

## ARTICLE NO.5

**Cyprus International Trusts and their uses****Information**

The use of the Trust as a vehicle of prudent international tax planning, and business structuring is constantly growing. Trusts have been created for many reasons, in an effort to reduce tax liabilities, to alter the devolution of assets on death, to avoid the inconvenience and publicity of probate and to protect assets from actual or potential creditors. As the title of the present article focuses on the popular "asset protection trust", special attention will be paid to this "product" launched by legislators wishing to attract investors to their local market. In this context the article will outline the main advantages of an asset-protection trust, referring to the specific planning advantages which accrue in the context of the Cyprus domicile. A note of caution will also be sounded in respect of jurisdictions which have drafted particularly "settlor-friendly" asset-protection provisions in an effort to attract investors – the experience of the Cook Islands is illuminating and one to guard against.

**Concept of a trust**

In the most simple terms, under a trust, trustees, who get no benefit from the trust, are required to hold property of which they are the legal owners for the benefit of other persons, known as "the beneficiaries". Even before the times of the Conquest, the device of the Trust was popular: it enabled a landowner to evade some of the feudal dues which fell on the person seized of land. But while even from these early days the trust was utilized for reasons of tax mitigation, there are today other, possibly more compelling reasons for creating a trust. Tax mitigation can be achieved through the establishment of a limited liability company in a low tax or zero tax jurisdiction. But while a corporate structure may achieve some of the tax planning objectives of the owner, it is certainly not as "personalized" or as "tailored" a solution to the owner's objectives as a trust.

**Trust Law in Cyprus**

Cyprus Trust Law is based on:

- (a) The Trustees Law (Cap 193) which largely adopts the text of the English Trustee Act 1925;
- (b) Equity and case law in England;
- (c) The International Trusts Law 69/92 enacted in 1992 with the aim of providing incentives for the establishment and administration of trusts in Cyprus by non-residents.

The latter has enabled the creation in Cyprus of what we call "International Trusts", that is, trusts set up under the provisions of the International Trusts Law. The Exchange Control and Income Tax laws exempt such trusts from income tax, capital gains tax and estate duty tax, making International Trusts a very attractive tax planning vehicle for the non-resident investor. Briefly, the essential elements of an International Trust are that:

- The settlor is not a permanent resident of Cyprus (a Cyprus company owned by a non

- resident will qualify as a settlor)
- The beneficiary is likewise not a permanent resident (charitable institutions are an exception to this rule)
- The trust property does not include any immovable property in Cyprus;
- A minimum of one trustee is resident in Cyprus (a Cyprus company owned by a non resident or partnership is considered a resident trustee).

### **Asset Protection Trust**

As the title of the present article refers to the asset protection mechanisms utilized in Trusts we will now turn to examine the asset protection trust, its aims and the provisions of the Cyprus legislation in relation to this type of trust.

*Asset Insulation.* What is an asset protection trust? In essence, an asset protection trust is a trust intended to protect, preserve and insulate the assets of the settlor against his creditors or other persons who may have a claim against him. In one sense, every trust created is an asset protection trust because the aim each time is that the assets held in trust are segregated from the settlor's estate, and cannot be absorbed to satisfy the settlor's debts. But when offshore trust practitioners refer to an asset protection trust, the reference is more specific. An asset protection trust normally has three features which set it apart from normal tax planning trusts: first, the settlor remains the beneficiary and is very much in control of the "protected" assets; second, asset protection trusts are situated in low tax jurisdictions with particularly favourable legislative provisions for asset protection; third, the legislation in question usually allows for a change of the proper law of the trust.

The potential user of an asset protection trust is also quite particular. Normally, it includes individuals such as entrepreneurs embarking on a hazardous enterprise or professionals exercising a profession the risk of which they consider best insured.

