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Switzerland: Trust in the law

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Ever since the Hague Convention on the Law Applicable to Trusts entered into force in Switzerland on 1 July last year, the Swiss courts and authorities have been required to recognise trusts, which have their origins in common law but are unknown to Swiss law. It is also now mandated by law that trust assets cannot be put at risk by a trustee's bankruptcy.

The tax treatment of trusts, however, is unaffected by the Hague Convention; article 19 expressly leaves powers in fiscal matters in the hands of the individual contracting states. Existing laws must form the basis for tax issues pertaining to trusts. Consequently, the application of the Hague Convention is not directly reflected in the provisions of Swiss tax law. This raises the question of whether and how trusts (or trust assets) are to be classified as possible taxable entities, to what extent distributions from the trust assets are covered by what is known as the general income clause and are thus taxable, whether and to what extent capital gains are tax-exempt, and when and to who the respective taxes are due.

Another key issue is gift tax. Because of a lack of uniformity among the 26 Swiss cantons with respect to how the various types of trusts are taxed in practice, and given the steadily growing importance of the trust business in Switzerland and the new applicability of the Hague Convention, the Swiss Tax Conference (SSK), which includes representatives of all cantonal tax administrations and the Swiss federal tax administration), finally issued a circular (KS) regarding this in August 2007.

On the one hand, the KS clearly states that the trust is not a taxable entity. Thus, in cases where the trust assets can be attributed neither to the settlor nor to a beneficiary, the trust itself is henceforth subject to no tax. This clarification merits unqualified approval. It is likely to boost Switzerland's status as a good trust management location. In particular, irrevocable discretionary trusts will benefit from this change in, or clarification of, practices.

On the other hand, the trustee does not pay taxes on the trust assets or the income derived from them, even though he is, under civil law, the owner. He does not hold beneficial entitlement to the trust assets. If he is domiciled in Switzerland, then of course he must pay income tax on fees earned for his activities.

The circular first makes a distinction between the revocable and the irrevocable trust. Whether a trust is revocable or irrevocable depends not on the designation in the trust deed, but rather on the actual legal structure. Thus, what matters are the actual operative circumstances: if it appears, judging from the overall situation, that the trustee is for whatever reason simply the recipient of orders from the settlor (e.g. if he allows the settlor to interfere with the management of the trust and consistently complies with his wishes or instructions) then the settlor is still considered to be in power to dispose of the respective assets.

The KS contains a list of cases in which a trust should be qualified as 'revocable' since the settlor retains beneficial entitlement to the assets: this is certainly the case if he is one of the beneficiaries. But a trust must also be considered revocable if the settlor has the right to recall the trustee and appoint a new one, designate new beneficiaries, alter the trust deed, or, of course, revoke the trust. The same is true if the settlor has the right to veto the trustee's decisions.

But where are the parting lines? Is it, for instance, acceptable for the settlor to be involved, not on the level of the trustee, but instead as manager, director, or board member for an 'underlying company'? This question cannot be answered in the abstract; it depends on who exercises actual economic control.

In the case of a revocable trust, the economic perspective means that the trust assets and the income derived from them are attributed to the settlor even after the trust is established. In other words, the trust is treated as being entirely transparent.

This means that from the fiscal point of view, the establishment of a trust is not considered a disposition of assets. If the settlor is a Swiss resident, he remains liable for tax on the trust assets and on income derived from them. Capital gains effectuated on the trust assets generally remain tax-exempt.

In the case of distributions from the trust, the tax treatment depends on who is the beneficiary: distributions to the settlor himself are obviously not taxable, since from the fiscal standpoint they are, owing to their transparent treatment, not considered a disposition of assets. There is no such thing as a gift to oneself. Distributions to third parties, however, are considered gifts by the settlor to the beneficiary. If the settlor is, at the time of the distribution, a Swiss resident, or if property situated in Switzerland is among the distributed (or bequeathed) assets, then gift tax liability can be incurred. The rate depends on kinship, which is to say on the relationship between settlor and beneficiary: if the beneficiaries are direct offspring of the settlor, many cantons levy no gift tax. But the gift tax can be assessed at 40% or more in the absence of such a relationship.

Trusts are often set up by persons who are initially residents of other countries but might be planning to move their legal residence to Switzerland. As noted, bequests made to a beneficiary by a revocable trust after the settlor has moved his legal residence to Switzerland may be subject to gift tax, and possibly at a high rate. In such a situation it is advisable to structure the trust as irrevocable.

The previous remarks concerning distributions also apply to liquidation of the trust: the assets received by the beneficiary are subject to gift tax.

For tax purposes, the circular also distinguishes between the fixed interest trust and the discretionary trust. Whether a trust is fixed interest or discretionary depends, from the fiscal standpoint, on the contents of the trust deed but also on the actual operative circumstances.

