
Taxation of Trusts in Switzerland

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(informal translation)

1. Introduction

With the increasing internationalization, the desire for a uniform tax treatment of trusts has been increasingly expressed on the part of taxpayers and authorities. The current different taxation practices in the cantons lead to problems that are detrimental to transparency and legal certainty.

The purpose of this circular is to bring the current inconsistent taxation practice into line with one another. Due to the manifold manifestations of trusts, the following explanations are limited to the essential features necessary for the tax assessment. In a first step, the basic legal nature of a trust as well as the terms used in connection with a trust arrangement are explained. Based on this, the tax conclusions are drawn in a second step.

2. Trusts

2.1. Basics of a Trust

The term refers to a legal relationship that arises when the settlor transfers certain assets to one or more persons (trustees) based on a trust deed with the task of managing and using these assets for the benefit of the beneficiaries with effect vis-à-vis everyone.

The trust is a legal institution that has evolved over time, originating in England and therefore spreading mainly in the common law countries (Great Britain, USA, Australia, Canada, South Africa, New Zealand). Moreover, trust-like institutions can also be found in other countries such as Japan, Panama, Liechtenstein, Mexico, Colombia, Israel and Argentina.

In practice, the trust has proven to be an enormously flexible instrument and is frequently used in connection with estate planning and asset protection for individuals. Furthermore, in the Anglo-Saxon legal area, trusts are also a dominant phenomenon in the area of charitable institutions and employee benefit plans, as well as a frequently used instrument to implement employee benefit plans of listed companies. In view of the variety of possible manifestations of trusts, listing all types of trusts would be an impossible undertaking and would be of little use for tax assessment purposes. Instead, principles for the tax treatment of trust structures should be established irrespective of the type of trust to be assessed.

The trust can be established either by a legal transaction inter vivos or by a disposition upon death.

Even though it is related to a Swiss foundation in terms of its structure, the trust lacks its own legal personality. The trustee is the formal, albeit only fiduciary, bearer of the trust assets. On the other hand, the trust is also not a (mere) contract. Although the trust is originally established by the settlor, after its establishment it is essentially a legal relationship between the trustee and the beneficiaries, which is primarily governed by the trust instrument and secondarily by the specific trust rules of the applicable legal system. The settlor has relatively great freedom in structuring the trust.

However, as soon as the trust has been established, the settlor has, in principle, only limited possibilities to exert influence, similar to the case of a founder of a Swiss foundation. After the trust has been established, the trustee is primarily obliged to protect the interests of the

beneficiaries and not those of the settlor. Another typical characteristic of a trust is the complex legal relationship that exists with regard to the trust assets: Although the trustee is the owner of the trust assets under civil law (common law: legal interest), he has to administer the assets separately and, in the event of the trustee's death or bankruptcy, for example, they are not regarded as his own but continue to be subject to the right of segregation applicable to the trust in favor of the beneficiaries or the new trustee to be appointed.

2.2. Distinction to the foundation

The Swiss foundation serves, similar to the trust, the dedication of assets for a special purpose (Art. 80 ZGB). The foundation acquires legal personality upon its establishment. In contrast, the trust lacks its own legal personality. The trust has no legal capacity and thus no property capacity. In contrast to the trust, the foundation becomes the owner of the earmarked assets.

2.3. Distinction to the fiducia

The Swiss fiduciary relationship (fiducia) is based on a contractual relationship (mandate according to Art. 394 ff. OR). The trustee must consent to the mandate for the contractual relationship to come into existence. In contrast, the consent of the trustee is not required for the creation of the trust. Therefore, the settlor may appoint any person as trustee during his lifetime in the form of a unilateral legal transaction or a disposition upon death. Such an appointment is similar to the appointment of an executor under Swiss inheritance law, which grants him the position of an "independent trustee of his own character".

The trust is not a (mere) contract. Although the trust is originally established by the settlor, after its establishment it is essentially a legal relationship between the trustee and the beneficiaries. After the establishment of the trust, the trustee is primarily obliged to protect the interests of the beneficiaries and not those of the settlor.

