Use of Trusts for Succession Planning: A Peruvian legal approach

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Once a person decides to plan his/her economic future, it commonly comes to his/her mind how to increase his/her wealth or how to find new kinds of investment. However, there is a matter that is quite important, and usually is not thought enough: How this person could keep the assets protected from risks, or how this patrimony can be transmitted to his/her heirs without problems.

In Peru, it is usual that people use wills or advanced inheritances[1] for succession purposes. Nevertheless, a trust is not normally used as a tool that allows individuals to plan their future or their families'. In this essay, we will analyse how useful a trust can be for these purposes and what legal implications shall be considered. In addition, we are going to propose some ideas to enhance the Peruvian legal system regarding this matter.

A. The trust and its use in succession planning

1. The trust

A trust is a legal relationship, generated by a contract, in which a person (individual or legal entity), named the trustor, transfers goods or property for the constitution of a trust asset. This patrimony is subject to the administration, or trust possession, of a person named trustee, and has a specific purpose, indicated in the contract, in favour of the trustor or a third party referred to as trust beneficiary[2].

It should be noted, that the trust asset is different from the assets of the trustee, trustor's or the trust beneficiary's, and, this is also applicable for the recipient of any remaining assets.

This description is included in Article 241 of the General Law of the Financial and Insurance Systems and Organic Law of the Superintendence of Banking and Insurance, Law N° 26702 (hereinafter the "General Law")[3]. It is important to indicate that the trustor should be an authorized company[4] by the Superintendence of Banking and Insurance, according to the applicable law.

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1 According to the Peruvian Civil Code, these advanced inheritances includes donations and liberalities.

2 It is importante notice that the beneficiary can be the trustor or a different person. However, the beneficiary cannot be the trustee.

3 The article 241 establish the following (Spanish version):
"*A trust is a legal relationship by means of which the trustor transfers property into trust to another person, called the trustee, for the constitution of a trust asset, subject to the possession in trust of the latter, and having the purpose of complying with a specific objective in favour of the trustor or third party referred to as trust beneficiary.*
The trust asset is different from the assets of the trustee or trustor or trust beneficiary, and, as applicable of the recipient of any remaining assets.
The assets that make up the autonomous trust property do not generate charges on the effective equity corresponding to the trust assets, except in cases where, through a jurisdictional resolution, a liability is assigned due to bad management, and for the amount of the corresponding damages.
The liquid part of the funds which make up the trust is not subject to the requirements of legal reserves.
The Superintendence provides for general regulations as to different types of trust transactions."

4 Article 242 of the General Law.

Furthermore, as the trust asset is separated from the trustor, to block the trust from third parties, it is required that the transfer of registered goods and rights to the trustee (such as real estate) is entered in the corresponding registry office. In the case of other goods and rights, they would be completed with tradition, endorsement or other requirement provided for by the law[5].

Finally, a requirement that could be perceived as obvious but is demanded by the General Law is that for the constitution instrument of trust to be valid, the trustor must have the power to dispose of the property and rights transferred without prejudice to the requirements set forth by the law for such legal act[6].

As we can note, the main benefits of the trust are the following:

(i) The constitution of an autonomous patrimony: the trust asset, protected from risks, liabilities or debts that should be assumed by the trustor.
(ii) The possibility to name an asset's possessor.
(iii) To indicate a beneficiary of the trust.

Therefore, it could be considered that these benefits can be capitalised for succession planning without problems. However, in Peru some considerations must be taken, in order to meet legal requirements.

2. Use of the trust for succession planning

Having pointed out the benefits it is necessary to find out if trust can be used for succession purposes.

First, we must distinguish between a testamentary trust from a regular trust that had the purpose to protect the patrimony from risks but is not testamentary. In the first case, a testamentary trust is set up since the opening of the succession. In addition, the formality of the constitution instrument of the trust must fulfil the conditions required by the Civil Code for the constitution of wills[7].

In the second case, a regular trust created for the protection of the assets or patrimony (hereinafter, a management trust), is not set up with the succession's opening and does not have the death as the origin. On the contrary, these trusts are constituted when the trustor is still alive, and the trust asset is created with current goods.