According to KS no. 30, the establishment of a fixed-interest trust constitutes a gift by the settlor to the beneficiaries. Thus, gift tax is owed if its prerequisites are met. Understood correctly, the assessed rate depends on the kinship between the settlor and the beneficiaries. Unlike with the revocable trust, therefore, the gift tax is levied with respect to the time of establishment of the trust, not the time of distribution. This means that there is no further detriment to a settlor moving to Switzerland after the trust is established; i.e. no additional gift tax is levied in Switzerland. As noted previously, these differences should be considered during the planning stage.

With regard to the beneficiaries' entitlements to certain payments from the trust as specified in the trust deed, the treatment afforded to beneficiaries in the KS is similar to that of usufructuaries, in keeping with previous practices in most of the cantons. Usufructuaries must pay taxes on the trust assets, corresponding to their entitlement thereto, if they are subject to taxation in Switzerland or if

the trust assets include real property situated in Switzerland. If beneficiaries are treated similarly to usufructuaries, the distributions they receive are generally subject to income tax.

As a change of practice for some cantons, however, the KS gives the beneficiary the opportunity to show that the respective income derived from the trust assets constitutes capital gains, which are generally tax-exempt under Swiss law.

To that end, the trustee must provide exact information on the composition of the trust income, even in the case of temporarily reinvested income. How the trustee satisfies this obligation is up to him. Thus, the trustee must organise his reporting accordingly.

There are no fiscal consequences associated with liquidation of the fixed interest trust, at least as far as the contributed trust assets are concerned. After all, the actual bequest of the trust assets took place upon establishment of the trust. If the liquidation proceeds exceed the amount of contributed assets N i.e., if income was reinvested N then tax on them is owed by the beneficiaries who receive the liquidation proceeds, unless they can show that said amounts are tax-exempt (reinvested) capital gains.

In the case of a discretionary trust, the trust assets or proceeds from them cannot be attributed to the beneficiary until he has actually received them. This principle is also acknowledged by the new KS No. 30. At the same time, however, the trust assets can no longer be attributed to the settlor either; i.e., he no longer owes taxes on them, since he has definitively relinquished them. As the KS expressly states, the trust itself is also not a taxable entity.

Based on these premises, the KS treats the establishment of the discretionary trust as a gift by the settlor. However, it does not address the question of who is to be considered the recipient of the gift. This is a very important issue, since it governs the applicable gift tax rate.

The view taken here is that bestowing the assets to the trust cannot constitute a gift to the trust itself if it is assumed at the same time N and rightly so N that the trust is not an independent taxable entity. For the purposes of determining the gift tax rate, it would surely be more appropriate to essentially look through the trust and focus on the relationship between the settlor and the beneficiary.

Because the trust is not an independent taxable entity, and taxes on the respective trust assets and income cannot be assessed against the settlor or the beneficiary, the assets and income are not taxed at any time prior to distribution to the beneficiary.

To compensate in part for the suspended taxation of the assets, therefore, virtually all distributions to a beneficiary (if he is subject to taxation in Switzerland) are to be subject to income tax, and no opportunity is to be provided to show that such distributions are merely capital gains. This latter provision is sharply criticised in practice.

The liquidation of the discretionary trust follows the same principles as the tax treatment of distributions: anything beyond the contributed trust capital is subject to payment of income tax by the beneficiary once he receives it. Given the income tax consequences that apply in the case of liquidation, a beneficiary would be well-advised to consider which canton, or even which country, he wants to have as his legal residence at the moment when he receives the respective assets and reinvested earnings.

The SSK contends that a further restriction should apply to what is referred to as an internal trust (Binnentrust). This is a form of discretionary trust in which the settlor has legal residence in Switzerland when the trust is established: the KS denies such trusts recognition as irrevocable trusts and equates them with revocable trusts for the purposes of tax treatment. This means that the trust is considered nonexistent, and the settlor thus remains liable for tax on the trust assets and the income

derived from them.

It is unclear, however, why domestic and foreign settlors should be treated differently. For example, from the Swiss perspective it makes, in particular, no difference whether the settlor sets up a fixed-interest trust with beneficiaries residing abroad or whether he establishes a discretionary trust: in either case, the assets are no longer subject to taxation in Switzerland, at least temporarily. Furthermore, this restriction can be easily circumvented with a temporary change of residence.

The preceding remarks provide only an initial overview of the tax treatment of the various types of trusts, as indicated in the new KS No. 30, and of possible problems in practical application.

However, it is clear that, at least for a large number of cases, the KS makes it possible to predict more or less what the tax situation might be. Thus, the KS can serve as orientation for estate and tax planning. It is not yet possible to say whether it can, and will, be followed in all regards.

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