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by Marcel R. Jung

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Marcel R. Jung is with Reichlin & Hess in Zug, Switzerland.

I. Introduction

A. Trusts and Treaties

Trust law has its origins in English law, and trusts are widespread in common law jurisdictions. Switzerland has concluded many treaties, some of which mention trusts and trustees. However, there is a lack of appropriate provisions in Swiss treaties and in the OECD model to help deal with the complex issues of trusts.[1] The Swiss Federal Tribunal has not yet issued a (published) ruling on the treatment of foreign trusts under Swiss treaty law. Also, the OECD has not yet submitted proposals for the insertion of specific provisions or interpretations in the OECD model or OECD commentary.

B. Hague Trust Convention

Although foreign trusts were broadly recognized in Switzerland, the former legal situation was still uncertain. On April 26, 2007, Switzerland ratified the Convention of July 1, 1985, on the Law Applicable to Trusts and on Their Recognition (hereafter the Hague trust convention); it was enacted effective as of July 1, 2007.[2] However, a trust is still not a legal institute in Swiss law, even after the enactment of the Hague trust convention and the amendments to the Swiss Federal Private International Law Act (IPRG) of December 18, 1987, and to the Swiss Federal Debt Enforcement and Bankruptcy Act (SchKG) of April 11, 1889.

Chapter 1, article 2 of the Hague trust convention states: ''For purposes of the Convention, the term 'trust' refers to the legal relationships created — *inter vivos* or on death — by a person, the settlor, when assets have been placed under the control of a trustee for the benefit of a beneficiary or for a specified purpose.''[3] Even though the Hague trust convention does not prejudice the powers of states in fiscal matters, the

[1] *See* Walter Ryser, ''Trusts and Double Taxation Treaties Concluded by Switzerland,'' *Archiv für Schweizerisches Abgaberecht* (1996-1997), p. 309; Robert J. Danon, *Switzerland's Direct and International Taxation of Private Express Trusts,* Zurich/Basel/Geneva: Schulthess, 2004; Robert J. Danon, ''L'Imposition du 'Private Express Trust' — Analyse Critique de la Circulaire CSI du 22 Août 2007 et Proposition de Modèle d'Imposition *de lege ferenda*,'' *Archiv für Schweizerisches Abgaberecht* (2008), p. 435; Sibilla G. Cretti, *Le Trust — Aspects fiscaux*, 2nd ed., Basel: Helbing & Lichtenhahn (2007); Xavier Oberson and Fouad Sayegh, in: Simon Jennings, Joseph A. Field, and Anthony Travers (eds.), *Planning and Administration of Offshore and Onshore Trusts,* West Sussex: Tottel (Nov. 2006), Switzerland, p. 1.

[2] Convention of July 1, 1985, on the Law Applicable to Trusts and on Their Recognition, SR 0.221.371. *See* Thierry V.A. Boitelle, ''Trust Convention Enters Into Force,'' *Tax Notes Int'l*, Sept. 3, 2007, p. 908; Filippo Noseda, ''Praktische Auswirkungen des Haager Trust-Übereinkommens für den Schweizer Trustee, Protector, Trust Administrator und Investment Adviser,'' *Aktuelle Juristische Praxis* (2006), p. 482; Filippo Noseda, ''Switzerland and the Hague Trust Convention: Where Are We?'' *Trust Law International* (2005), p. 37; Nedim Peter Vogt, in: Nedim Peter Vogt, Heinrich Honsell, Anton K. Schnyder, and Stephen V. Berti, *Basler Kommentar zum Internationalen Privatrecht*, 2nd ed., Basel: Helbing & Lichtenhahn (2007), para. 1 of art. 149a IPRG.

[3] *See also* Underhill and Hayton, *Law of Trusts and Trustees*, 17th ed., London: LexisNexis Butterworths (2007), p. 2.

question arises as to whether it affects the treatment of foreign trusts under Swiss national and international tax law.[4]

C. Circular Nos. 30 and 20 on Trusts

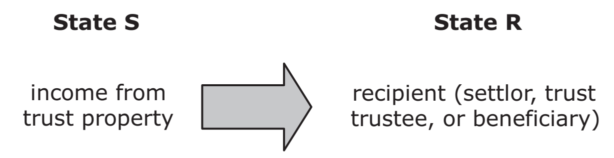
Swiss domestic tax law has no specific provisions dealing with the treatment of foreign trusts. The Swiss Tax Conference issued Circular No. 30 on the taxation of trusts on August 22, 2007.[5] It outlines and interprets the Swiss fiscal attribution rules under the Federal Acts of December 14, 1990, on federal direct tax (DBG) and on the harmonization of cantonal and communal direct taxes (StHG). The DBG enacts individual and corporate income taxes. The StHG provides detailed rules on individual income and net wealth taxes as well as corporate income and capital taxes. The tax acts of the cantons must comply with the federal guidelines of the StHG. It remains to be seen whether Circular No. 30 will harmonize the different practices applied by cantonal tax administrations. Circular No. 30 does not address cantonal and communal gift and inheritance taxes since indirect taxes have not been harmonized by virtue of the StHG.

