Foundations and Trusts

Block 3 – Part II

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D. Taxation of Foundations from a Swiss perspective

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I. Swiss Foundations

- Separate legal entity
- Taxable Profit
  - According to rules of entities (accounting)
  - Taxable income: realised income inlcuding capital gains
  - Exempt income: gifts or bequests
  - Inheritance and gift tax on transfer of assets to a foundation by as Swiss resident donor or deceased

I. Swiss Foundations

- In case of family foundations
  - If distribution is not in line with purpose – distribution is added back to taxable profit
  - Distribution is taxed as income in the hands of the beneficiary
  - Distribution is not a gift triggering gift tax. Council has no *animus donandi*

I. Swiss Foundations

- Taxable Assets
  - Fair market value of assets not book value
  - No depreciation taken into account
  - Liabilities are deductible

II. Charitable Foundations

- Foundations with public or charitable purpose are tax-exempt
- General requirements
  - Legal entity – Foundation is a legal entity
  - Irrevocable Purpose – repayment of funds to the founders in case of a dissolution is prohibited
  - Carrying out effective Activities
  - Irrevocable Charitable Purpose – the activity must be exclusively dedicated to a public or charitable purpose. No business interest to be pursued.

II. Charitable Foundations

- Public Interest
  - pursued through activities that are in general charitable, humanitarian, constitutional, ecological, educational, scientific or cultural areas
  - Whether activity qualifies as pursuit of a public interest is decided with reference to the public opinion
  - activities can be carried out within Switzerland or abroad, as long as they pursue a public interest and are completely altruistic

II. Charitable Foundations

- Tax Exemption
  - No profit and asset Tax
  - In principle, no gift and inheritance tax
  - No exemption from capital gains tax or VAT
  - Contributions to tax exempt charitable foundations are deductible up to a certain threshhold
  - If foundation pursues both charitable and business purposes, it may be able to apply for a partial tax exemption

II. Charitable Foundations

- Altruism
  - activity is also based on an altruistic spirit
  - own interests must be sacrificed in order to pursue a public interest
  - Associations with the purpose of encouraging leisure activities lack such altruistic purpose
  - board members must carry out their activities on a voluntary basis and, in principle, cannot be remunerated
  - compensation of the management and other employees in accordance with market conditions is permissible

III. Liechtenstein Foundations

- “controlled” vs. “uncontrolled” foundation
  - Supreme Court and most tax authorities ignore a Liechtenstein Foundation for tax purposes in case of avoidance or abuse of rights.
  - Tax avoidance: the legal arrangement chosen by the taxpayer appears to be

    (i) unusual, improper, or abusive, and

    (ii) it can be assumed that the taxpayer made this choice with the intention of saving taxes that would have been due otherwise, and

    (iii) the chosen procedure would lead to a significant tax saving if it were accepted by the tax authority

III. Liechtenstein Foundations

- “controlled” vs. “uncontrolled” foundation
  - The qualification is based on a case-by-case analysis of
    - the foundation deed
    - the by-laws
    - a potential letter of wishes
    - and possibly a mandate agreement between the (economic) founder and the foundation council
    - as well as on the actual implementation (Substance-over-Form)

III. Liechtenstein Foundations

- Controlled Foundation
  - the founder retained a right of revocation
  - the founder has reserved a right to amend the purpose of the foundation
  - the founder can continue to regularly appropriate the income from the foundation's assets without violating the foundation deed or the foundation's purpose
  - the founder acts as if the foundation assets were still his own personal assets, without regard to statutory powers and their limits,
  - the founder is the first beneficiary with unrestricted entitlement to the capital and income of the foundation,
  - based on banking powers of attorney, the founder has access to the bank accounts and custody accounts of the foundation and can therefore freely dispose of the assets of the foundation

III. Liechtenstein Foundations

- Tax consequences in case of a controlled foundation
  - “pass-through», i.e. it is fictitiously assumed that the foundation does not exist for tax purposes
  - Transfer of assets it not complete, thus not gift tax on the transfer
  - Assets and income therefrom still allocated to founder
  - Distributions to beneficiaries are a deemed gift from the founder to the beneficiary triggering gift tax unless exemption (e.g. spouse or children)
  - Upon death of the Founder – inheritance tax unless allocation of assets to beneficiaries.