2.4. Liechtenstein establishments, foundations and fiduciary settlements

Establishments, foundations and trusts under Liechtenstein law are very different from the legal institution of trusts due to the way they are structured and are therefore not discussed further in this circular.

2.5. The Hague Convention

The Hague Convention on the Law Applicable to Trusts and on their Recognition entered into force in Switzerland on July 1, 2007. It enables the civil law recognition of foreign trusts on the basis of internationally recognized standards and is thus intended to increase legal certainty in this area.

The tax treatment of trusts continues to be governed exclusively by Swiss tax law. Indeed, Art. 19 of the Hague Convention provides that the Convention does not affect the powers of the Contracting States in tax matters. Accordingly, the ratification of the Hague Convention has no effect on the tax treatment of trusts.

3. Terms

3.1. Settlor

The settlor is the person who establishes a trust through a legal transaction *inter vivos* or upon death. If the settlor establishes an irrevocable trust, he or she is definitively discharged of his or her rights and obligations with respect to the trust assets. Alternatively, the settlor can establish a revocable trust. In this case, he still retains access to the trust assets.

3.2. Beneficiary

The Beneficiary is the person benefited with the benefits from the Trust. The Settlor may appoint himself or any other natural person or legal entity in Switzerland or abroad as Beneficiary. The assets of the trust may be transferred to the Beneficiary during the Settlor's lifetime or after his death.

The beneficiary can sue in court for any claims to benefits from the trust assets as well as for the dutiful administration of the trust by the trustees. He has beneficial ownership of the trust assets (common law: equitable interest). Furthermore, he has a right of segregation in the event of the trustee's bankruptcy. The beneficiary therefore not only has an actionable claim with regard to the beneficiary, but also has certain control and supervisory powers, which also makes him a kind of organ. If the trust assets are lost by the trustee, the beneficiary can demand the return of the corresponding assets to the trust or trustee.

3.3. Trustee

Through the establishment of a trust, certain assets are transferred to one or more natural persons or legal entities (trustees), who must manage them and use them for a purpose specified by the settlor. The trustee has full power of disposal (civil law ownership) over the trust assets, whereby he is obliged to manage the trust assets for the benefit of the beneficiaries in accordance with the trust provisions. He manages and uses the trust assets within the framework of the trust provisions in his own name as an independent legal entity *vis-à-vis* everyone, but separately from his own assets.

Towards the Beneficiaries (and not towards the Settlor) as well as towards a possible Protector, the Trustee is obliged to grant access to the records regarding the administration and management.

3.4. Protector

The protector is a natural or legal person who may be appointed voluntarily by the settlor to monitor whether the trustee is fulfilling its obligations as defined by the settlor. The powers and functions of the protector may be greater or lesser, depending on the settlor's discretion. They result in detail from the trust provisions.

3.5. Trust Deed

ormally, the trust must be established by a written property deed to be signed by the settlor and trustee (however, the trustee's consent is not required for the trust to come into existence). In this trust deed, which is binding on the trustee, the provisions regarding the management and preservation of the value of the trust assets for the benefit of the appointed beneficiaries are set out.

3.6. Letter of Wishes

By means of a Letter of Wishes, if any, the settlor informs the trustee of his will and his dispositions. Unlike the trust deed, this declaration of intent is legally non-binding and thus merely represents an idea of how the settlor would like his trust to be administered. The Letter of Wishes is of practical importance especially for Irrevocable Discretionary Trusts.

3.7. Revocable / Irrevocable Trust

A distinction must be made between revocable and irrevocable trusts. The latter are further subdivided into so-called discretionary and fixed interest trusts.

The decisive factor for the tax treatment is whether the settlor has definitively "divested" himself of his assets on the basis of the trust instrument or has continued to reserve access to the trust assets by means of legal or economic arrangements.

Insofar as the settlor creates an irrevocable trust, he definitively divests himself of his assets and, in principle, is no longer entitled to any rights or obligations with respect to the trust assets. Alternatively, the settlor may establish a revocable trust. Thus, in general, there is no irrevocable divestiture if the settlor has appointed himself as trustee or beneficiary. Nor can this be assumed if the settlor has any other kind of influence on the trust. The following indications (exemplary list with reference to the Federal Supreme Court practice on family foundations) help to distinguish between revocable and irrevocable trusts:

If the settlor

- Benefited in the case of capital distributions from trust assets?
- Benefited in distributions of income from the trust assets?