Thus, management trusts are constituted as any kind of trust, but shall have the purpose to protect the trustor patrimony from risks and keep it save to transfer it to his/her heirs once the trustor dies. As Molina Sandoval stated, a management trust is not an advanced succession, but is a way to organize the current patrimony and to obtain an asset to transmit to the future generations[8].

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5 Article 246 of the General Law.
6 Article 243 of the General Law.
7 CORZO DE LA COLINA, Rafael. "El fideicomiso. Alcances, alternativas y perspectivas". In: Themis – Revista de Derecho. Number 35. Lima. page 50.
8 Molina Sandoval, Carlos A. "El fideicomiso en la planificación sucesoria". En: La Ley. Number 70. Year 78. page 2.

As we can see, the succession planification through trusts could be performed using two different options:

(i) A testamentary trust, which implies a will and has its origin in the death of the trustor. In addition, if this trust does not include heirs apparent as beneficiaries, cannot affect his/her rights to the testator's patrimony. In Peru, heirs apparent have a forced heirship equivalent to two-thirds of the patrimony.

(ii) A management trust, when it is indicated in contract that the purpose is to invest the trust asset and to obtain more profits to make it more valuable. In this way, the trust will be constituted with current patrimony and does not have to fulfil will requirements, different to the previous case.

Once the trust ends[9], the increased assets could return to the trustor and be ready to be transmitted to the individuals when they are considered heirs.

Second, even when there are two types of trusts that can be used for succession planning, other aspects should be taken into consideration if a person decides to use this tool.

(i) Property versus Trust Possession

Neither the General Law, nor other Peruvian laws, have established if the property right of the trustor is suspended during the trust, or if the trust possession excludes the property right[10].

Given that, there is not legal certainty if the trustor needs to be included in the transfer of goods performed by the trustee, or in the constitution of rights over the goods that could affect them. As a solution, lawyers and other agents that are involved in this type of contracts, require the confirmation of the trustor in order to avoid problems to the purchasers[11].

This is an urgent aspect that need to be modified by the lawmakers if we wish trust legislation to be enhanced.

(ii) Heirs rights

According to the Peruvian Civil Code, heirs apparent have the right to inherit two thirds of the testator patrimony, even if there is a will that establishes the opposite.

Both, a management trust and a testamentary trust need to respect these heirs apparent' rights. For this reason, the article 244 of the General Law establishes that the heirs apparent of the trustor may demand the return of trust assets by the person responsible under gratuitous trust title, to the

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9 In Perú, according to the article 251 of the General Law, a trust has a maximum term of 30 years. However, there are some exceptions as the life trust, cultural trust or philanthropic trust.

10 VILLANUEVA GUTIÉRREZ, Walker. "El fideicomiso y sus implicancias tributarias". In: Ius Et Veritas. Number 47. 2013. Lima. page 265.

11 Ibidem.

extent in which their legitimate rights had been violated. In this case, the trustee has the power of choosing, among the trust assets, those that would have to be returned.

The General Law includes only gratuitous transfers, as donations. This means a trustor could sell all his patrimony, however, he or she is not allowed to donate it because it is forbidden by inheritance legislation in the Peruvian Civil Code. This is a way to avoid the usage of trusts to circumvent these rules.

Though the aim of the legislation is to protect heirs, we consider that these rules need to be more flexible to improve trust operations, especially if the trustor wishes to limit heirs' access to the patrimony after his death.

As we pointed before, the testamentary trust should fulfil inheritance rules. Nevertheless, what happens if a trustor desires to transmit the patrimony to the heirs apparent without involving them in the management, due to their lack of capability to do business? Clearly, that will be a limitation to the heirs' right, as they would not be able to transfer the patrimony or to invest it, because the patrimony is compromised in a trust.

In other words, if a trustor considers that the heirs are not capable of managing the inheritance, it is not possible for him or her to constitute a testamentary trust to transfer the assets to the heirs once the trustor dies but keeping them away from the management.

This is a limitation of one of the purposes of the trust. If we determine that one of the advantages of the trust is to generate a trust asset (autonomous from other patrimony or trust), and the purpose of the inheritance legislation is to protect the heirs, we consider that it is perfectly possible and efficient to allow the trustor to constitute a testamentary trust, considering the heirs as beneficiaries and keeping them away from the management. In this case, the trustee, as a possessor, will perform a better job than the heirs, due to its specialization.

