

UAE Trusts and Foundations for Tax-efficient Wealth Preservation

Trusts have been around a long time. Even though the Dubai International Finance Centre (DIFC) and the Abu Dhabi Global Market (ADGM), both free zones with their own bespoke legal systems, only introduced trusts in recent years, trusts and similar legal instruments have a long history spanning multiple legal systems.

The trust most familiar to practitioners and businesspeople alike is probably the English Common Law trust. With its origins in medieval England, where nobles departing on crusades needed to temporarily convey their lands to caretakers, trusts have evolved into a legal instrument that provides for tax-efficient protection and growth of wealth. Similar legal mechanisms exist in Civil Law, such as the *stiftung* and Sharia Law, such as the *waqf*.

What is a Trust?

Under Common Law, as applied in the ADGM legal system and codified under DIFC statute, a trust is not a person like an individual or a corporation, it is a relationship between three entities, generally referred to as the settlor, the trustee and the beneficiary.

At the outset, the settlor will contribute assets to the trust, which are managed by the trustee. Although the trustee holds legal title to the assets, they are held for the benefit of the beneficiary. In other words, the ultimate owner of the trust assets is the beneficiary, but the trustee generally has a lot of control over how the assets are managed and distributed. To complicate matters, there may be multiple trustees and numerous beneficiaries - or even classes of beneficiaries yet to be born.

Foundations - a Trust Alternative

The ADGM has been promoting foundations as a vehicle for wealth and estate planning. Many people think of foundations as philanthropic organizations. However, ADGM foundations have great utility as a vehicle for private family wealth and especially family offices. ADGM foundations combine characteristics of trusts and corporations - assets are managed by directors of the foundation who have a fiduciary duty similar to that of a trustee; but like a corporation, the foundation is a legal person with perpetual existence. ADGM foundations are also governed by a specific statute that aims for simplified governance and protection of foundation assets (and therefore its beneficiaries) from claims in the event of bankruptcy or divorce claims or forced heirship rules. The DIFC also has its own foundations statute similar to ADGM.

How is a Trust Taxed?

The taxation of trusts is not straightforward. Because a trust is a relationship, not a person, it does not fit neatly in the categories of individual or corporation. Further, even though the trustee has legal title to the trust assets, the assets really belong to someone else, i.e. the beneficiary or beneficiaries.

Despite this, most jurisdictions treat trusts as persons for tax purposes and require the trustee to file a separate tax return for the trust, distinct from its own tax return.

In the UAE, trusts are not subject to income tax. This is not because trusts have a special status, but simply because only oil companies and branches of foreign banks pay income tax at the emirate level in the UAE, and not other corporations or individuals.

However, in order for a trust to be resident in the UAE, we need to take a careful look at the cast of characters who make up the trust relationship.

Generally, the settlor is the least important figure in the trust. This may seem counter-intuitive because the settlor contributes assets to the trust, but often this initial contribution is nominal, and other entities, such as family members, will later contribute cash or other assets to the trust. For this reason, the settlor may vanish from the picture as soon as the trust is formed, even though generally the settlor must make its contribution with the intention to contribute to the trust.

Where the settlor – or contributors – to the trust become especially important for tax purposes is if they reside in a taxable jurisdiction. Very often, a contribution to a trust, whether of cash or other property, results in a taxable disposition for the contributor or renders the contributor liable for gift tax. It is a good idea to consult your tax advisor before making any contributions to a trust.

Conversely, the trustee – or trustees – are crucially important to the trust. Similar to how the residency of a corporation is determined by where its mind and management is located, and not necessarily the statute under which it is formed, the residency of a trust is determined largely by where its trustee(s) reside.

This can lead to conflicts between jurisdictions who both claim the trust as a resident. Fortunately, tax treaties (discussed further in this article) can help iron out these disputes.

Residence of the Trustee

Many jurisdictions allow for the formation of trusts and similar instruments. However, the jurisdiction under which the trust is formed is not determinative of the jurisdiction in which the trust is resident.