Does the settlor have the right

- remove the trustee and appoint another?
- to make new beneficiaries or have them made beneficiaries?
- replace the protector, who in turn has powers similar to those of a trustee?
- amend the trust instrument or have it amended?
- revoke the trust?
- to demand the liquidation of the trust?
- of a veto on trustee decisions regarding trust assets?

An affirmative answer to any of the above questions supports tax treatment as a Revocable Trust.

3.7.1. Revocable

In the case of a revocable trust, the settlor reserves the right to revoke the trust at a later point in time and to return the remaining assets to the settlor or to a third party. The settlor has therefore not definitively expropriated his assets.

For the tax treatment, it is not the designation in the trust instrument (trust deed) that is decisive, but the economic meaning. Even a trust with the designation "irrevocable" falls into the category of revocable trusts in the case of a non-final "dispossession".

Revocable trusts become irrevocable trusts upon the death of the settlor, unless the right of revocation is vested in or passes to another person.

3.7.2. Irrevocable Fixed Interest Trust

In the case of fixed interest trusts, the details regarding the beneficiaries and their corresponding rights are set out directly in the trust deed. Thus, the trustee has no discretionary power in this type of trust to allocate the income and/or assets of the trust. The trustee has no economic benefit from the trust assets, nor does he have any independent freedom to dispose of them. Upon the establishment of the Irrevocable Fixed Interest Trust, the settlor definitely disposes of his assets.

In contrast to the discretionary trust, where the beneficiary's rights are merely of a maintenance nature, the beneficiary of a fixed interest trust has an actionable claim to assets. Consequently, the beneficiary of a fixed interest trust can be equated with the usufructuary.

3.7.3. Irrevocable Discretionary Trust

In the case of discretionary trusts, only abstracted classes of beneficiaries are normally designated in the trust deed. The decision as to who should ultimately benefit from the trust is left to the trustee.

In a letter of wishes, if any, the settlor explains to the trustee his reasons for setting up a trust and informs the trustee, in a legally non-binding manner, how he should exercise his powers.

If the settlor attaches particular importance to certain matters, the trust deed may provide that certain decisions of the trustee require the prior consent of a protector.

At the time of the establishment of a discretionary trust, no enrichment of the beneficiary takes place yet, since it is not yet certain which persons will actually benefit from a grant, to what extent and at what time. The rights of a beneficiary are therefore merely of an expectant nature.

4. Taxation of Trust, Trustee and Protector

4.1. Taxation of Trust

Foreign law does not grant legal personality to the trust. With reference to private international law (IPRG, incorporation theory), Swiss tax law cannot provide for this either.

A trust is also not a "foreign legal entity" within the meaning of Art. 49 para. 3 DBG and Art. 20 para. 2 StHG, since this legal provision only covers entities to which Swiss private law grants legal personality. However, Swiss private law does not confer legal personality on a trust.

According to the prevailing doctrine, a trust also does not fall within the scope of application of Articles 11 DBG and 20 para. 2 StHG. The autonomous tax qualification provided for in these provisions is intended to cover only entities whose members have a "personal relationship" with each other. These are, for example, communities of heirs or "partnerships" under Anglo-Saxon law. The common characteristic typical of these institutions does not exist in a trust.

Accordingly, there is no legal basis in current Swiss tax law which would allow to equate a foreign trust with a legal entity for tax purposes. Consequently, it must be assumed that the question of limited or unlimited tax liability of the trust (e.g. on the grounds that one or more trustees reside in Switzerland) does not even arise.

4.2. Taxation of Trustee and Protector

The assets donated to the trust and the income generated therefrom are generally not taxable for the trustee. This view is in line with the principle of taxation according to economic capacity. This principle requires that no element of income or property may be attributed to a taxpayer over which he has no power of disposition. From an economic point of view, the trustee is not entitled to the assets in spite of formal ownership.¹ Moreover, the risks of the trustee are only within the scope of liability for diligent management in analogy to the law of mandates.

