
Taxation of Trusts in Switzerland

Circular No 30 issued by the Swiss Tax Conference on
August 22, 2007

Introduction

With the entry into force of The Hague Convention of July 1, 1985 on the Law applicable to Trusts and their Recognition, the Swiss Tax Conference considered it necessary to issue a circular indicating a number of principles regarding the tax treatment of trusts in Switzerland.

Already in 2004, a special task force of the Swiss Tax Conference (the gathering of each cantonal tax administration and of the federal tax administration) was appointed to prepare a circular. According to its own terms the task force faced difficulties in particular with the tax treatment of the formation of trusts by Swiss resident settlors as well as with the qualification of attributions made to Swiss resident beneficiaries. For quite some time it was not clear whether any circular would become effective at all.

Finally, by the end of August 2007, the Swiss Tax Conference issued a circular No 30 on the taxation of trusts (“**Circular**”). Only recently this Circular had been published on the website of the Swiss Tax Conference and can be accessed under www.steuerkonferenz.ch.

The purpose of this memorandum is to give an overview of the content of the Circular and of the effects that the Circular may have on existing trusts.

I. Summary

The main principles set out by the Circular 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 Circular – 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 Circular 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. Basic Taxation Principles

1. Revocable vs. Irrevocable Trust

The Circular distinguishes between revocable and irrevocable trusts. However, the terms of the trust deed are not conclusive in this regard. The Circular states that for Swiss tax purposes one must analyse whether the settlor has definitely “disposed” of his or her assets by forming a trust or whether he or she has reserved a right to either legally or economically keep or re-take control of the trust assets.

According to the Circular, a trust is very likely to be transparent for Swiss tax purposes if the settlor has appointed himself as trustee or beneficiary. In such case the settlor may influence the trust assets and has, therefore, not disposed of the assets. Furthermore, a trust would typically be considered revocable for tax purposes if the settlor may do any one or more of:

- appoint or dismiss a trustee;
- appoint or dismiss beneficiaries
- change the protector who in turn has similar powers to the trustee
- amend or cause the trust deed to be amended
- require the termination of the trust
- veto decisions of the trustee with regard to the trust assets

It is, therefore, important to note that an irrevocable trust may be treated as non-existent for Swiss tax purposes if one or more of the above features applies.

2. Fixed Interest vs. Discretionary Trust

The Circular further distinguishes fixed interest trusts from discretionary trusts.

With a fixed interest trust, it is accepted that the settlor disposed of his or her assets upon formation. Unlike a discretionary trust, the beneficiary has an enforceable claim and can therefore be treated like a usufructuary.

As regards discretionary trusts, the Circular accepts that the beneficiary has no legal claim but a mere expectancy to receive a distribution in the future. Ordinarily, the trust assets can, therefore, not be attributed to the beneficiary at all. Exceptions might be where there is a pattern of regular distributions or contrary indications in the trust documents.

3. Tax Treatment of Trust, Trustee or Protector

The trust is typically not a legal entity according to its governing law. Rather, a trust is a legal relationship created by the settlor when assets have been placed under the control of a trustee for the benefit of a beneficiary or for a specified purpose¹. The trust assets constitute a separate fund and are not part of the trustee’s own estate, although title to the trust assets stands in the name of the trustee. Whilst the trustee has legal ownership, the beneficiary is the beneficial owner of the trust assets. The trustee has the power and the duty to manage, employ or dispose

¹ Cf. Art. 2 of the Hague Trust Convention.

of the assets in accordance with the terms of the trust and the special duties imposed upon him by law.

The Circular expressly mentions that a trust cannot be subject to tax in Switzerland since it is not a legal entity. There is no legal basis in Switzerland which would allow the treatment of a trust as a corporation or as any other taxpayer. Consequently, a trust can have one or more Swiss trustees without becoming subject to limited or unlimited taxation in Switzerland.

Based on the principle of taxation according to financial capacity, the trustee is not liable to income and net wealth taxes on the trust assets and the income thereof. According to this principle, assets as well as income cannot be attributed to a taxpayer if he cannot beneficially make use of them. From an economic point of view the trustee is, despite his or her legal interest, not entitled to the trust assets. He or she is only liable for the proper management of those assets. Consequently, the question of the place of effective management does not arise. Trust assets can, therefore, be managed in Switzerland without triggering a Swiss tax liability.

