5.1 Taxation of Trusts in Switzerland

Marnin Michaels, Baker McKenzie, Zurich
Heini Rüdisühli, Lenz & Staehelin, Zurich
J. Rodney Allen, Barclays Bank (Suisse) SA, Geneva

Introduction

A trust arrangement is based on the Rules of Equity traditionally found in common law jurisdictions and is not known in civil law. It is a relationship created by a person (typically known as the settlor) who transfers assets to a person who holds the assets (typically known as the trustee) who hold those assets for the benefit of others (typically the beneficiaries) while retaining legal title to the assets. Notwithstanding, the fact that a trust arrangement is a concept that originates in common law countries, trust administration in Switzerland has been commonplace for many years.

In fact, prior to July 1, 2007, Switzerland was the largest trust administration centre that did not recognise the existence of trusts. Since the concept was not known in Switzerland, many legal issues with trusts arose. Among those issues were: (1) conflict of laws; (2) whether or not the assets of a trust arrangement are subject to the bankruptcy estate of a bankrupt trustee; (3) taxation issues. While, historically, Switzerland had no provisions for dealing with trust in its statutory law, some Swiss courts did recognise the trust concept in various court decisions. The application was always difficult because the courts had to make significant efforts to find the method to apply rules that were not designed to work with trusts.

Various Swiss tax authorities tried to grapple with the issues raised by trusts, in relation to people who needed to use trusts for other reasons. Examples are those people who would move to Switzerland on a lump sum tax agreement, but had non-Swiss reasons for using a trust. Another example is Swiss families with members of the family living outside of Switzerland for which using a trust made sense. There was no uniformity of views in relation to such structures, and various Cantons had different practices. The attitude of the French speaking Cantons tended to produce more tax friendly results than the German speaking Cantons.

The ratification of The Hague Convention on Trust on July 1, 2007 did not introduce the trust as a legal structure in Switzerland. Rather, it recognised the existences and relationship formed in jurisdictions with a trust law. However, it became self evident that some uniformity of view, in respect to taxation, would be required. In August 2007, the Swiss Tax Conference issued circular No 30 on the taxation of trusts for cantonal/communal income tax purposes (“Circular”). Meanwhile, the Federal Tax Authorities have issued a circular essentially identical to the Circular with respect to federal income tax (together the “Circulars”). This article gives an overview of and comments on the content of the Circulars and of the effects that the Circulars may have on existing trusts and the trust administration industry in Switzerland¹.

I. Summary of the Circular

The main principles set out by the Circulars with respect to the tax treatment of trusts in Switzerland can be summarized as follows:

- The trust itself is never subject to tax (no permanent establishment or effective management analysis) due to a lack of legal personality. Furthermore, trust assets and income cannot be attributed to the trustee or the protector. Therefore, the trust assets can be managed by a Swiss resident trustee without triggering a tax liability on the trust assets and income.
- A revocable trust (in an extended sense, and as construed in the Circulars – see below) is always treated as transparent, whether it is a fixed-interest or discretionary trust. A particular feature of the practice of Swiss tax administrations, introduced by the Circulars, is that irrevocable trusts can also be treated as if they were revocable trusts if the settlor has any controlling influence over the trust assets.
- The trust assets of an irrevocable fixed-interest trust as well as the income thereof are attributed to the beneficiaries (in analogy to the usufruct).
- A Swiss resident settlor, taxed under the ordinary regime, is considered not to have disposed of his or her assets when forming an irrevocable discretionary trust. The assets as well as the income thereof will remain taxable in his or her hands.
- A foreign resident settlor forming an irrevocable discretionary trust (as is determined by the Circular - see below) is considered to have disposed of his or her assets. If he later moves to Switzerland, the trust assets will consequently not be attributed to him.

II. Swiss Withholding Tax

Since it is not a legal entity, a trust cannot claim a refund of Swiss withholding tax. However, the settlor of a revocable trust may claim such a refund since the trust assets remain taxable in his or her hands. By analogy, the beneficiary of a fixed-interest trust may claim a Swiss withholding tax refund if he or she was a Swiss resident when receiving the distribution.

With regards to discretionary trusts, the refund claim depends on the residency of the settlor when forming the trust. If he or she was a Swiss resident at that time, the trust assets will be attributed to him or her. In this case he or she may claim a refund. However, if the settlor was a foreign resident when forming the trust, no claim is possible as the trust assets are not attributed to him or her.

The Circular does not address underlying companies and such situation is to be dealt with on a case by case basis.

III. Effects of the Circular on Existing Trust Structures

Rulings obtained from the Cantonal or Federal Tax Administrations are binding. Current practice is that binding rulings are not altered or terminated by tax administrations, except...
for changes of the law. Such rulings are not decisions which are challengeable, but expressions of the tax administration’s view on a certain matter. Tax administrations may grant such rulings and the taxpayer, on the other hand, may rely on them, according to the general good faith principles in civil law.