In this scenario, the heirs will not be separated from the property of the trust asset, as they will inherit it, but will be benefited from the efficient management of the trustee and receive a bigger patrimony at the end of the trust.

The same issues can be found in the problem of the *property versus trust possession*, this aspect needs the attention of the lawmakers to promote the use of this type of trust in the succession planning.

B. Tax implications

1. Income Tax

According to the article 14-A of the Peruvian Income Tax Law[12] (hereinafter "ICT"), in a trust, the taxpayer can be the following:

(i) Banking trust: the taxpayer is the trustor.
(ii) Securitization trust: the taxpayer could be the trustor, the beneficiary or a third party if that is indicated in the contract.

The banking trusts are the ones that are under the rules of the General Law, meanwhile the securitization trust is the regulated by the Peruvian Securities Market Law[13]. Therefore, the testamentary trust and the management trust are considered as a banking trusts for income tax purposes.

Given that, the profits, incomes and capital gains obtained from the assets or rights transferred to the trust shall be considered as generated by the trustor. However, this regulation will only be applied to the trust management, as the ICT establishes that in a testamentary trust the taxpayer will be the beneficiary of the incomes.

Therefore, even when both trusts, testamentary and management trusts are considered as banking ones, in the first one, the taxpayer will be the beneficiary and, in the second one, the taxpayer will be the trustor. We consider this rule reasonable as testamentary trust is constituted after the death of the assets' owner.

Despite the indicated before, the ICT establishes that the trustee will be liable for the income tax generated by the trust, due to its faculties to manage it. Nevertheless, the liability cannot be higher than the sum of income tax generated by the trust.

As we can appreciate, the trust does not have the condition of taxpayer for income tax purposes. This type of taxation is named tax transparency, applying the rule of "flow - through of income" or "pass-through of income" and has the purpose to avoid the income transformation, situation produced when the kind of income changes when it is distributed from the entity to the owner[14].

Nonetheless, ICT has not applied completely the principle of transparency or full transparency. According to ICT, trust can "produce" incomes or capital gains due to transfers from the trustor to the trust if these assets will not return to trustor's patrimony.

The only kind of trust that is fully transparent is the guaranty trust, which does not have tax implications, considering the trustor as the taxpayer, and obtaining an income if the guaranty is executed. This partial application of the transparency principle could be an obstacle for people who desire to use trusts for succession planning.

Another exception to the fully transparency principle is how the ICT establishes that the trust income shall be taxed. A distinction must to be performed between

[12] Unique Ordered Text (TUO, by Spanish initials), approved by the Supreme Decree N° 179-2004-EF.
[13] Unique Ordered Text (TUO, by Spanish initials), approved by the Supreme Decree N° 093-2002-EF.
[14] VILLANUEVA GUTIÉRREZ, Walker. Op. Cit. pages 272-273.

the kind of income that is generated and the kind of taxpayer, if it is a Peruvian resident or a non-resident.

If the trust obtains business incomes, the income shall be recognised according to the accrual basis method (when the securities are sold or redeemed, or at the end of the fiscal year, what occurs first). If the trust is one that generates passive incomes, the income will be recognised according to the cash basis accounting method.

Moreover, if the taxpayer is a Peruvian resident, the income tax rate applicable will be 5% of the gross incomes (income passive trusts) or 29,5% (business incomes trusts). In non – resident's cases, the rate applicable will from 4.99% to 30%, depending of the type of income. It has been stated that this distinction is a lawmaker's meaningful effort[15].

To summarize, the ICT establishes the following rules to the trusts that can be used for succession planning:

(i) Testamentary trust: The taxpayer is the beneficiary, which will be the heir (heirs apparent or testamentary).
(ii) Management trust: The taxpayer is the trustor.
(iii) Both trusts are transparent for income tax purposes. However, it is possible to generate incomes with the transfer made from the trustor to the trust if there is not return of the asset. Besides, the income recognition will depend on the type of trust/income (business or non-business income), and the rate applicable will depend on the residence of the taxpayer and the kind of income distributed or generated.

2. Valued Add Tax (VAT)

The Law of VAT[16] does not consider the trust as a taxpayer. Therefore, the taxpayer for the trust's operations that are subject to VAT will be the trustor.

