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TRUSTS FREQUENT QUESTIONS

WHAT IS A TRUST?

A simple and down to the point definition: a trust is an agreement whereby a person (settlor) gives another person (trustee) the right to hold title to given assets for the benefit of one or more third parties (beneficiaries), so that they may permanently transfer those assets to the third parties (or other beneficiaries) once an established time-period has elapsed or once a given condition is fulfilled (usually, but not necessarily, the death of the settlor).

The Hague Conference on Private International Law held in 1984 defined this legal concept as follows:

"the term 'trust' refers to the legal relationships created by a person when assets have been placed under the control of a trustee for the benefit of a beneficiary."

While trusts are not entirely similar to ***"fideicomisos"*** in Civil Law, both are characterized by the obligation to manage and transfer assets that is imposed by a settlor on a trustee.

The main legal effect produced by trusts, from which all practical and legal consequences thereof derive, is splitting ownership into two types: legal ownership, assigned to the trustee; and beneficial ownership, assigned to the beneficiaries.

WHAT ARE TRUSTS USED FOR?

Not only does this type of structure allow for an appropriate management of the assets that are entrusted, but also it serves to clearly establish the circumstances surrounding the transfer of ownership to the beneficiaries.

Moreover, in the case of irrevocable trusts -where the party that establishes the trust is not a beneficiary nor a protector and does not hold any power of administration of the entrusted assets-, the assets that were transferred leave the settlor's estate. On the one hand, this entails a series of tax benefits. On the other, the assets are automatically protected against any legal action filed by potential creditors of the settlor.

In other words, trusts are used with tax, succession, and heritage protection/privacy purposes. The specific type of trust and the most suitable jurisdiction in which to establish it shall be chosen based on the goals established by each client.

In fact, there is no other instrument that is more appropriate nor more flexible than a trust to meet the wealth planning needs of a family. This is precisely why legal systems worldwide have adapted to this entity in one way or the other.

WHAT TYPES OF TRUSTS ARE THERE? WHERE CAN THEY BE ESTABLISHED?

There are several types of trusts (revocable, irrevocable, discretionary, non-discretionary, among others) and many jurisdictions where they may be created. With a few exceptions, all those jurisdictions are governed by Anglo-Saxon Law, or Common Law.

Each type and each jurisdiction shall be examined in detail by an international expert on these issues (eventually, **UNTITLED SLC**), as well as by legal advisors and accountants acting locally on behalf of the settlor.

IS THERE ANY SUBSTANTIAL DIFFERENCE BETWEEN A TRUST CREATED IN THE UNITED STATES AND ONE CREATED IN ANOTHER JURISDICTION, SUCH AS NEW ZEALAND OR THE CAYMAN ISLANDS?

On top of the different requirements and conditions for the creation and regulation of the trust, the main difference is the compliance with the Common Reporting Standard (**CRS**) in jurisdictions other than the United States.

As mentioned above, one of the aims of trusts is to protect the settlor's privacy, i.e. to avoid disclosing that the settlor is in any way related to the assets in question.

Unfortunately, countries have come a long way in terms of the exchange of financial information, and the right to privacy previously enjoyed by taxpayers has been restricted.

As of the effective date of the **CRS**, those countries that signed the agreement to comply with the automatic exchange of information have been automatically obtaining and exchanging financial information on most trusts, including the identity of settlors, the entrusted assets, and the profits made. The information of the beneficiaries, however, is only reported during the years in which they receive distributions.

WHY HAVE THE UNITED STATES BECOME ONE OF THE MOST USED JURISTICTIONS?

In addition to what is explained above, it should be emphasized that several American States, such as South Dakota -one of the most frequently used to create this type of structures- have sound legislation in terms of asset protection. Thus, it is practically impossible for the settlor's creditors to access such assets. Moreover, this state's asset protection statute specifically excludes claims on mandatory distribution of estate to legal heirs.

WHAT ROLES OTHER THAN SETTLOR, BENEFICIARY AND TRUSTEE ARE THERE?

Besides the mandatory parties required for any trust to be considered as such, there are two additional categories of relevance that are usually included to strengthen the structure and to ensure that the settlor's goals are achieved.

1) **Financial advisor:** The person or entity that will actually manage the trust's investments. In case this party does not exist, these powers shall be vested in the trustee.

2) **Protector:** A key role for the settlor, since they provide the settlor with some degree of control after they have transferred their assets, given that the protector is a trustworthy person in charge of monitoring the trustee.

Generally, **though not mandatorily**, the protector is endowed with the following rights or powers:

(a) the power to remove the trustee and the financial advisor;
(b) the power to change the proper law applicable to the trust;
(c) the power to remove or add beneficiaries;
(d) the power to approve asset distributions;
(e) the power to advise on investments; and
(f) the power to terminate the trust or to approve the termination of the trust.