The same reasoning applies to protectors being Swiss resident individuals or companies. Like a trustee, the protector is not entitled to the trust assets. Consequently, the assets will not be attributed to the protector and taxed in his or her hands.

However, fees received in the capacity as trustee or protector are treated as a taxable income.

4. Taxation of Settlor and Beneficiaries

Applying the principle of transparency to trust assets, the Circular states that trust assets have to be attributed either to the settlor or to the beneficiary or beneficiaries. Furthermore, the settlor is considered under the Circular to dispose of his or her assets if and only if another taxpayer is enriched. Thus, according to the Circular:

The trust assets of a revocable trust as well as the income thereof remain taxable in the hands of the settlor due to his or her right of revocation. The assets and the income of a fixed interest trust are taxable in the hands of the beneficiaries since they have a determined entitlement. The attribution of assets and income of a discretionary trust - as defined by the Circular - is more difficult, as the settlor has disposed of the assets but the latter cannot yet be attributed to the beneficiaries. According to the Circular, the tax treatment depends on whether the settlor was a Swiss or foreign resident upon settlement of the trust. Due to the lack of enrichment of another taxpayer, a Swiss settlor cannot dispose of his or her assets. Consequently, the trust assets and the income thereof will remain taxable in the hands of the Swiss resident settlor. If, however, the settlor was a foreign resident when forming the discretionary trust, the assets and income cannot be attributed to anyone. In such situation, the Circular accepts the fact that a foreign resident settlor of such a trust has disposed of his or her assets.

The Circular further states that as long as trust assets and the income thereof are attributed to either the Swiss resident settlor or to a Swiss beneficiary, capital gains from the sale of trust assets are not subject to income tax according to Swiss law. However, it is the beneficiary that has to demonstrate the capital gain source of the distribution. As regards Swiss beneficiaries of

discretionary trusts, the Circular states that any distribution made is a taxable income, except when it can be evidenced that the payment is actually sourced from the original capital of the trust (such capital payment to take place only if and when all accumulated income and gains of the trust have been distributed).

III. 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.

IV. Application of the Circular

The Circular has been issued by the Swiss Tax Conference and not 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.

Our informal inquiries have left us with the understanding that the Zurich Cantonal Tax Authorities have decided that they will apply the Circular with immediate effect. Thus, the canton of Zurich's former practice no longer applies. It is still unclear what the cantons of Geneva and Vaud will do in this respect.

It is expected that the Federal Tax Administration will issue its own circular reflecting or adopting the guidelines of the Swiss Tax Conference Circular with regards to federal income tax. Unlike the Swiss Tax Conference Circular, the federal circular will be binding upon the Cantonal Tax Administration when assessing federal income tax.

V. 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.

VI. Conclusion

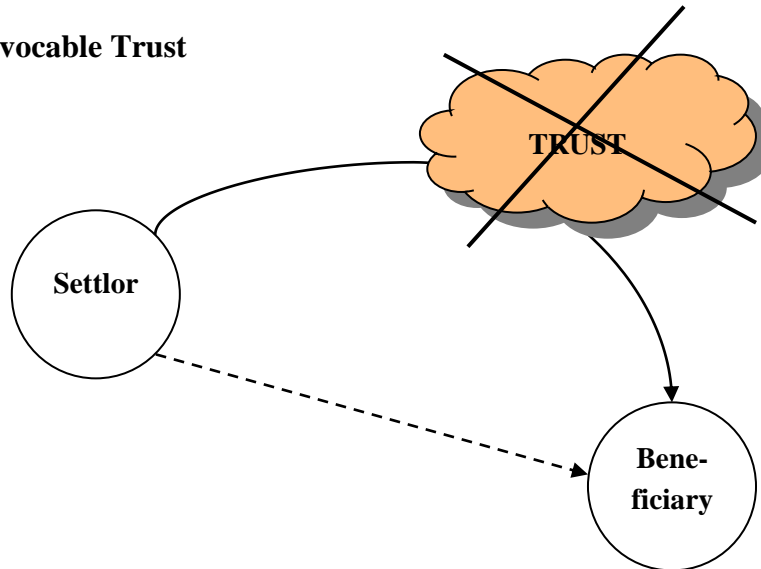
The application of the Circular to trusts may open up opportunities as it does not conclusively regulate the tax treatment but outlines certain basic principles. Within the principles there is still room to offer tailor-made trust structures meeting the needs of the settlor. At this early stage, it is, however, highly advisable, if not necessary, to obtain a tax ruling in advance.