III. Liechtenstein Foundations

- Uncontrolled Foundation
  - the founder has no retained any powers
  - The founder is not a beneficiary
  - Transfer to assets trigger gift tax in the canton of the founder’s residence. Typically in the highest tax bracket (exceptions in ZG, NW, GR and others)
  - Distributions are taxable as income. According to the Supreme Court a distribution cannot be a gift as the Council has no *animus donandi*

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VI. Irrevocable Discretionary Trust

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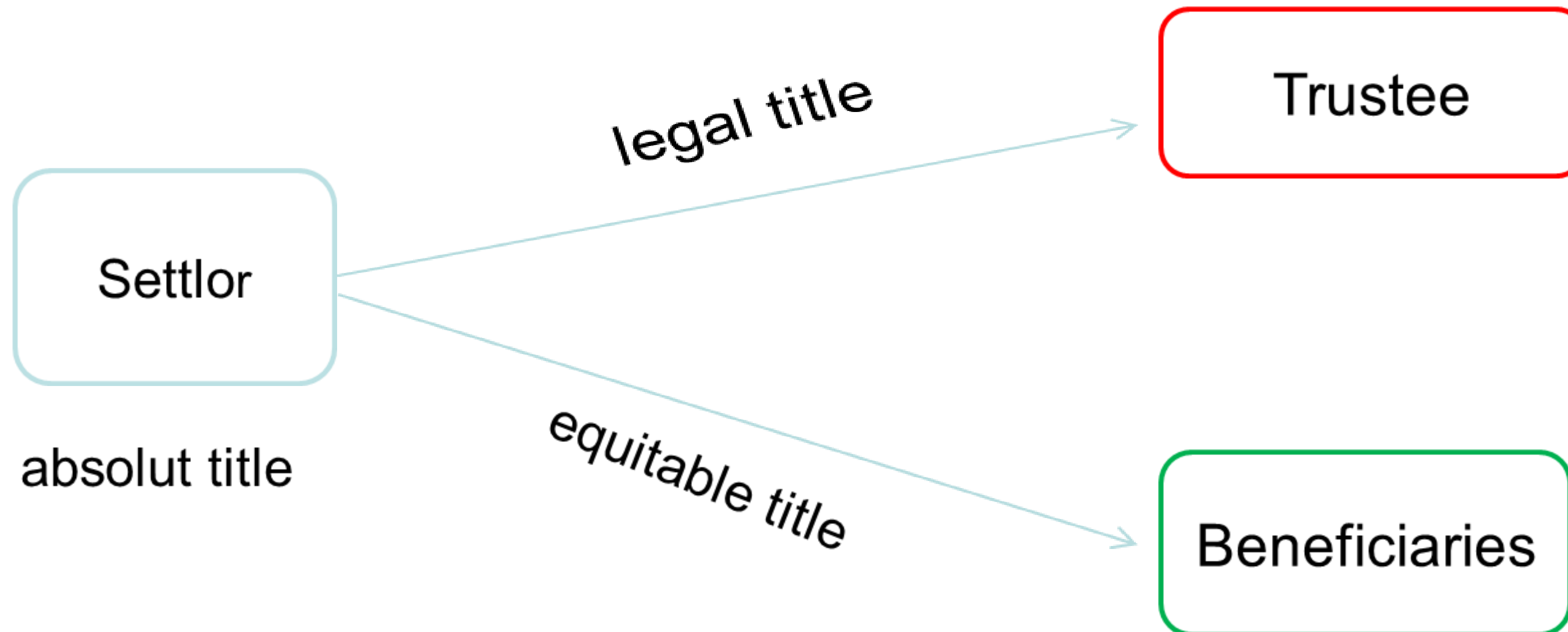
I. General Remarks

- With ratification of the Hague Covention on Trusts – expert group to find a common taxation
- Expert group included representatives of various Cantons and SFTA
- Various drafts of Circular before final Circular was issued August 22, 2007
- The Cantons interpret the Circular differently, thus a tax ruling is typically required