The role of protector is quite new, hence the relatively limited case history. In Latin America, it is virtually non-existent.

What is highly important when determining their powers is that, in praxis, they must not be equated to the trustee.

WHAT KIND OF ASSETS CAN BE TRANSFERRED TO/PLACED IN A TRUST?

Trust property may consist of shares, interests, bonds, personal property (for example, rights, credits, works of art) and real estate located anywhere in the world, at present or in the future.

WHAT ARE THE EFFECTS OF TRUSTS IN LATIN AMERICA?

Legal professionals with little experience on the subject frequently state that trusts are not recognized by civil law schemes currently in force in Latin America, and therefore, that they are not enforceable to third parties and have no legal effects.

Many of these arguments are based on the fact that the majority of the countries in this region apply laws and regulations for the mandatory distribution of estate to legal heirs, and that trusts were first regulated by Common Law and not by Roman Law.

While this argument may be reasonable, it is by no means correct. In fact, the courts of countries that implement similar legal frameworks (as in the case of ***"fideicomisos"***) would never say that trusts, as entities, are foreign to their legal system. These countries include Argentina, Mexico, Brazil, Peru, Paraguay, and Uruguay.

All in all, provided that precautions are taken when setting them up- which vary from country to country-, trusts are perfectly valid, and their effects are almost always fully respected. In countries where wealth tax is levied, it does not apply to assets that are transferred to irrevocable trusts, and any income tax is deferred until distribution takes place. Furthermore, setting up an irrevocable trust prevents being affected by taxes created after the fiduciary transfer of the assets.

WHAT ARE THE MAIN PRECAUTIONS TO BE CONSIDERED WHEN ESTABLISHING A TRUST?

When it comes to precautions, we will mostly refer to what applies in Argentina, which is the Latin American country with the richest trust case law to date. Several rulings passed by Argentine courts have been cited both in legal scholar analyses conducted by lawyers of the region as well as in court decisions issued in other countries of the Americas.

Other countries where trusts have been reviewed in further detail, and where the precautions to be taken are quite clear, are Chile, Mexico, and Peru. Creating trusts is even simpler in Panama, where it is governed by a domestic trust act.

Based on case law and on the opinion of tax authorities, these are the precautions that should be followed in order to minimize potential risks:

(a) The documentation pertaining to the trust must be sound and as comprehensive as possible.

(b) The trustee must be an independent third party, so that the trust is not deemed transparent. If the trustee is a company that is particularly engaged in providing fiduciary services, so much the better. Under no circumstances whatsoever shall the settlor be also the trustee.

(c) Neither is it favorable that the settlor be a benefi ciary as well, nor that they hold the power to manage the entrusted assets. Cases in which a person asks a third party to manage a given asset for their own benefit are more of a mandate contract than a trust.

(d) Both the type of trust and the jurisdiction as well as the trustee that will be appointed must be chosen carefully. In this regard, it is preferable that the trust is irrevocable and that the jurisdiction is not a non-cooperative one. It is also unadvisable to choose a random person as the trustee and then take away all their powers by appointing a financial

advisor and a protector and/or by bestowing general administration powers on third parties (even more so if these powers fall on the settlor). This is against the principle of "substance over form," unless the client has no intention to reduce their tax burden and the trust is only being established for succession purposes.

(e) Once the trust is established, assets must be transferred very carefully.

(f) The final issue to be taken into account is how much much control the settlor is going to have over functioning of the trust, which they will exert in praxis in some way or the other. The greater the control wielded by the settlor, the most confident they will feel; but at the same time, the greater the risk of the structure being attacked by claiming that its assets were never really separated from the settlor's estate. It is important that the assets are effectively transferred to the trustee. In order to do so, it is necessary to limit the settlor's rights and powers as much as possible.

SPLIT TRUSTS

In some of the countries of the region (like Mexico, Peru and others), there are rules preventing taxpayers from deferring the income tax tied to the profit made from their assets by transferring them to companies they can oversee themselves.

In countries that enforce these rules, known as controlled foreign company rules (or CFC rules), a special structure called Split Trust is used.

This structure entails the establishment of two (2) different trusts- a revocable one and the other, an irrevocable. Additionally, a holding company is set up, which, in turn, issues two types of stock:

(a) common shares; and
(b) preferred shares without dividends rights.

Preferred shares, which does not pay dividends, is issued in favor of the revocable trust's trustee, while common shares are issued for the trustee of the irrevocable trust.

The latter, which confer voting rights, are shares that grow in tandem with the profit generated by the company holding the assets. Preferred shareholders only earn income from capital gains.