In view of the above-mentioned reasoning, the question of the place of actual management, which is frequently cited in doctrine as a reason for denying the tax liability of the trustee, does not arise either.

These statements also apply to a natural person or legal entity with domicile or statutory seat or actual place of management in Switzerland acting as protector of a trust. A person acting solely as protector has no legal or beneficial interest in the assets of the trust, any more than the trustee. Consequently, its assets cannot be attributed to it.

The fees received by the trustee or the protector for their activities must be clearly accounted for and taxed. For this purpose, they must be disclosed and verifiable.

5. Taxation of Protector

The constellations of possible relationships in a trust are very diverse. It is therefore impossible to provide a tax assessment of all forms of relationships. In the following, only the principles for the individual treatment of settlor and beneficiary can be presented. It is assumed that these are cases of estate planning or so-called "asset protection" of a natural person (most frequent cases of application).

5.1. Basics of Taxation

The assets and income of the trust (capital, capital gains, current income) are attributed either to the beneficiaries or to the settlor for taxation purposes (principle of transparency). This

results from the fact that the corresponding assets cannot be attributed to either the trust or the trustee under the applicable Swiss tax law.²

Income is defined in Swiss tax law on the basis of the so-called income access theory, which states that income comprises the "access" of net assets (including rights of use) during a given period. Income is not considered to be received at the time of its creation, but only at the time of its realization. According to established doctrine and practice, income is generally considered to have accrued and been realized for tax purposes at the time when the taxpayer has received a benefit or has acquired a fixed claim to it, which he can actually dispose of, unless the fulfillment of the claim is particularly uncertain. In this case, the point in time of the actual fulfillment is to be taken into account. The prerequisite for the tax-triggering inflow is therefore a completed acquisition of rights, which can be the acquisition of claims or property. Mere expectancies and conditional legal claims, on the other hand, do not lead to income.

In principle, all inflows from the trust constitute taxable income for the beneficiary on the basis of the income general clause (Art. 16 para. 1 DBG, Art. 7 para. 1 StHG), unless there is a gift (Art. 24 lit. a DBG and Art. 7 para. 4 lit. c StHG).

The term "gift" does not follow the definitions of the cantonal, non-harmonized inheritance and gift tax laws. Rather, it is defined in distinction to the income (tax) concept according to DBG and StHG. It is based on civil law, according to which four conditions must be met for a gift: Donation inter vivos, enrichment from the assets of another person, gratuitousness and the will to donate.

In the assessment procedure, according to doctrine and case law, the generally accepted principle applies that the tax authority bears the burden of proof for tax-creating facts, while the taxpayer bears the burden of proof for facts that cancel or reduce the tax liability.

Furthermore, tax avoidance and abuse are reserved.

5.1.1. Taxation of the Settlor

5.1.1.1. Generally

The taxation of the settlor depends on whether he establishes a revocable or an irrevocable trust. In contrast to an irrevocable trust, the settlor of a revocable trust does not finally divest himself of the assets donated to the trust. See example in 5.2.

5.1.1.2. Settlor resident in Switzerland

When a trust is established, the settlor is in most cases resident abroad, but he may also be resident in Switzerland. If the settlor is resident in Switzerland, under Swiss tax law the settlor is only deprived of his assets if another taxable entity is enriched. This only applies in the case of the establishment of an irrevocable fixed interest trust (cf. para. 5.1.2). In all other cases, the assets and the income from the assets continue to be attributed to the settlor (cf. also Art. 335 CC and the general reservation of tax avoidance). This attribution is subject to taxation at cost

(Art. 14 DBG and Art. 6 StHG), since only assets and income from assets from domestic sources are included in the control calculation.

5.1.2. Taxation of Beneficiary

In the case of irrevocable fixed interest trusts, the group of beneficiaries and the scope and timing of the payments to the beneficiaries are fixed. Based on the existing and known legal entitlement, an allocation to the beneficiary can be made to the extent of the pro rata trust assets. In the case of the donation, it must be examined whether it is taxable income or a gift exempt from income tax (Art. 24 lit. a DBG; Art. 7 para. 4 lit. c StHG).

