

Switzerland Issues Guidelines for Taxation of Trusts

by Peter R. Altenburger and Thierry V.A. Boitelle

Reprinted from *Tax Notes Int'l*, October 29, 2007, p. 441

Switzerland Issues Guidelines for Taxation of Trusts

by Peter R. Altenburger and Thierry V.A. Boitelle

After years of discussion, the Conference of Swiss Cantonal Tax Directors on October 24 published Circular Letter no. 30 regarding taxation of trusts. The circular letter on the one hand explains how Switzerland approaches the delicate matter of taxing trust arrangements and on the other hand aims to establish a uniform practice throughout the 26 Swiss cantons.

Underlying Civil Law Considerations

The circular letter starts with an analysis of the underlying legal aspects of a trust and a glossary of the relevant terms in the field of trusts. According to the circular, a trust incorporates a legal relationship that emerges when, based on a trust deed, a settlor confers certain assets onto one or several persons (the trustee(s)), requiring them to administer and use the assets to the best advantage of the beneficiaries.

The trust can either be an *inter vivos* or testamentary trust (*de mortis causa*).

Even though a trust bears a certain resemblance to a Swiss foundation (*stiftung*), it ought to be distinguished from a *stiftung* because the trust is not a legal entity. The trust, therefore, is necessarily a transparent entity. A trust is not a fiduciary relationship either, at least not under Swiss law.

The circular letter specifically notes that it is not applicable regarding *Anstalten*, foundations, and trusteeships (*treuhaenderschaften*), under the laws of Liechtenstein.

The circular letter briefly explains the most important terms pertaining to a trust arrangement,

such as settlor, beneficiary, trustee, protector, trust deed, and letter of wishes.

It also draws a basic distinction between revocable and irrevocable trusts; the latter are to be subdivided into discretionary and fixed interest trusts.

The circular further lists a number of questions that, if answered positively, lead to the conclusion that the trust is revocable if, for example, the settlor retains the right to appoint or replace a trustee or if the settlor has the right to appoint new beneficiaries.

Taxation of Foreign Trusts

The circular letter determines that if neither the settlor nor any of the beneficiaries are Swiss residents and if the trust assets do not include any Swiss real property, the trust arrangement is not subject to Swiss income taxes. The reasoning is that because foreign law does not give the trust legal personality, Swiss international private law and tax law cannot treat the trust as a foreign or Swiss legal person either. Further, for Swiss tax purposes the trust cannot be considered as a partnership or a similar body of persons or members. For this reason, the trust cannot fall under the rules of unlimited or limited Swiss tax liability designed for resident and foreign legal entities. The circular further provides that if a foreign trust has a Swiss resident trustee (or a Swiss resident protector), only the fees generated by the trustee (or protector) will be subject to Swiss income taxes. The underlying analysis relates to the Swiss (constitutional) principle of taxation

based on economic contribution capacity, and because the trustee (or protector) is not entitled to the trust's assets and the income derived therewith, he cannot be taxed thereon.

Cantonal Gift and Estate Tax Rules

Donations and estates are only subject to tax at a cantonal level, which still means Switzerland applies some 25 different cantonal tax regimes in this respect (out of the 26 Swiss cantons, only Schwyz does not levy gift and estate taxes).

The basic principle is that for a donation or an estate to be subject to tax in Switzerland, the donor, or respectively the decedent, is (or was until the time of death) a resident of Switzerland. Alternatively, Swiss gift or estate taxes can also become due in case of real property located in Switzerland and transferred by way of a gift or through inheritance.

Another important principle in the field of Swiss gift and estate taxes is that the transfer of property to a donor's or a decedent's spouse and to his or her direct descendants is generally exempt from gift and estate (or inheritance) tax in most of the cantons.

Taxation of Swiss-Related Trusts

Hague Convention

The Hague Convention, which entered into force in Switzerland as of July 1, 2007, does not contain any fiscal provisions. (For prior coverage, see *Tax Notes Int'l*, Sept. 3, 2007, p. 908, *Doc 2007-19785*, or *2007 WTD 168-4*.)