The underlying idea is that the settlor benefits from the trust's capital but does not receive the profit generated by assets and does not have any control over the holding company.

In countries where there are no CFC Rules in place (like Argentina), there is no reason to establish this type of trust.

WHAT TAXES MUST SETTLORS PAY ONCE THEY CREATE A TRUST? WHAT ABOUT THE BENEFICIARIES?

This will depend on two key factors- on the one hand, the jurisdiction in which the trust is established; and on the other, the type of trust that is chosen. Of course, the settlor's tax residence is of relevance as well.

Generally, irrevocable trusts entail the division of the settlor's estate, thus resulting in a new and separate estate.

Therefore, the general principle is that the profit earned from trusts is not taxable locally, provided that there is no local resident who is arguably in control of the structure or the assets that were entrusted. This happens, for example, when trusts are revocable, or when the settlor holds excessive administration power, which results in the tax authority arguing that their trust is transparent and, as such, it is subject to taxes.

Consequently, this is the first precaution that should be considered when drafting both the Trust Deed and the Letter of Wishes- the two main legal documents of every trust.

With regard to the former issue, in Argentina there is a resolution issued by AFIP (Federal Administration of Public Revenues; acronym in Spanish) on August 1, 2000 in which the tax authority- using the principle of substance over form- dictated that, if a person reserves the right to revoke the trust at any moment, it becomes evident that there has not been a real transfer of assets in favor of the trustee. In this case, the settlor is also acting as trustee. The ruling in re: "Julio César Moreno" of 2002 followed this line. The judges examining the case determined that trusts in which the settlor is also acting as trustee are perfectly valid but, in turn, fiscally transparent.

In other words, taxpayers must continue paying taxes -including taxes on personal property- over the assets that they transfer to their trust.

The "Eurnekian" case is the most widely known case on this matter, and one that became subject of numerous analyses. However, it should be noted in a previous case -namely, "Gonzalo Aguilar"- the Court examined a trust created in Guernsey and laid down some principles that are still in force today, even outside of Argentina:

(a) irrevocable trusts in which the settlor does not retain control of their assets constitute a valid mechanism to structure an estate;
(b) if such a structure is used, the settlor shall not pay taxes; and
(c) beneficiaries shall pay taxes only upon receiving distributions from the trust.

Concerning the duty of trust beneficiaries to declare and pay taxes, AFIP's resolution No. 9/13 of February 8, 2013, confirms that a beneficiary of a trust that was established in accordance with the laws of another country must not include the entrusted assets in their tax return (and, hence, shall not pay the corresponding taxes) as long as they do not hold any decision-making powers. While the enactment of the so-called Social Solidarity and Productive Reactivation Act in December 2019 rekindled the discussion surrounding this issue (the beneficiaries' obligation to pay personal property taxes due to an eventual profit earned from setting up an irrevocable trust), it is our understanding that the situation remains unchanged. Not only is this related to the taxable capacity, but also to the fact that Argentina's case law has long maintained that inchoate rights cannot be taxed.

In terms of the taxes that must be paid by trust beneficiaries once they receive their profit, most countries of the region establish that beneficiaries must pay the income tax rate on the portion of the amount received that qualifies as yield or profit, and not on the portion that is considered the initial capital contribution of the trust.

OTHER EFFECTS

Notwithstanding the foregoing, it should be underscored that even when a trust is deemed valid, if it infringes a country's public order laws (such as rules of succession), the courts are entitled to respect the conditions imposed by the trust on assets located outside of the country in question, but they may offset this by distributing/allocating the assets located within the country. This is something that should be analyzed—or an additional precaution to be taken into account—upon setting up the structure of a trust, so as to achieve the settlor's purpose and to avoid any obstacles that might be imposed by the court.

FINAL ADVICE

The main two issues to be considered are: the goals sought by the settlor (and eventually their family) when resorting to a trust, and the way trusts are regulated in the settlor's and beneficiaries' country of residence.

To summarize the above, we highlight here some of the relevant issues that should be taken into consideration when establishing a trust:

(i) to have documentation that is as comprehensive as possible, and to make sure that the initial transfer of assets to the trust is valid;

(ii) to select a reliable trustee, who must be an independent third party;

(iii) to make sure that the settlor is not a beneficiary and is not in control of the trust, thus avoiding that it be considered a transparent trust (actually, it is best that nobody holds a larger power of control of the structure than the trustee);

(iv) to choose carefully the type of trust and the jurisdiction in which it will be established; and

(v) to seek legal advice both domestically and internationally.

- This document is merely a general guideline, and each estate and family must be analyzed individually.
- Document updated in April 2023

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