, taking risk-based and adequate measures to understand the ownership and control structure of the customer;

(c) obtaining information on the purpose and intended nature of the business relationship;

(d) conducting ongoing monitoring of the business relationship including scrutiny of transactions undertaken throughout the course of that relationship to ensure that the transactions being conducted are consistent with the institution's or person's knowledge of the customer, the business and risk profile, including, where necessary, the source of funds and ensuring that the documents, data or information held are kept up-to-date.

2. The institutions and persons covered by this Directive shall apply each of the customer due diligence requirements set out in paragraph 1, but may determine the extent of such measures on a risk-sensitive basis depending on the type of customer, business relationship, product or transaction. The institutions and persons covered by this Directive shall be able to demonstrate to the competent authorities mentioned in Article 37, including self-regulatory bodies, that the extent of the measures is appropriate in view of the risks of money laundering and terrorist financing.

Annex III

The New French Fiducie [trust]

Chapter I

General Provisions

Article 1st

In book III of the civil code, a title XIV is reinstated, reading as follows:

TITLE XIV

OF THE FIDUCIE

Article 2011 – The fiducie is the transaction whereby one or several settlors [*constituants*] transfer assets, rights or sureties, or a group of assets, rights or sureties, present or future, to one or several trustees [*fiduciaires*] who, holding the same separate from their own estate, act for a specific purpose for the benefit of one or more beneficiaries [*bénéficiaires*].

Article 2012 - The fiducie is organised by law or by contract. It must be express.

Article 2013 – The fiducie contract is null and void if it is based on an intention to effect a gift in favour of the beneficiary. This nullity is of public policy.

Article 2014 – May only act as settlors those juridical persons that are as of right or on a voluntary basis subject to corporate income tax. The rights of the settlor in relation to the fiducie are not transmissible without consideration, nor assignable for consideration to persons other than corporate persons subject to corporate income tax.

Article 2015 – May only have the status of trustees the credit establishments referred to in article L. 511-1 of the monetary and financial code, the institutions and services listed in article L. 518-1 of the same code, the investment enterprises referred to in article L. 531-4 of the same code as well as the insurance enterprises governed by article L. 310-1 of the insurance code.

Article 2016 – The settlor or trustee may be the beneficiary or one of the beneficiaries under the fiducie agreement.

Article 2017 - Except if provided otherwise in the fiducie agreement, the settlor may, at all times, designate a third-party charged with ensuring the preservation of its interests in connection with the implementation of the agreement and who may enjoy the powers conferred upon the settlor by law.

Article 2018 - The fiducie agreement defines, under penalty of nullity:

- 1° The assets, rights or sureties transferred. If they are future they must be identifiable;
- 2° The duration of the transfer, which may not exceed thirty-three years as from the date of signature of the agreement;
- 3° The identity of the settlor or settlors;
- 4° The identity of the trustee or trustees;
- 5° The identity of the beneficiary or beneficiaries or, failing that, the rules allowing for their designation;
- 6° The mission entrusted to the trustee or trustees and the scope of their powers to administer or alienate.

Article 2019 – Under penalty of nullity the fiducie agreement and amendments thereto are registered within one month of their date at the tax office of the trustee's head office or at the tax office for non-residents if the trustee is not resident in France².

When they relate to real estate or real estate in rem rights, they are, subject to the same sanction, published in accordance with the conditions provided for in Article 647 and 657 of the general tax code.

The transfer of the rights resulting from the fiducie agreement and, if the beneficiary is not designated in the fiducie agreement, its subsequent designation, must, under penalty of nullity, be reduced to writing in a deed that is registered under the same conditions.

Article 2020 - A National Registry of fiducies is instituted subject to modalities to be set forth in a Council of State decree.

Article 2021 - When the trustee acts on behalf of the fiducie, it must expressly so indicate.

Similarly, when the trust fund includes assets or rights, the assignment of which is subject to publicity, the latter must include the name of the trustee ex officio.

Article 2022 - The fiducie agreement defines the conditions in which the trustee reports on the his mission to the settlor. The trustee reports on the performance of his mission to the beneficiary and to the third-party designated under Article 2017, at their request, following a periodicity set forth in the agreement.

² Article 13 of the Act : "The settlor and the trustee must be resident in a Member State of the European Community or in a State or territory that has agreed with France a tax treaty for the avoidance of double taxation containing an administrative assistance clause for the purpose of fighting tax fraud or evasion."

Article 2023 – In its relationship with third parties, the trustee is deemed to have the widest powers with respect to the trust fund [*patrimoine fiduciaire*], unless it is demonstrated that the third parties had knowledge of limitations of its powers.

Article 2024 - The initiation of safeguard, judicial reorganisation or judicial liquidation proceedings in favour of the trustee does not affect the trust fund.

Article 2025 - Without prejudice to the rights of the settlor's creditors enjoying a right of pursuit resulting from sureties published prior to the fiducie agreement and excepting the case of fraud to the rights of the settlor's creditors, the trust fund may not be seized except by owners of claims originating from the maintenance or management of the said fund.

In the event of insufficiency of the trust fund, the settlor's estate shall be the common claim of such creditors, except in the event of contrary provisions in the fiducie agreement providing for the allocation of all or part of the liabilities to the trustee.

The fiducie agreement may also restrict the obligations pertaining to the fiducie's liabilities to the trust fund only. Such a clause is effective only with respect to those creditors who have expressly accepted the same.

Article 2026 - The trustee is responsible, on his own patrimony, with respect to faults that he commits during the performance of his mission.

Article 2027 - If the trustee is wanting in his duties or puts the assets entrusted to him in jeopardy, the settlor, the beneficiary or the third-party designated under article 2017 may enter a plea in court for the appointment of a provisional trustee or apply for the replacement of the trustee. The court decision that finds in favour of such a claim entails the automatic dispossession of the trustee.

Article 2028 - The fiducie agreement may be revoked by the settlor so long as it has not been accepted by the beneficiary.

After the beneficiary's acceptance, the contract may not be modified or revoked unless with his approval or by court decision.

Article 2029 - The fiducie agreement terminates at the term, upon the completion of the intended objective if this obtains before the term, or in the event of revocation by the settlor of the corporate tax option.

It also terminates automatically if the contract so provides or, failing that, by court decision, if, in the absence of provisions providing for the conditions under which the contract continues, all the beneficiaries waive their rights to the fiducie. The same obtains if the trustee is the object of judicial liquidation or is wound up, or disappears on the occasion of an assignment or a merger.

Article 2030 - Whenever the fiducie agreement terminates for want of beneficiaries, the rights, assets or sureties included in the trust fund are automatically returned to the settlor.

Article 2031 - In the event of the winding up of the settlor, whenever its successors at law are not juridical entities subject to corporate income tax, the trust fund may not be allocated to such successors before the date on which the fiducie agreement terminates. In such a case, the rights of the successors under the fiducie may not be assigned for no consideration inter vivos nor transferred for consideration.