In fact, article 19 of the convention explicitly provides that "nothing in the Convention shall prejudice the powers of States in fiscal matters."

It is clear, however, that in a country like Switzerland, where trusts have been widely used for decades already and which has the desire to enhance the trust-related business, a fiscal framework for trusts is a necessity. The new circular letter is an interesting starting point.

General Considerations

The circular letter extensively addresses the situation in which either the settlor or any of the beneficiaries are Swiss residents.

A trust is a foreign law entity that according to Swiss tax law cannot be classified as a legal entity, that is, it is not a body corporate. This implies that trusts are basically treated as transparent entities, because under Swiss tax law the assets of the trust cannot be allocated to the trust or to its trustee. The question of whether a trust could be subject to Swiss taxation thus becomes obsolete.

According to the circular letter, the trustee (and the protector) may have the legal or formal ownership, but he is not the economic owner of the assets

as they are not at his disposition (but are merely kept for the beneficiaries). He is therefore not subject to income tax as far as the trust assets (or any income derived from these assets) are concerned. Only the fees generated by a resident trustee (or a resident protector) are subject to tax.

The trust assets and any income derived therewith are thus either taxable at the level of the settlor or at the level of the beneficiaries.

As far as the settlor is concerned, the tax analysis made by the circular depends on whether there is a revocable or an irrevocable trust arrangement. In a revocable trust arrangement, the settlor remains the sole owner of the trust assets because of the transparency principle described above, and he will be taxed accordingly.

The circular letter recognizes a Swiss resident settlor's right to establish an irrevocable fixed interest trust. Any other irrevocable trust arrangement established by a Swiss resident settlor (including a discretionary trust) will not be recognized for Swiss tax purposes.

Whatever the beneficiary receives from the trust is his income, unless it is a gift. Gifts are defined in accordance with civil law principles. Gifts are *inter vivos* grants that stem from somebody else's patrimony and that were effectuated with the intention to make a gift (*animus donandi*).

Examples

Revocable Trusts

Revocable trusts are transparent for Swiss tax purposes, that is, the settlor remains the sole owner of all of the trust's assets, and all income earned by the trust is allocated to him. This has the following tax implications at the level of the settlor:

- The establishment of the trust has no gift or estate tax consequences.
- Capital gains are generally tax exempt in accordance with general Swiss income tax rules.
- Distributions to the beneficiaries are taxed as donations. Donations from parents to their children (or vice versa) are generally not subject to gift tax in most of the 26 Swiss cantons. This means that a resident beneficiary of a revocable trust established by a direct line settlor can still be fully exempt from tax, regardless of whether the settlor is a Swiss or a foreign resident.
- Upon a settlor's death a revocable trust becomes an irrevocable trust.

Irrevocable Fixed Interest Trusts

The establishment of an irrevocable fixed interest trust is treated as a donation. The establishment will therefore be subject to cantonal gift and estate (or inheritance) laws.

The beneficiary is a usufructuary. This means that the trust assets and all income derived from these assets must be attributed to the beneficiaries.

The fraction of trust property that is attributable to the Swiss beneficiary is subject to cantonal net wealth tax. If that fraction cannot be determined, the distributions can be capitalized to arrive at the taxable net wealth.

Periodical distributions constitute taxable income in the hands of the Swiss beneficiaries. However, in accordance with the general income tax rules, capital gains and distributions of (originally contributed) trust property are not subject to tax.

Irrevocable Discretionary Trusts

The establishment of an irrevocable discretionary trust is also considered a donation. The establishment will therefore in principle be subject to cantonal gift and estate (or inheritance) tax. No Swiss tax is due on the establishment if the settlor is not a Swiss resident (and if it does not pertain to real property located in Switzerland).

There is, however, a special rule that applies regarding Swiss resident settlors; in that case, the trust assets remain attributable to the settlor. As the beneficiaries will only have contingent rights it is not possible to argue that a donation occurred. The resident settlor will therefore continue to be taxed as the owner of the trust assets, even though the trust in question is an irrevocable, discretionary arrangement. This is not a transparency rule but rather a nonrecognition rule.