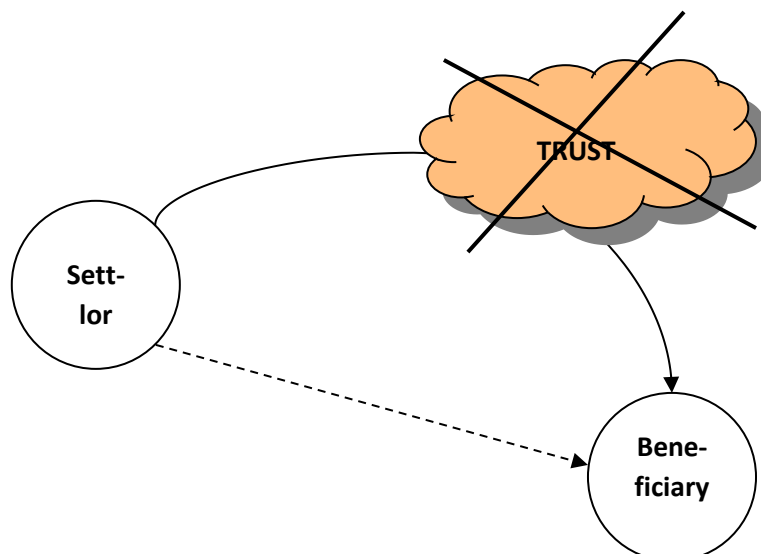
The rights of the beneficiaries of Irrevocable Discretionary Trusts are merely of an expectant nature. The time and extent of the possible allocations are not determined, as these are at the discretion of the trustee. Sometimes the beneficiaries do not even know that they are beneficiaries of a trust. For this reason, the donation can only be subject to taxation at the time of the effective payment, whereby it must be examined whether it is taxable income or a gift not subject to income tax (Art. 24 lit. a DBG; Art. 7 para. 4 lit. c StHG). In the rarest case, where the extent and timing of the gift have been legally determined or are also made on a regular basis, the same treatment as for the fixed interest trust may apply. See example in 5.2.

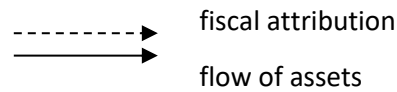
5.2. Example

Due to the great variety, the examples cannot cover all variants. They are limited to the tax assessment of the three basic variants (revocable trust, irrevocable fixed interest trust, irrevocable discretionary trust). The assessment is based on the tax principles described above. It is assumed that the settlor is alive at the time of the establishment of the trust (inter vivos trust) and that it is a case of estate planning or so-called asset protection of a natural person (most frequent cases of application).

5.2.2. Revocable Trust

There is a tax transparent treatment as there is no irrevocable divestment of the trust assets (attribution of trust assets and income to the settlor). This results in the following tax treatment:

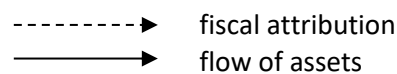
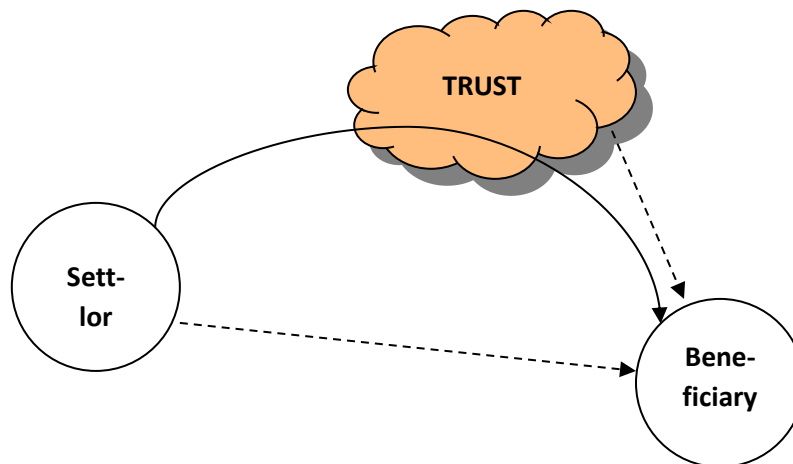