Trusts are widely used for the protection of assets from the claims of actual or potential creditors. To a large extent, the asset-protection use of a Trust has developed as a response to litigation in the United States because of the large awards of damages handed down by juries in civil law cases. In Cyprus, the International Trusts Law 69/92 makes specific provision to asset protection trusts. It provides that notwithstanding the provisions of any bankruptcy or liquidation laws in Cyprus or in any other country, and notwithstanding the fact that the trust is voluntary and without consideration, unless it is proven to the Court that the trust was made with intent to defraud persons who, at the time when the payment or transfer of assets was made to the trust, were creditors of the settlor, the trust shall not be void or voidable. The law specifies that the burden of proof of such an intent on the part of the settlor lies with the creditors seeking to annul the transfer made to a Cyprus International Trust. Moreover, such an action must be instituted by the creditors within two years from the date of transfer or disposal of the assets to the trust.

Prima facie, this legislative provision renders Cyprus an "asset protection trust haven" in that it

effectively insulates the trust assets from creditors whilst limiting the time period within which they can bring any such claim to court. However, the provisions stand unchallenged in court to date and it is unclear whether they provide effective insulation, particularly where the trust property is located in other jurisdictions. In light of this, there are a number of considerations which should be kept in mind when a settlor decides to insulate his assets via the vehicle of a Cyprus International Trust. Most of these considerations, which will ultimately offer protection in terms of judicial upholding of the planned asset insulation, relate to the “relatedness” of Cyprus as a jurisdiction, a concept which is outlined below.

“Where to Trust?” is a valid and often confounding question for many settlors, particularly in view of the growing number of domiciles offering favourable asset protection provisions in an effort to attract investment. However, one should be cautious in choosing an overly-asset protection friendly jurisdiction. A danger lurks in legal proceedings for a determination to be made that in choosing an asset-protection friendly but completely “unrelated” jurisdiction the settlor’s motive may have been the “friendliness” of the particular legislative provisions, pointing to a tax evasion rather than a tax planning intention. The “relatedness” of a jurisdiction refers to the where the majority of the trustees are situated, the situs of the assets held by the Trust, the place of administration of the Trust as designated by the settlor, the place where the objects of the trust are to be carried out et cetera. If all or the majority of these criteria are unrelated to the jurisdiction chosen as the place of residence of the trust for the purposes of taxation and the governing law, then the danger is that a court in legal proceedings will infer an “intention to defraud”.

A basic problem is that no clear demarcation line exists yet between trusts created to provide asset protection from future but as yet unidentified claims by creditors on the one hand, (which should be allowable and is the traditional purpose of trusts) and trusts created to defraud existing creditors on the other (which should be struck down), but indications from recent case law suggest that judges will jump at the opportunity of catching out those trying to bypass creditor claims. (Note that *Re Butterworths* is often quoted as establishing the principle that an intention to defraud a creditor may be inferred not only where there are actual creditors or even potential creditors, but also where the settlor proposes to embark on a particularly hazardous activity even though he/she may not have done any business yet or contacted any potential creditors at all.) Poorly drafted legislation in the Cook Islands which did not specifically set the trigger date for the two year limitation period for claims from the date when the cause of action arose led to an injunction in favour of the creditors (*Orange Grove* case).

Cyprus has prudently drafted the legislation so as to set the trigger date for the two year limitation period at the date when the payment or transfer of assets is made to the trust. It is anticipated that in conjunction with the rest of the provisions of the 1992 Law the asset protection provisions compare favourably with those of other leading trust jurisdictions and that prudent drafting will facilitate the upholding of the protective mechanisms, unlike the experience of the Cook Islands. Attention must still be paid however, to maintaining the “relatedness” of the jurisdiction but this is partly achieved in Cyprus by the requirement under the 1992 Law for a minimum of one trustee to be a Cyprus resident.

## Other uses for the Trust

In addition to asset protection, there are of course a number of other reasons settlers decide to create a trust, the most popular of which are enumerated below. The enumeration will also serve to highlight the legislative and regulatory advantages which accrue in the context of Cyprus.