As mentioned above, it is unlikely that the tax administrations will disregard rulings which have been obtained in the past for existing trust structures. There is however no certainty in this respect.

This being said, Swiss resident ordinary or forfeit taxpayers who are the settlor and/or beneficiary of a trust or have substantial influence on the trust assets would be advised to review their circumstances and any existing ruling in light of the Circular.

VII. Illustrative Examples

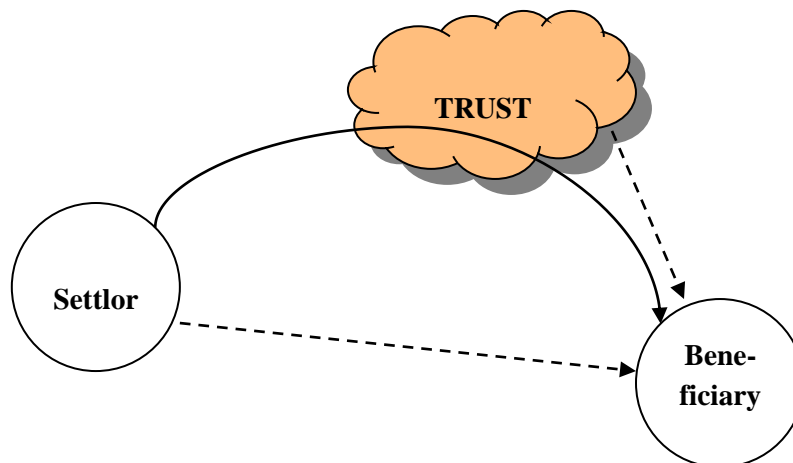
1. Revocable Trust



-----> fiscal attribution
 —————> flow of assets

Formation: Trust Assets and income still attributed to Settlor
Distribution: taxable gift from Settlor to Beneficiary
Liquidation: no taxation if assets flow back to Settlor; gift tax if to beneficiary

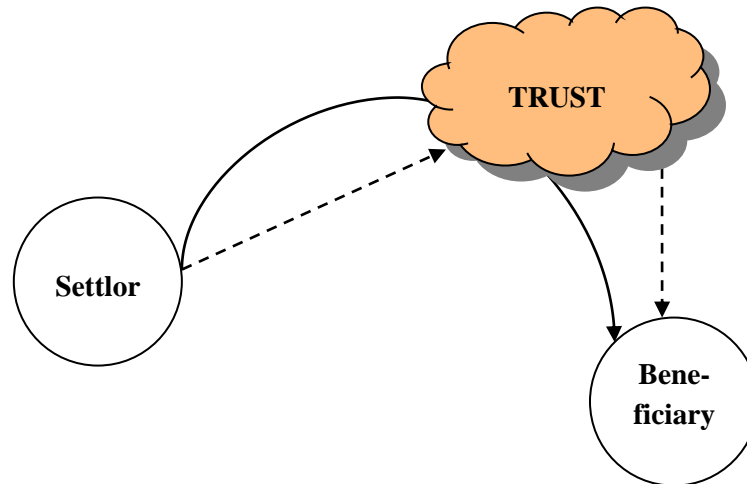
2. Irrevocable Fixed Interest Trust



-----> fiscal attribution
 —————> flow of assets

Formation: taxable gift from Settlor to Beneficiary
Distribution: taxable income in hands of Beneficiary (unless capital gains)
 Trust Assets attributable to Beneficiaries subject to asset tax
 cf. distributions
Liquidation:

3. Irrevocable Discretionary Trust



-----> fiscal attribution
-----> flow of assets

Formation: gift from Settlor to Trust (only if Settlor resident abroad)
Distribution: taxable income in hands of Beneficiary (incl. capital gains)
no attribution of Trust assets to Beneficiaries
Liquidation: cf. distributions