- Formation:** Trust Assets and income still attributed to Settlor
- Distribution:** taxable gift from Settlor to Beneficiary
- Liquidation:** no taxation if assets flow back to Settlor; gift tax if to beneficiary

5.2.2. Irrevocable Fixed Interest Trust

The beneficiary of the trust can be treated as the usufructuary (see ASA 55, 657 et seq.), which is why trust assets and income are attributed to the beneficiary for tax purposes. This results in the following tax treatment:

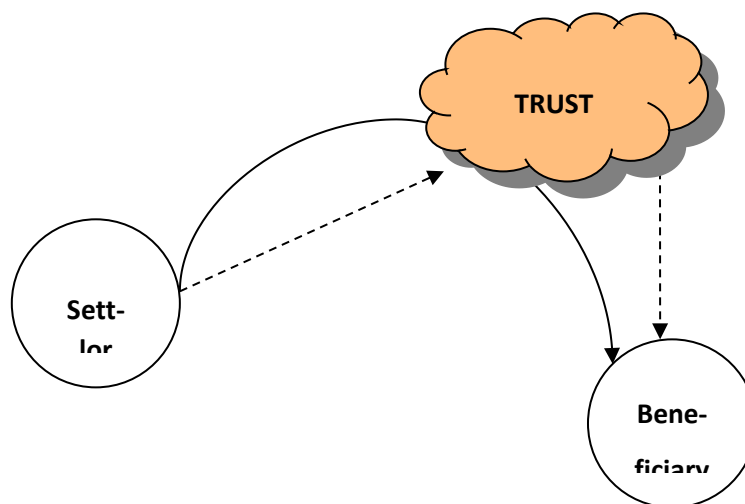


- Formation:** taxable gift from Settlor to Beneficiary
- Distribution:** taxable income in hands of Beneficiary (unless capital gains)
Trust Assets attributable to Beneficiaries subject to asset tax
cf. distributions
- Liquidation:**

5.2.3. Irrevocable Discretionary Trust

If the settlor is domiciled in Switzerland at the time of the establishment, the assets and the investment income continue to be attributed to the settlor (cf. 5.1.1.2.). Thus, the same tax consequences arise as in the case of a revocable trust (cf. para. 5.2.1).

If the settlor is domiciled abroad at the time of establishment, the trust assets cannot be attributed to either the settlor or the beneficiary (cf. para. 3.7 above on the question of whether an irrevocable discretionary trust exists at all). This results in the following principles of tax treatment



-----> 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

6. Information Rights and Cooperation Obligations

Settlors, trustees or beneficiaries who are liable to pay tax in Switzerland must, pursuant to Article 126 DBG or Article 42 StHG, provide all the necessary information and submit receipts, documents or certificates from third parties in order to prove the trust as well as the corresponding pecuniary benefits or expenses.

It should be added that the trustee may not invoke his professional secrecy when the circumstances are examined by an external tax audit. He must disclose the trust with all deeds. This

also applies to those cases in which the trustee is a lawyer, since the trust administration is not an actual lawyer's activity.

7. Indication to Withholding

7.1. Income from Trust Assets

The following is the practice of the Federal Tax Administration (FTA)

7.2. Refund of Withholding Tax

In the absence of legal personality, the trust cannot apply for the refund of withholding tax itself. Nor can the trust be qualified as a trading company entitled to a refund without legal personality.⁵ Art. 55 lit. c VStV cannot be applied to the trust, since the trust does not constitute an "estate".

In the international relationship, the explanations according to section 8 below ("Double taxation treaties") remain reserved.

7.2.1. Revocable Trust

Ein widerruflicher Trust ist steuerrechtlich dem Settlor zuzurechnen, der - eine allfällige Steuerumgehung vorbehalten - als Inhaber des Rechts zur Nutzung zu qualifizieren ist. Mithin hat der Settlor die Voraussetzungen zu erfüllen, die ihn zur Rückerstattung der auf den Erträgen des Trustvermögens erhobenen Verrechnungssteuern berechtigen

7.2.2. Irrevocable Fixed Interest Trust

If the trustee can prove the trust relationship by submitting the trust deed, the trust assets are not attributable to him for tax purposes. In this case, the Beneficiary is deemed to be the holder of the right of use. If the Beneficiary was domiciled in Switzerland at the time the taxable benefit became due (Art. 22 para. 1 ITA), he can reclaim the withholding tax in analogy to the rule for trust relationships (Art. 61 para. 2 ITA).