*Inheritance Laws.* A trust provides a confidential and flexible way in which an individual can decide how their assets are to pass on death. Many countries have what we call "forced heirship" laws which govern how assets pass to relatives on death. An individual may want to circumvent these laws and decide for himself the proportions in which his assets will pass, or the special provisions he will make for a needy or disabled relative, or a gift he may wish to pass to a friend or a charitable institution. A trust is a good way of overcoming forced heirship

laws thus permitting the settlor to dispose of his assets in the way he chooses in utmost confidentiality. In Cyprus, provision is made in the 1992 International Trusts Law that the

Inheritance Law of the Republic of Cyprus or of any other country shall in no way affect any transfer or disposition made to a Cyprus International Trust and the validity of such transfer shall not be challenged.

This can be read in conjunction with Section 1 of the 1976 Convention on the Recognition and Enforcement of Foreign Judgements in Civil and Commercial Matters which has been ratified by Cyprus and which strengthens the position of immunity of Cyprus International Trusts from forced heirship claims. Specifically, this Section provides that the provisions of the Convention do not apply to decisions relating to the capacity of persons or questions of family law, including personal or financial rights and obligations between parents and children or between spouses and questions of succession.

Read together, the provisions of the 1992 International Trusts Law and the 1976 Convention on the Recognition and Enforcement of Foreign Judgements in Civil and Commercial Matters, make a strong rebuttal of any potential forced heirship claim for assets held under Cyprus International Trusts.

*Tax Planning.* As mentioned above, many persons turn to trusts as a way of mitigating income, capital gains tax and inheritance tax. In Cyprus the International Trusts Law 69/92 provides that the income and gains of an international trust derived from sources outside the Republic shall be exempted from all kinds of tax in Cyprus and no estate duty shall be chargeable in respect of assets belonging to an international trust. In fact the only charge payable to the Cypriot Inland Revenue in respect of an international trust is a one-off stamp duty payable when the trust is created.

*Double Taxation Treaties.* Cyprus has a rich network of double taxation treaties which are accessible by "residents" of the contracting states, the OECD definition of a resident being a person liable to tax in the contracting state. Under this definition, it is clear that while a Trust may not be considered a "person" or "body of persons" the trustees certainly are.

*Limitation of Benefits Articles.* Many Tax Treaties contain clauses which effectively limit the benefits accruing to entities which are taxed at a rate which is substantially lower than the

prevailing rate of the jurisdiction in question. For example, the provisions in the Double Taxation Agreement between Cyprus and the United Kingdom in relation to dividends, interest and royalties do not apply if the recipient is a company liable to tax at a rate which is substantially lower than the rate usually imposed. This limitation of benefits article clearly targeted the Cyprus IBC which, till recently enjoyed the preferential taxation of 4.25% instead of the 25% widely applicable for local companies. Therefore if a Cyprus IBC was in receipt of royalties from the United Kingdom, the reduced withholding tax would not kick in because of this article. Even with the recent changes to the tax status of IBCs, a large number of eligible IBCs have opted to fall under the "grandfather clause" which permits them to maintain preferential taxation till 31 December 2005.

Where, however, the recipient of royalties is a trustee in the form of a Cyprus Company, taxed at the prevailing rate of 10% (but notably, only on its trustee fees) the limitation of benefits articles are inapplicable and the reduced withholding tax rate kicks in.

*Avoiding dissipation of wealth.* Individuals concerned with avoiding the dissipation of their amassed fortune by spendthrift children or grandchildren often resort to the use of a Trust to which they transfer a controlling shareholding in a successful family-run company to trustees and restrict the circumstances in which the shares may be sold by the trustees. The wishes of the settlor are often indicated in a non-binding letter of wishes and a further security measure may be imposed on the trustees in the form of a protector whom the trustees must consult before taking any major decision, such as a significant change in the nature of the business, sale of the business etc.