II. Ownership



III. Circular No 20

- Trust has no legal entity, thus it is not subject to tax
- Art. 126 and 127 Federal Taxation Law provide for a duty of the taxpayer to cooperate and a certification requirements
- Tax authorities may request copies of a letter of Wishes, the Trust Deed, By-laws, as well as financial accouns etc.
- In principle, Incorporation princple is applied, i.d. a trust ist recognised if validly settled

III. Circular No 20

- *substance-over-form*
- In principle – fiscal transparency, i.d. trust is ignored for tax purposes
- Either settlor or beneficiary is subject to tax, i.e. trust assets and income is allocated to either of them
- Income is realised for tax purposes when received or in case the recipient has a legal claim
- In principle: taxable income, only exceptionally gift

III. Circular No 20

- Taxation of Trustee / Protector
  - Trustee ist the legal owner, but not the beneficial owner
  - Trustee is not subject to tax based on the principle of taxtion according to the economical capacity («wirtschaftliche Leistungsfähigkeit»)
  - Protector is neither legal nor beneficial owner
  - Protector is not subject to tax based on the principle of taxtion according the economical capacity («wirtschaftliche Leistungsfähigkeit»)

III. Circular No 20

- Indications for a transparent tax treatment, i.d. trust is ignored
  - Settlor is a beneficiary receiving income and/or capital distributions
  - Settlor has the power to
    - remove a Trustee and to appoint another one
    - appoint new Beneficiaries
    - replace the Protector who has similar powers like a trustee
    - amend or have the Trust Deed amended
    - revoke the Trust
    - request the termination of the Trust
    - veto trustee decisions regarding the trust funds

IV. Revocable Trust

- No final transfer of ownership from Settlor to Trustee
- No gift tax on transfer of ownership to Trustee
- Trust assets and income therefrom typically allocated to Settlor
- Distributions to beneficiaries are subject to gift tax, unless exempt (e.g. gifts to spouses and children)
- Termination has no tax consequences, unless funds are not paid back to Settlor but distributed to beneficiaries (gift tax as above)

V. Irrevocable Fixed Interest Trust

- Definition of a Fixed Interest Trust vs. a discretionary Trust
  - Beneficary has a legal claim to receive a certain amount based on the Trust Deed
  - It can be either a fixed amount or the entire annual income
  - The beneficiary of a discretionary trust has no claim, but a mere expectancy. It is up to the trustee to decide on a distribution

  - Just because a trust has one beneficiary only, it is not a fixed interest trust if the trustee decides if and when the beneficiary receives a distribution

V. Irrevocable Fixed Interest Trust

- Beneficiary is treated alike a usufructury («Nutzniesser»)
- Settlement of the trust: Transfer of funds to the trustee are a deemed gift from the settlor to the benficiary. Gift tax is applied unless exemption.
- Distribution: the beneficiary declares the distribution in his tax return and pays income tax on it. If he can prove that income received are either capital gains from the sale of trust property or initial capital paid into the trust, the distribution is tax free
- Assumption – distribution is first inocme, then capital gain, then capital
- Beneficiary has to pay wealth tax on the trust fund generation the distributed income
- Termination: see Distribution

VI. Irrevocable Discretionary Trust

- Definition of a discretionary Trust
  - Typically class of beneficiaries, e.g. «the Settlor and his issue» or all beneficiaries are named
  - One single beneficiary is possible too
  - Trustee decides on if, when a how much shall be distributed to the beneficiary
  - Beneficiary has no legal claim, but mere expectancy
  - Substance-over-Form – if a letter wishes states clearly that the trustee shall distribute current year income to the settlor, the trust may be viewed as fixed interest trust for tax purposes

VI. Irrevocable Discretionary Trust

- Settlor is resident in Switzerland when settling the trust
  - Trust is ignored for tax purposes even the indications as seen before are not met
  - The reason being – the trust assets could not longer be taxed
  - Settlor must declare trust assets and income therefrom directly in his tax return

VI. Irrevocable Discretionary Trust

- Settlor is resident abroad when settling the trust
  - Settlement of the trust: Transfer of funds to the trustee are a deemed gift from the settlor to the trustee, no Swiss tax consequences
  - Distribution: the beneficiary declares the distribution in his tax return and pays income tax on it. If he can prove that income received is initial capital paid into the trust, the distribution is tax free
  - Assumption – distribution is first inocme, then capital