7.2.3. Irrevocable Discretionary Trust

In the case of a discretionary trust, the trust instrument does not grant the beneficiary any entitlement to distributions from the trust. It is rather at the discretion of the trustee when he wants to make which payments from the trust to the beneficiaries named in the deed. Between the time of the creation of the trust and the time of an effective distribution, the trust assets and the income accruing thereon cannot be attributed to the beneficiaries; they are mere expectancies. Nor can the trust assets be attributed to the settlor for tax purposes, since the settlor has finally disposed of the trust assets. As long as the trust assets cannot be attributed to any person for tax purposes, there is no possibility of refunding the withholding tax until the actual distribution. This is also in line with the direct tax treatment, according to which no tax access is possible in the case of discretionary trusts before the effective distribution.

If the settlor is domiciled in Switzerland at the time of the creation, there is no unjust enrichment of the settlor due to the lack of enrichment of another tax subject with the consequence that the assets and the income from the assets continue to be attributed to the settlor. Consequently, the same rules apply to the refund of the withholding tax as to a revocable trust and

the settlor has to fulfill the conditions entitling him to the refund of the withholding taxes levied on the income of the trust assets.

8. Indication to the Double Taxation Agreement (DTA)

8.1. General

The double taxation treaties concluded by Switzerland govern, among other things, the entitlement of persons resident abroad to a refund of withholding tax levied in Switzerland on dividends and interest and the entitlement of persons resident in Switzerland to a refund of withholding tax levied abroad.

Since the trust is not a "person" under Swiss law, the provisions of the double taxation treaties cannot be applied according to uniform rules. The specific cases have to be examined on the basis of the double taxation treaties applicable to them.

Certain double taxation treaties, such as the treaties with the USA, Canada and the UK (by interpretation), contain provisions on trusts. In particular, they provide that the trust is a "person" within the meaning of the treaty. However, this provision alone does not mean that there is an entitlement to a refund. Indeed, only persons who a) are tax residents of a Contracting State within the meaning of the treaty and b) are the actual beneficiaries of the corresponding income are eligible for the double taxation treaties.

8.2. Refund of Withholding Tax

If a trust under foreign law applies for a refund of Swiss withholding tax, the Swiss Federal Tax Administration first examines whether the trust is a tax resident of the other Contracting State (subjective tax liability), whether the trust itself or the trustees are tax subjects in the other Contracting State. In this case, the Swiss Federal Tax Administration considers the application of the treaty provisions for the reduction of double taxation (dividends, interest) to be correct and refunds part of the withholding tax; the fact that the trust does not have a legal personality under Swiss law (and not necessarily according to the meaning of the treaty) is less significant in this case than the fact that a tax subject is fully subject to ordinary tax liability for the income of the trust in the other contracting state.

The eligibility for refund has to be examined more closely if the trust income is subject to ordinary taxation in the other Contracting State, but a deduction or imputation mechanism may result in the trust actually being treated in a fully or partially transparent manner (and the income passed on to the beneficiaries is not taxed). In this case, it is possible that non-taxable persons (persons who are not resident in the state of the requesting trust) are the actual beneficiaries of the Swiss-source income. This is only one example among many, which shows the difficulties that arise in the application of the treaty provisions and why each individual case must be examined according to the applicable double taxation treaty. In any case, it is the responsibility of the foreign beneficiary or the person invoking a double taxation treaty to provide the Federal Tax Administration with the information necessary to process the application.

8.3. Refund of foreign withholding tax

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8.4. Savings tax agreement with the EC

The special provisions for trusts in the Guide to the EU Taxation of Savings Income are only authoritative for the withholding of tax and the voluntary reporting under the Savings Tax Agreement with the EC.