The issuance of the Circular is not a change of law. In various situations, the Circular does not even change some cantonal practices with regards to the taxation of trusts. Therefore, many rulings obtained may still comply with the Circular.

Normally, the tax administrations adhere to rulings granted, even if it deviates from a new practice. They respect the jurisdiction of the Swiss Supreme Court, which held that the confidence of an individual shall be protected if (a) a ruling relates to an actual matter of a taxpayer, (b) the authority was competent to issue such ruling, (c) the taxpayer has made arrangements based on the ruling, and (d) the law has not changed.

Conclusions

The new Circulars clearly confirm that a trust cannot be subject to tax in Switzerland. Consequently, a trust can have one or more Swiss trustees without becoming subject to federal taxation in Switzerland. This clear rule will support further growth of the Swiss trust industry and will strengthen Switzerland’s position as a prime wealth manager and perhaps create wider use of trusts by Swiss residents as an estate planning tool.

However, several issues are still outstanding which could be addressed. Foremost, amongst them is the treatment of personal investment companies (“PICs”). PICs are often interposed between trusts and the economic assets for a variety of reasons, such as avoiding estate duties in the countries where the investments are located and the potential liability arising from them. Professional trustee companies routinely provide administrative services to joint trust/PIC structures and the uncertainty surrounding the Swiss tax consequences of these structures may continue to inhibit growth of the industry. Understandably, Switzerland has been reluctant to address this topic, as the consequences of any changes to the taxation of trustee companies with regards to PICs would spill over into and significantly disrupt the current system of Swiss corporate taxation.

While the Swiss Tax Conference Circular and the Federal Circular are generally good for trusts and the trust services industry, the rules therein are not binding for the cantons, except as they apply to collecting federal taxes. While it is expected that the cantons will follow the rules in collecting their own taxes, it would be helpful for each of them to confirm agreement with the principles set forth to provide the absolute certainty that high net worth individuals need in planning their affairs. Planners can obtain tax rulings to minimize the uncertainty, but ruling requests add to the cost of planning and are thus a hurdle to the use of Switzerland as a trust administration center.

Consistent with, but not directly addressed in the Circulars, is the VAT treatment of services provided in Switzerland related to the administration of trust structures. In a draft brochure, expected to be officially adopted in 2008, Swiss VAT authorities have recently clarified, and for the most part confirmed, existing favourable practice. One comment in the draft brochure, though, on the treatment of services provided to certain discretionary trusts, may dissuade individuals from using Swiss trustees. Where beneficiaries cannot be specifically identified and there is a Swiss trustee, there will be a Swiss VAT charge, even if the settlor, assets, and expected future beneficiaries are all outside of Switzerland.

Finally, with clear rules and the fact that the trusts themselves are not taxable, they may become more attractive to those with some connection to Switzerland. There are, however, anomalies that could make taxation worse in trust structures than would otherwise be the case if assets were held directly. The most serious of these arises where Swiss resident beneficiaries of a discretionary trust receive a distribution. Where they can show that the distribution is sourced from the original capital, they can avoid tax. Practically speaking, this may be difficult as trustees are often unwilling to divulge the details of the payment to protect other beneficiaries or the settlor himself. Even where they can obtain sufficient information to meet their burden of proof, capital gains would still be taxable, whereas they would not be under normal Swiss principles. Furthermore, if there was a Swiss anticipatory tax withheld, there is no mechanism to reclaim it.

Taken in total, these new rules are welcome developments for professional trustees based or looking to be based in Switzerland. They also provide non-tax opportunities for families with Swiss connections to benefit from the estate planning opportunities of the common law trust. For the most part, the rules are clear and fair. They help Switzerland maintain its role as a leader in the financial services industry. The few issues that remain can mostly be addressed through proper planning by individuals, although their resolution through official guidance would be helpful.

About the authors:
Michael Marnins is Associate at Baker McKenzie in Zurich. He is also a member of the Tax Chapter Board of the Swiss-American Chamber of Commerce (SACC).

Heini Rüdisühli is Attorney at Law and Certified Tax Expert at Lenz & Staehelin in Zurich. He is also Chairman of the Tax Chapter Board of the Swiss-American Chamber of Commerce (SACC).

J. Rodney Allen is Global Head of Wealth Structuring at Barclays Bank (Suisse) SA in Geneva. He is also a member of the Tax Chapter Board of the Swiss-American Chamber of Commerce (SACC).

1) The Circulars have been issued by the Swiss Tax Conference and by the Federal Tax Administration. The Swiss Tax Conference is an association of cantonal tax officers addressing special tax issues. The conference seeks to harmonize inconsistent tax practices amongst the cantons in order to enhance legal certainty. However, it has no legislative power. The Circular is, therefore, meant to be a guideline for the Cantonal Tax Authorities. It is up to each of them to decide upon practical consequences of the Circular. Unlike the Swiss Tax Conference Circular, the federal circular is binding upon the Cantonal Tax Administration when assessing federal income tax.