For example, ignoring the application of tax treaties, a trust formed under the laws of California, but where all of the trustees are residents of Ireland, is likely to be subject to income tax in Ireland and not California. Further, depending on the domestic law applicable to the beneficiaries, tax may be payable where the beneficiaries are located and receive distributions.

This principle is of great importance for DIFC and ADGM trusts because of the desire on the part of the trustees and beneficiaries to maintain UAE tax treatment on income and distributions. If a DIFC or ADGM trust ends up resident in a taxable jurisdiction, such as the UK or USA, then that desired UAE status may be lost.

The best scenario for a DIFC or ADGM trust is to have one or more UAE nationals (providing they intend to remain resident in the UAE) or UAE-formed corporations or foundations as trustees. This provides the security of knowing that even if the beneficiaries of the trust are not UAE residents, the trust can continue to earn income and accrue capital without being subject to taxation.

For foundations, residence is somewhat easier to determine as the foundation is a legal person. However, if control over the foundation is held by a non-UAE resident, that jurisdiction may consider itself to be residence of the foundation.

Who can act as Trustee?

Having a UAE-resident trustee does not mean that a corporation needs to be set up specifically to act as trustee. The UAE has numerous professional corporate trustees that provide stability and good management. By definition, trustees have a fiduciary duty to the beneficiaries, but also have to respect the wishes of the settlor which are usually set out in the trust instrument. Very often, trusts will also appoint a protector with the power to advise or replace trustees. This is especially important in the case of discretionary trusts, where the trustee determines which distributions to make to the beneficiaries.

What is critical in choosing a trustee is good communication with the beneficiaries and the protector (if there is one) and maintaining consistent management and residency.

In contrast to the wide discretion often granted to trustees of a trust, the founder of a foundation can provide highly-detailed instructions, which the Foundation Council is bound to follow, making a foundation an interesting option for some personalities.

How long does a Trust last?

Many people have heard about the famous 21-year rule or as it is known to lawyers cringing at their bar exams – the rule against perpetuities. The 21-year rule is newer than trusts – it arose out of court cases decided in England in the 15th and 16th centuries where its intention was to limit the ability of a settlor to keep assets in trust indefinitely following death. The application of this rule has been excluded in both DIFC and ADGM law.

Many jurisdictions have integrated the 21-year rule into their tax laws, resulting in a deemed capital gain on the assets of the trust on its 21st anniversary. Typically, trustees will plan around this by making a distribution prior to the anniversary. However, the UAE, which does not tax trusts, has no such limitations, so a UAE trust does not require asset distribution prior to its 21st anniversary to avoid taxes.

ADGM and DIFC foundations have a perpetual existence, which means they will last until wound up by the administrators, even after the death of the founder.

Trusts and the Jet Set

High net worth individuals and their families tend to travel and live in different places. This is not particularly helpful when trusts are in the mix.

As discussed earlier, *where* a trust is resident is a vital factor for tax planning. If a UAE trust is resident in a taxable jurisdiction because of where its trustees are resident (or, as some jurisdictions work, if certain beneficiaries are resident), then all you have is a fruit salad of a trust governed by the laws of one jurisdiction but subject to tax in another jurisdiction – not a desirable outcome.

To simplify things, the UAE has entered into many tax treaties with foreign jurisdictions. Unfortunately, not all of the treaties are clear when it comes to their application to trusts.

In short, a tax treaty supersedes the domestic tax law of the signatory jurisdictions. So if you would be considered a tax resident of both France and the UAE under domestic legislation, the treaty should determine where you are actually resident.

If only it were that simple for trusts - not every tax treaty considers a trust to be a person or provides useful guidance on determining the residency of trusts based on the trustees. This is where the art and science of tax planning with trusts comes in.

In a simple scenario, where the trustees and beneficiaries all reside in the UAE or a similar non-taxable jurisdiction, managing the trust can be easy. But where the parties to the trust are spread out, the trust deed (or indenture, as it is often called in legalese) needs to contain language that preserves the tax advantages the trust was established to enjoy. Similar planning needs to go into the creation of an ADGM foundation, although somewhat simplified because a foundation is a legal person.

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