VII. Tax Consequences on the transfer of Swiss Real Property

- Swiss real estate is transferred without consideration to the trustee
  - If trust is recognized for tax purposes (opaque)
    - gift tax typically in the highest tax bracket (exceptions ZG, GR, NW, and others)
    - deferral of capital gains tax on real property
    - Transfer tax may be due (depends on Canton)

VII. Tax Consequences on the transfer of Swiss Real Property

- Swiss real estate is transferred without consideration to the trustee
  - If trust is ignored for tax purposes (transparent)
    - No gift tax since property is still allocated to Settlor
    - No capital gains tax since no completed transfer
    - If trustee sells property, Settlor pays capital gains tax
    - If distribution in kind – deemed gift from Settlor to Beneficiary

VII. Tax Consequences on the transfer of Swiss Real Property

- Trustee sells Swiss real estate
  - Trustee is subject to tax (exception)
  - Transfer tax and capital gains tax to be paid by trustee

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I. Purpose of the DTA

- Double taxation agreements (DTAs) prevent the double taxation of private individuals and legal entities with an international nexus in the area of taxes on income and capital.
- Over 3’000 DTA is place – number is growing
- Art 2 of the Vienna Convention on the Law of Treaties

  A treaty is an international agreement (in one or more instruments, whatever called) concluded between States and governed by international law.
- DTAs confer rights and impose obligations on the two contracting States, but not on third parties such as taxpayers.
- Under Article 26 of the Vienna Convention, DTAs are binding on the contracting States and must be performed by them in good faith.

I. Purpose of the DTA

- Prevention of tax evasion and avoidance or double non-taxation
- Treaties should apply to ensure that income is taxed once, and only once
- Elimination of discrimination against foreign nationals and non-residents, i.e. Any country entering into a treaty wants to ensure that its residents who carry on business in the other contracting State are treated the same as the residents of that other State who carry on similar activities.
- Administrative cooperation between the contracting States: exchange of information, assistance in the collection of taxes and dispute resolution
- DTAs do not impose tax. Tax is imposed by domestic law, therefore, DTAs limit the taxes otherwise imposed by a State
- DTAs are primarily relieving in nature

II. Contents of a typical DTA

- Based on OECD Model Convention, first published, in draft form, in 1963. Since then, revisions have been made every few years, on nine occasions, most recently in 2014
- OECD Commentary, organized on an article-by-article basis, as become increasingly important with respect to the interpretation and the application of tax treaties, including some treaties between countries that are not members of the OECD.
- The Commentaries on the OECD Model Convention also contain observations by particular countries on specific aspects of them. Countries register observations to indicate that they disagree with the interpretation of the treaty provided in the Commentary.

II. Contents of a typical DTA

- Chapter I consists
  - of Art 1, which identifies the persons whose tax obligations are affected by the treaty, generally residents of the contracting States,
  - and Art 2, which describes the taxes covered by the treaty, generally income and capital taxes imposed by the contracting States and their political subdivisions

II. Contents of a typical DTA

- Chapter II provides
  - definitions of important terms used in the treaty including general definitions in Art 3
  - a definition of the term “resident” in Art 4
  - “permanent establishment” in Art 5

II. Contents of a typical DTA

- Chapter III contains the distributive rules of the treaty
  - Art 6-21 deal with various types of income derived by a resident of one or both of the States.
  - In general, these provisions determine whether only one or both of the contracting States - the State in which the taxpayer is resident (the residence country) and the State in which the income arises or has its source (the source country) - or whether both of them can tax the income and whether the rate of tax imposed is limited

II. Contents of a typical DTA

- Chapter IV deals with the taxation of capital (not income from capital)
- Chapter V provides two alternative methods for eliminating double taxation
  - Art 23A (Exemption method) - the residence country excludes or exempts the income from residence country tax.
  - Art 23B (Credit method) - the residence country taxes the income but provides a deduction from that tax for the tax paid to the source country on the income