The only exception is the securitization trust, which will be a VAT taxpayer only if performs business activity. However, according to we stated, the trust that can be used for succession planning (testamentary and management) are not a securitization trust.

In addition, the Law of VAT establishes that the transfers in trust possession from the trustor to the trustee for the constitution of the trust asset, is not considered as a sale or service for VAT purposes. The same rule is applicable to the transfers made from the trustee to the trustor once the trust is finished. Likewise, the constitution of the trust by the trustee is not considered as a sale or service taxed with VAT.

Regarding this, we consider that VAT regulation is neutral, avoiding to create a new taxpayer. This aspect helps to people to use trusts as an investment tool,

[15] Idem. page 274.
[16] Unique Ordered Text (TUO, by Spanish initials), approved by the Supreme Decree N° 055-99-EF.

due to the constitution will not mean an additional element to the production chain, thanks to the absence of valued add.

3. Alcabala Tax

The Law of Municipal Taxation[17] (hereinafter the "LMT") establishes the following:

"*Alcabala Tax is generated immediately and considers taxed the property transfers of real estate, urban or rustic, under gratuitous or onerous title transfers*[18]*.*"

Therefore, transfers from the trustor to the trustee for the constitution of the trust asset are not subject to alcabala tax, due to property right is not transferred.

4. Real estate property tax (REPT)

According to LTM, the individuals or legal entities that own real estate are subject to REPT.

Given that LTM does not include trusts as taxpayers, this will be the trustor, owner of the good.

C. Other considerations

1. Costs

In the previous part of this essay, we have summarized the legal aspects that are involved in the constitution of a trust, even if it is a management or testamentary trust.

As trust is not only a theorical institution, it implies the execution of many actions focused in the trust operation.

One of the costs is established by the article 242 of the General Law. This article indicates the following:

"*The companies authorised to act as trustees are COFIDE*[19]*, the companies of multiple operations referred to in Paragraph A of Article 16*[20] *and the companies of trust services set forth in Paragraph b-5 of the above-mentioned article, the companies referred to in Item 1 of Article 318,*[21] *as well as companies and institutions supervised by the Superintendence, which aims to guarantee, support, promote and advise directly or indirectly the Micro and Small Enterprise (MYPE) of any economic sector.*
In case of fraud or gross negligence, the Superintendence may order the removal of the trust company or institution and appoint its replacement if the trustor does not do so within the fixed period.

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17 Unique Ordered Text (TUO, by Spanish initials), approved by the Supreme Decree N° 156-2004-EF.
18 Article 21 of the LMT.
19 COFIDE means "*Corporación Financiera Del Desarrollo*" and is a Peruvian bank.
20 Banks and other financial entities.
21 Insurance companies.

In order to perform the duties of trustee in the securitization trusts referred to in the Securities Market Act, companies and institutions of the financial system must incorporate securitization companies."

According to this article, not every company could be a trustee. Peruvian legislation requires that only authorised companies shall have this duty. We understand that this regulation obeys to the lawmakers' desire to supervise all the companies that possess or manage people's assets.

One of the bases or principles of financial regulation is that if a company controls, possess or manages peoples' assets, it must be supervised. This principle is applied by the General Law to banks and companies that act as trustees.

Though this requirement could be thought as unnecessary, we consider that given the levels of informal economic and the quantity of fraud proceedings, in Peru, a rule like this is still necessary.

However, the need of this control, even when it has a justification, implies a cost for people who desire to use trust of succession planning. This cost includes the money amount that the trustor should pay to the trustee company for management services and payments to be made for the labour performed by specialists as lawyers and accountants.

Consequently, the costs involved to create a trust or related to trust management are high, making a trust expensive. We suggest that these aspects should be taken into consideration once people decides to be a trustor.

The patrimony included in the trust asset needs to be big enough to absorb this cost. Otherwise, it will be inconvenient for the trustor to expense a bigger sum for the trustee fee o trust expenses, than the profit or benefit that he receives from the operation of the trust.

Moreover, it is important to point that, depending of the kind of trust investment, and the amount of assets involved, more specialists will be needed.

Finally, other aspect to be analysed is the evaluation that needs to be made by the trustor of the benefits that he or she (or his or her heirs) could obtain by themselves, without the trust. If the trustor is capable enough to obtain similar profits and keep the assets away from risks, a trust will not be necessary.