Advantages accruing specifically in the context of Cyprus International Trusts also include:

- (a) An international trust is irrevocable unless special provision to the contrary is made in the instrument creating the trust;
- (b) the rules against perpetuities does not apply to international trusts which may last for a hundred years and in the case of charitable or purpose trusts may continue in force indefinitely;
- (c) accumulation of income is valid for any period for the entire duration of the trust and there is no limitation on the kind of investments in which the assets of an international trust may be put;
- (d) The 1992 International Trusts Law provides that purpose trusts are valid and are enforceable either by the settlor (or his/her personal representatives) or by the individual designated in the Trust instrument as having the right to enforce. This individual may also be a beneficiary under the Trust;
- (e) The 1992 Law further provides that if the terms of the Trust Instruments so permit, the proper law of the trust may be changed from or to the Law of Cyprus provided that (i) in the case of a change from the law of Cyprus to the law of another jurisdiction, the new proper law would recognise the validity of the trust and the respective interests of the beneficiaries; (ii) in the case of a change from the law of another jurisdiction to the law of Cyprus, this change is recognised by the proper law of the trust previously in effect;

- (f) variation of the provisions of the trust is possible by order of the Court;
- (g) there are no registering or reporting requirements of any nature. Nor the government, nor the Central Bank of Cyprus may disclose to anybody any information pertaining to the identity of the settlor, the beneficiaries, the trustees and their duties, or the accounts or assets of the trust. Only a court may order the disclosure of information or the presentation of documents pertaining to the above in civil or criminal proceedings, and to do so, disclosure must be deemed very important to the outcome of the case.

### **New Tax Law**

The present regime under which Cyprus International Trusts are set up and are operated (the International Trusts Law 69/92) remains unaffected by the new tax law. As was the position before the recent tax revision, Cyprus International Trusts will remain exempt from taxation in Cyprus and the beneficiaries will still be taxable via the trustees. The specific provision in the new Income Tax Law, now under section 31 provides that:

“Receivers, trustees, executors, administrators of estate, guardians, curators or committees having the direction, control or management of any property or concern on behalf of any person, shall be chargeable with tax in respect of income derived from such property or concern in like manner and to the like amount as such person would be chargeable if he had received such income and every such receiver, trustee, executor of a will or administrator of an estate, guardian, curator or committee shall be answerable for doing all matters and things required to be done under the law for the purpose of assessment and payment of tax.

Provided that nothing in this section shall affect the liability of any person represented by any such receiver, trustee, executor of a will or administrator of an estate, guardian, curator or committee to be himself charged to tax in his own name”.

This section effectively ensures that if the beneficiary is not resident in the Republic and the income of the Trust is not derived from sources within the Republic, then even if the trustee is resident in the Republic, the income of the trust will not be subject to Income tax in the Republic.

As noted above, for the time being there are no registering or reporting requirements of any nature for setting up a Cyprus International Trust. The eventual transposition of the EU Council Directive on Mutual Assistance (which provides for exchange of information between member states) may well bring a change to the current system since it is expected that some exchange of information procedures will have to be implemented.

### **Conclusion**

The trust, whether used to protect assets from claims, to determine inheritance shares, or for a combination of reasons, is an invaluable tool for flexible and effective estate and tax planning. After the introduction of the 1992 International Trusts Law, Cyprus can compare favourably with most tax locations worldwide, particularly in view of the competitive tax incentives for trust

formation in Cyprus which render the trust a very attractive tax vehicle for non-residents in Cyprus. Furthermore, in light of the continuance of the incentives for non residents wishing to settle their assets in Cyprus International Trust even post the recent tax reform in Cyprus, it is expected that the popularity of Cyprus as a trust jurisdiction will increase.

Provided that the correct professional advice is sought and obtained, trusts can maximize the tax benefit of prudent investors and organize their business matters in a way which best suits their particular circumstances and needs. Once the question of choice of the place of residence of the trust for the purposes of taxation and the governing law are settled in a satisfactory manner, taking into account the "relatedness" of the chosen domicile, then a Cyprus International Trust can prove a most efficient means of organising and protecting the business and assets of settlors worldwide.

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