



Euro Tax Flash from KPMG's EU Tax Centre



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CJEU decision in the Trustees of the Panayi Settlements case

Exit taxation – Capital gains – Free movement of persons – Freedom of establishment – Right of access by trusts to EU fundamental freedoms

On September 14, 2017, the Court of Justice of the European Union ('CJEU' or 'Court') rendered its decision in the *Trustees of the Panayi Settlements* case ([C-646/15](#)). The case concerns the compatibility with EU law of a UK tax imposed as a result of trustees of a UK trust becoming resident outside the UK. The key question was whether the trust could rely on the fundamental freedoms to challenge the exit tax.

The CJEU concluded that the trust could rely on the fundamental freedoms and that the contested tax infringes the freedom of establishment, but is justified by the need to preserve the allocation of powers of taxation between Member States. However, the Court decided that, by only allowing the immediate payment of the tax due without the possibility of deferral, the disputed measure goes beyond what is necessary to achieve that objective and is therefore not proportionate and constitutes an unjustified restriction on the freedom of establishment.

Background

The case concerns the imposition of a tax on capital gains as a result of the majority of the trustees of a UK trust becoming resident abroad – in this case, in Cyprus – whereby a disposal (followed by immediate re-acquisition at market value) is deemed to have taken place. The disputed measure does not allow for the deferral of the tax beyond January 31 of the year in which the deemed disposal occurs.

In addition to the substance of the case, a key question was whether the trust qualifies as a "company" or "firm" within the meaning of Article 54 of

the Treaty on the Functioning of the European Union (TFEU). While Article 49 TFEU safeguards the freedom of establishment of nationals of a Member State in the territory of another Member State, Article 54 TFEU extends its scope to companies or firms constituted under civil or commercial law, including any other legal persons governed by public or private law, with the exception of not-for-profit entities.

The CJEU decision

Observing that a trust does not constitute a company or firm under UK commercial or civil law, the Court addressed the question whether it fell within the meaning of 'other legal persons' in Article 54. In this respect the Court agreed with the Advocate General that that concept extends to an entity which, under national law, possesses rights and obligations that enable it to act in its own right within the legal order concerned, notwithstanding the absence of a particular legal form. It went on to note that the trustees have the right and the obligation to manage and dispose of the assets placed in trust, in accordance with the trust instrument and UK law. Furthermore, under local law, the trustees are regarded (i) as a single and continuing body of persons, i.e. separate from the persons who actually hold the position of trustees, that is (ii) capable of being resident in the UK, and (iii) is liable to pay the tax due under the disputed legislation rather than the trustees individually. The Court concluded that the activity of the trustees (in relation to the trust's assets) is inextricably linked to the trust itself, the two acting essentially as an "indivisible whole", which should be considered to be an entity that possesses rights and obligations acting within the national legal order, and therefore constitutes an 'other legal person' for the purposes of Article 54. Since the main purpose of a trust is to allow its beneficiaries to enjoy benefits generated from the assets put into trust, it is clear that the trusts concerned are profit-making, therefore satisfying the conditions for the application of the freedom of establishment.

As regards the existence of a restriction on the freedom of establishment, the Court noted that the transfer of the majority of the trustees of a trust (and hence of its place of management) to another Member State triggers the taxation of unrealized gains, which is not however the case when a similar transfer occurs in a domestic situation. The disputed legislation thus has the effect of discouraging the trustees from transferring the place of management to another Member State and the settlor from appointing non-resident trustees, therefore creating a restriction on the freedom of establishment.

However, as the Court has consistently held, a Member State is entitled to protect its taxing rights on unrealized capital gains that arise in its national territory. When a taxpayer transfers their residence abroad (causing that Member State to lose the right to tax those gains after the transfer), those rights are protected by taxing such gains upon exit. The Court rejected the argument that, since the beneficiaries remain resident in the UK and will be liable to tax on any payments received from the trust, the UK does not lose the right to tax. The Court noted that such a possibility to tax was not sufficient to preserve the UK's power of taxation since it would depend solely on the decisions of the trust or beneficiaries (i.e. whether to make payments to the beneficiaries or for the latter to remain resident in the UK).

On the issue of proportionality, the Court followed its settled case law and ruled that, by not allowing taxpayers the option to defer payment of the exit tax due upon the change in residence, the disputed legislation goes beyond what is necessary to achieve the objective of preserving the UK's taxing rights and therefore does not comply with the principle of proportionality and is contrary to the freedom of establishment.

EU Tax Centre comment

This is the first time the Court has ruled on the right of trusts to invoke the fundamental freedoms, but its decision is in line with an earlier decision of the EFTA Court (E-3/13 and 20/13) and to that extent is not surprising. The certainty its decision brings on this issue as well as the question when a Member State is to be regarded as losing its power of taxation, will be nonetheless welcome and likely to be of broader significance.

Should you have any queries, please do not hesitate to contact [KPMG's EU Tax Centre](#), or, as appropriate, your local KPMG tax advisor.



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