II. Contents of a typical DTA

- Chapter VI is entitled “Special provisions”.
  - Art 24 provides protection against various forms of discriminatory taxation by the source and residence countries.
  - Art 25 provides a mutual agreement procedure (MAP) to resolve disputes concerning the application of the treaty
  - Art 26 deals with exchanges of information between the States
  - Art 27 provides rules for the contracting States to assist in collecting one another’s taxes
  - Art 28 simply provides that nothing in the treaty affects the “fiscal privileges” enjoyed by diplomats and consular officials under international law or other international agreements

II. Contents of a typical DTA

- Chapter VII provides rules to govern the entry into force and termination of the treaty

III. Treaty relief and residence according to DTA

- Art. 3 para.1
  - a) the term “person” includes an individual, a partnership, a company, an estate, a trust and any other body of person
  - b) the term "company" means any body corporate or any entity which is treated as a body corporate for tax purposes under the laws of the Contracting State in which it is organized
  - d) the term "nationals" means
    - i) all individuals possessing the nationality (i.e., citizenship, in the case of the United States) of a Contracting State; and
    - ii) all legal persons, partnerships and associations deriving their status as such from the laws in force in a Contracting State

III. Treaty relief and residence according to DTA

- Art. 4 para.1 a) "resident of a Contracting State" means:
  - any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, nationality, place of management, place of incorporation, or any other criterion of a similar nature,
  - except that a United States citizen or "green card" holder who is not a resident of Switzerland shall be considered to be a resident of the United States only if such person has a substantial presence, permanent home or habitual abode in the United States;
  - if, however, such person is also a resident of Switzerland under this paragraph, such person also will be treated as a United States resident under this paragraph and such person's status shall be determined under paragraph 3;

III. Treaty relief and residence according to DTA

- Art. 4 para.1 d) "resident of a Contracting State" means:
  - a partnership, estate, or **trust**, but only to the extent that the income derived by such partnership, estate, or trust is subject to tax in that State in the same manner as the income of a resident of that State, either in its hands or in the hands of its partners or beneficiaries.

III. Treaty relief and residence according to DTA

- Art. 4 para. 3 "resident of a Contracting State" means:
  - Tie-Breaker Rule
    - a permanent home available
    - Closer personal and economic relations (center of vital interests);
    - Habitual abode (gewöhnlicher Aufenthalt)
    - State of nationality
    - Mutual agreement

IV. Application to Foundations and Trusts

- Foundation is an entity according to Art. 3 para 1 b) DTA USA
- Trust is a person according to Art. 3 para 1 a) DTA USA

IV. Application to Foundations and Trusts

- Example for a Liechtenstein Foundation holding the share of a Swiss company
- The Swiss underlying company pays a dividend to the foundation
- 35% Swiss withholding tax is dedecuted and forwarded to the Federal Tax Authorities
- If the foundation is taxed in Liechtenstein ordinarily, it can apply the DTA (Art. 4 para 1)
- If the foundation has a status as a «special vehicle» paying a fixed tax of CHF 1’800 p.a., the foundation is not considered resident and cannot apply the DTA

IV. Application to Foundations and Trusts

- Example for a Liechtenstein Foundation holding the share of a Swiss company
- Based on Art. 10 para 3 a) – the foundation could apply for a full refund of the Swiss withholding tax because it holds more than 10% in the Swiss company
- However - Protocol to the DTA FL contains anti abuse provisions!
  - Protocol point 4 to Art. 10 DTA
  - if there is no ohter reason for settling the foundation than receiving the 0% withholding tax - the withholding tax rate applies as if no foundation was settled;
  - i.e. if the settlor is resident in Germany, a 15% withholding tax rate would apply

IV. Application to Foundations and Trusts

- Example for a Liechtenstein Foundation holding the share of a Swiss company
- Protocol point 2 to Art. 4 contains special rules for Liechtenstein Foundations with Swiss resident settlors and/or beneficiaries
- A Liechtenstein foundation is only considered resident in this case if
  - The founder cannot revoke the foundation
  - The founder cannot amend or change that statues and/or bylaws
  - Neither the founder nor related persons can instruct the Council
  - The beneficiaries have no legal claim to receive a distribution
  - And, in any event, if the founder is also a beneficiary (not provided for in the Protocol)

V. Exchange of Information

- Sources for Information
  - Art. 26 of DTA
  - Country-by-Country Reporting
  - Tax Information Exchange Agreements (TIEAs)
  - Automatic Exchange of Information (OECD Common Reporting Standard)
  - Regional Agreements
  - Multilateral Convention on Mutual Administrative Assistance in Tax Matters.