As long as the trust assets are not attributable to particular beneficiaries, there is no net wealth tax payable by Swiss resident beneficiaries. This implies that the trust assets are considered to remain the net wealth of the settlor, and hence subject to tax at his level.

Distributions of periodical income are taxable income of the Swiss resident beneficiaries. Distributions of (originally contributed) trust property are, however, not subject to tax, provided that the settlor's original contribution was taxed as a donation.

In the case of an irrevocable discretionary trust, capital gains attributable to Swiss resident beneficiaries are exceptionally (and contrary to the general tax law principles) taxed as regular income.

The nonrecognition of irrevocable trust arrangements obviously cannot extend beyond the settlor's life, but the circular letter fails to answer the question of how to look at the nonrecognition rule once the settlor passes away.

Federal Withholding Taxes

Swiss Withholding Taxes

Dividends paid by Swiss resident payers and interest paid on certain debt instruments issued by Swiss resident obligors are subject to a 35 percent federal withholding tax.

A trust generally does not qualify as a legal entity that could be entitled to a refund of the federal withholding tax.

A revocable trust is attributable to the settlor, and hence a Swiss resident settlor would be entitled to a refund of, or a credit for, the federal withholding tax.

In case of an irrevocable fixed interest trust, a Swiss resident beneficiary is entitled to a refund of (or credit for) the federal withholding tax (article 61 (2A) Federal Withholding Tax Decree).

The prescribed nonrecognition of an irrevocable discretionary trust will not only apply for income tax, but also for withholding tax purposes. For an irrevocable discretionary trust, the rules set forth for a revocable trust will apply. A resident settlor will therefore be entitled to a refund of (or credit for) the federal withholding tax (even though he has irrevocably given up title to the trust assets).

Foreign Trusts Seeking a Refund

In case of a foreign trust seeking a refund of the federal withholding tax, the federal tax administration will first take an applicable treaty into consideration. There are, however, very few treaties dealing with trust situations, such as, for example, the treaties with the United States, the United Kingdom, and Canada (by virtue of an extensive interpretation). If no treaty is applicable, the Federal Tax Administration will apply a pragmatic case-by-case method.

Foreign Withholding Taxes

Foreign withholding taxes can only be refunded if the Swiss federal tax administration signs off on the applicable foreign tax form. The federal tax administration will only do so if the income in question is attributable to a Swiss resident beneficiary who is subject to Swiss taxes on that income.

Conclusion

As far as foreign trusts are concerned (that is, cases in which neither the settlor nor any of the beneficiaries are Swiss residents), nothing has changed. Those trust arrangements are not subject to Swiss income taxes. Only fees generated by Swiss resident trustees or protectors are subject to tax.

Swiss related trust arrangements (cases in which either the settlor or any of the beneficiaries is a Swiss resident) follow general income taxation and cantonal gift and estate law principles.

Why there is a nonrecognition rule for irrevocable discretionary trusts remains unclear. Particularly unclear is what happens with the nonrecognition principle if the settlor passes away. Considering that many trust arrangements are irrevocable discretionary trusts, the circular letter is a “nonstarter” for so many cases in which answers are most needed.

Whereas the fact that the circular letter finally provides a Swiss tax framework for trusts is widely saluted, tax scholars and trust law practitioners from Switzerland and beyond have voiced criticism and indicated that for specific cases the previously used case-by-case method will probably continue in most of the 26 Swiss cantons, despite the general

principles laid down in the circular and its clear aim to harmonize those cantonal practices.

Finally, as far as withholding taxes are concerned, the circular letter underlines once more the difficulties that settlors, trusts, and beneficiaries are encountering when trying to claim a reduction of withholding taxes in a cross-border situation. It is hoped that this point will be picked up by the Swiss (and foreign) double tax treaty negotiators. ♦

♦ *Peter R. Altenburger is a partner and Thierry V.A. Boitelle is a tax attorney with Altenburger in Geneva.*