2. <u>Can trust asset being seized?</u>

If a person reads the article 253 of the General Law, it will be easy to determine that the trust asset cannot being seized.

This article indicates the following:

"*The trust assets are not liable for the obligations of the trustor, trustee or his/her assignees. In the case of the obligations of trust beneficiaries, such liability is only payable through the proceeds or payments they have at their disposal, as applicable.*

In the event that the trust company agrees with the measures affecting the trust assets, the trustor or any trust beneficiary may do so. Both are empowered to cooperate in the defence, should the trust company have filed an objection. The trust company may assign to the trust beneficiary or trustor any necessary powers for them to practice protective measures regarding the trust assets, without being released from liability."

As we can notice, once the trust is set up, and no circumstance of invalidity or nullity is present[22], the trust assets must not be seized. However, the Peruvian Tax Authority[23] (SUNAT, by Spanish initials) considers the opposite.

According to the information described in the Peruvian Tax Court Resolutions N° 00772-4-2015 and 02048-10-2015, the Tax Authority executed a seizure over trust assets. In these cases, the seizure order was posterior to the constitution of the trust asset.

The result of the proceeding was that the Tax Court refused the legal resource due to the trustee (who presented the resource) was not the owner of the assets. From a legal perspective, the ruling of the Tax Court was made in accordance to the rules applicable to that resource, which needs requestor's property right to be presented.

However, what is unacceptable is the behaviour of the Tax Authority, which did not apply the article 253 and nor its own opinion, contained in the Report N° 254-2005-SUNAT/2B0000[24]. In this Report, SUNAT stated that a trust asset cannot being seized if it is constituted before the seizure's beginning.

As we can note, SUNAT acted against the applicable rules and even against its own opinion. Clearly, this situation is an obstacle for the use of trust as tools to succession planning, especially when during 2017 the trust industry has increased 14%[25], and during 2016 4,5%[26], meaning that it is becoming an important tool to perform investments.

To answer the main question of this section, we consider that a trust asset cannot be subject to seizures. Nonetheless, it is always possible that a government authority considers the opposite.

D. Conclusions

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22 The article 265 of the General Law indicates the following circumstances of nullity:
1. If it contravenes the requirement set forth in Article 243.
2. If its purpose is illegal or impossible.
3. If the trust company itself is appointed as trust beneficiary, except in cases of securitization trusts.
4. If all the trust beneficiaries are persons who are legally prohibited from receiving benefits from the trust.
5. If all the goods that should conform it are out of the market.

If the prohibition referred to in item 4 only involves some of the trust beneficiaries, the trust is valid with respect to the others.

23 SUNAT (Superintendencia Nacional de Aduanas y de Administración Tributaria).

24 This report can be reviewed on the following link: http://www.sunat.gob.pe/legislacion/oficios/2005/oficios/i2542005.htm.

25 https://elcomercio.pe/economia/mercados/mercado-privado-fideicomisos-crecio-14-2017-noticia-507394.

26 https://larepublica.pe/economia/851625-mercado-privado-de-fideicomisos-crecio-45-en-2016.

1. In Peru, a trust can be used as a tool for succession planning. The General Law allows to create any kind of trust. However, the management and testamentary trusts are the most appropriate for the studied purpose.

2. It is important to distinguish between a management trust and a testamentary trust. The first is created for the protection of the patrimony during the life of the trustor. The second, is constituted once the succession is opening, thus, it requires the death of the assets' past owner, and should fulfil will requirements (do not affect heirs apparent rights).

3. Neither the General Law, nor any other law, regulate which is the real reach of the trust possession of the trustee. This loophole has created operative problems during the trust term, especially with some government entities as SUNAT (Tax Authority) and the Peruvian Tax Court.

   In addition, inheritance legislation needs to be improved in order to become more flexible to trust purposes.

4. The main tax implications of trusts are referred to income tax. The Income Tax Law establishes that the taxpayer is (i) the trustor in the trust management and (ii) the beneficiary in the testamentary trust. In addition, the trust is transparent, and the taxation of incomes will depend on the kind of income and the type of taxpayer.

5. Trust asset cannot be subject to seizures. Nonetheless, SUNAT (Peruvian Tax Authority) considers the opposite and creates a scenario where taxpayers and trust operators are unprotected.