V. Exchange of Information

- Federal Act on the Exchange of Information (StAhiG)
- Ordinance on the Exchange of Information (StAhiV)
- typically Art. 26 DTA

V. Exchange of Information

- Art. 26 DTA
  - exchange of information as is foreseeably relevant for
  - carrying out the provisions of this Convention or
  - to the administration or enforcement of the domestic laws concerning taxes of every kind and description imposed on behalf of the Contracting States
  - Any information received shall be treated as secret and can only be used for the assessment, collection, enforcement or prosecution of the respective taxes
  - The requesting State must have used its own information gathering measures first

V. Exchange of Information

- Contracting States sends a request to the SFTA containing sufficient description of
  - the taxpayer concerned,
  - the suspicion
  - why the information sought for is foreseeably relevant – no fishing expeditions!
  - the period for which the information is sought for
  - The person or entity (typically a bank) holding the necessary information
- SFTA requests the information sought for from the information holder
- The information holder typically informs the account holder about the request

V. Exchange of Information

- the account holder can approach the SFTA and ask for the information received by the information holder and the treaty request
- SFTA grants the account holder or his representative 10 days (one extension possible) to provide a statement as to why the information shall not be sent to the requesting State
- SFTA assesses the statement received and issues its final decision on whether or not the information shall be sent to the Contracting State
- The account holder has 30 days to appeal this decision at the Federal Administrative Court
- If the decision of the Federal Administrative Court contains a decision that could be applicable to various taxpayers, an appeal is open to the Federal Supreme Court

V. Exchange of Information

- Automatic Exchange of Information
  - Multilateral Competent Authority Agreement (MCAA)
  - Federal Act on the Automatic Exchange of Information (AIAG)
  - Ordinance on the Automatic Exchange of Information (AIAV)
  - Agreements between Switzerland and other Contracting States on the automatic exchange of information
  - Common Reporting Standard (CRS)
  - Circulars and Explanations in respective Contracting States

V. Exchange of Information

- Automatic Exchange of Information
  - Either bank or foundation/trust is the Financial Institution (FI) obliged to do the reporting if necessary
  - FI is required to identify customers who appear to be tax resident outside of the country/jurisdiction where they hold their accounts
  - Tax residence means subject to unlimited taxation in a jurisdiction
  - Information reported: interest, dividends, account balance or value, sales proceeds or income generated from financial assets.
  - reportable accounts can be held by individuals and entities, which also includes trusts and foundations

V. Exchange of Information

- Automatic Exchange of Information
  - Controlling person by way of ownership
  - individuals who directly or indirectly effectively control a legal entity by way of a 25% ownership (voting power or equity participation). For domiciliary companies no such threshold exists, i.e. every beneficial owner, regardless of their participation quota, must be considered to be controlling persons.
  - Controlling person in another distinguishable manner

V. Exchange of Information

- Automatic Exchange of Information
  - Controlling person in another distinguishable manner
  - Exercise of actual control over a legal entity exercised by
    - a patron with less than 25% quota or voting power, but nevertheless holds de facto control of over the company,
    - a shareholder’s agreement if the shareholders can exercise control over the company,
    - a lender, exercising a dominant influence over the decisions of the management of the company because of a loan.

V. Exchange of Information

- Automatic Exchange of Information
  - In absence of a controlling person in another distinguishable manner
  - Controlling person as an executive of the legal entity
    - The managing person, i.e. the individual who effectively manages the legal entity

V. Exchange of Information

- Automatic Exchange of Information
  - In case of trusts and foundations
    - settlor/founder
    - trustee, provided it is an individual
    - protector is the supervisory body of the trust or the foundation, provided it is an individual
    - beneficiaries, in case they have a legal title to receive a distribution or are named explicitly

V. Exchange of Information

- Automatic Exchange of Information
  - In case of trusts and foundations
    - exception: beneficiaries of a discretionary trust/foundation, who have not received any distributions during a calendar year, do not have to be considered as controlling person
    - trustee confirms to FI in written form, that those beneficiaries have not received any distributions from the trust during the reporting period