Circular No. 30 also outlines the practice of the Federal Tax Administration (FTA) regarding relief from Swiss federal withholding taxes under the Federal Act of October 13, 1965 (VStG), by Swiss persons that are subject to Swiss tax liability and under tax treaties by persons that are resident in a foreign contracting state. It also outlines the practice of the FTA regarding relief from foreign withholding tax under tax treaties by Swiss resident persons. The FTA noted in Circular No. 20, on March 27, 2008, that the rules in Circular No. 30 are also applicable for federal income and withholding tax.

D. Principles of International Taxation

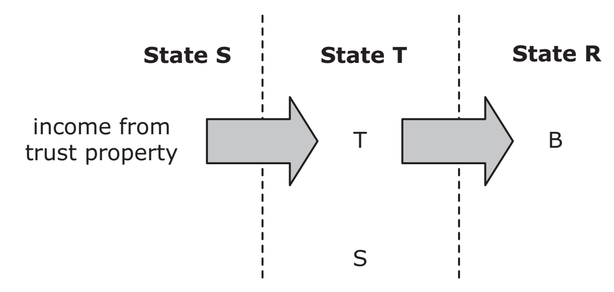
The basic principles of international taxation are briefly outlined below: source versus residence taxation and the avoidance of international double taxation. (See Figure 1.)

Figure 1



State S levies withholding tax on investment income sourced in its own state. The recipient of the trust income that is resident in State R is subject to withholding tax in State S on the investment income (source taxation). Also, State R taxes the recipient of the trust income based on the principle of worldwide income (residence taxation). The recipient of the trust income is subject to double taxation regarding income from trust property sourced in State S. (See Figure 2.)

Figure 2



If the trustee, settlor, and beneficiary are not resident in the same state and the trust directly obtains income from a third state (triangular situation), the trust income may be subject to source taxation in State S and to residence taxation in State T. Also, State T may treat the forwarding of trust income as trust distributions that are subject to source taxation. Those forwarding the income may also be subject to residence taxation in State R, the residence state of the beneficiary. (See Figure 3.)

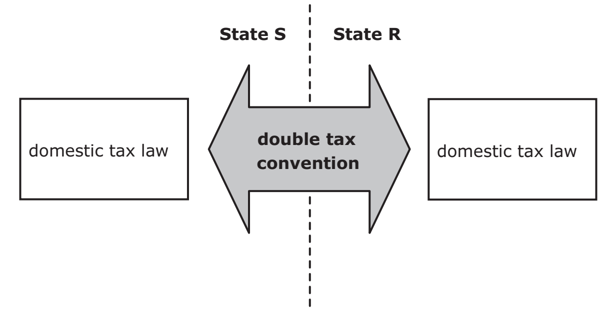
To avoid international double taxation, states S and R may enter into a tax treaty. Tax treaties limit the unilateral taxing rights of the contracting states. A tax treaty may fully or partially limit State S's taxing right. If State S's taxing right is not fully limited, double taxation may still arise. To avoid that, State R may apply two methods[6]: It may either exempt income sourced in State S from its domestic income tax (either

[4] Article 19 of the Hague trust convention.

[5] *See* Peter R. Altenburger and Thierry V.A. Boitelle, ''Switzerland Issues Guidelines for Taxation of Trusts,'' *Tax Notes Int'l*, Oct. 29, 2007, p. 441; Peter Böckli, ''Der angelsächsische Trust — Zivilrecht und Steuerrecht,'' Part I, *SteuerRevue* (2007), p. 710, and Part II, *SteuerRevue* (2007), p. 774; Filippo Noseda, ''Taxation of Trusts in Switzerland: New Clouds on the Horizon,'' *Trust Law International* (2006), p. 8; Philipp Betschart, ''Grundzüge der Trustbesteuerung — Dargestellt Anhand der Praxis des Kantons Zürich,'' *SteuerRevue* (2007), p. 158; Danon, *supra* note 1, at 435; Xavier Oberson, ''Le Traitement Fiscal du Trust en Droit Suisse — les Limites à l'Application des Principes Généraux de la Fiscalité,'' *Archiv für Schweizerisches Abgaberecht* (2008), p. 475; and Toni Amonn, ''Trustbesteuerung in der Schweiz — Eine Standortbestimmung,'' *Archiv für Schweizerisches Abgaberecht* (2008), p. 493.

[6] *See* para. 12 of the OECD commentary on articles 23A and B of the OECD model.

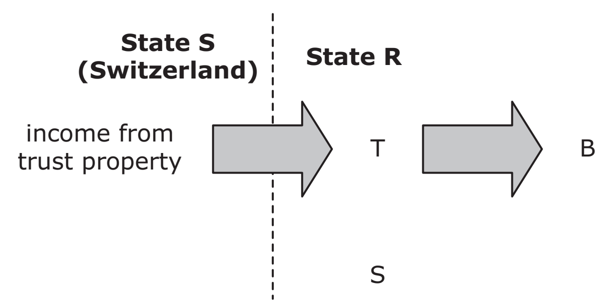
Figure 3



full exemption or exemption with progression), or it may tax the income sourced in State S, but allow a deduction from its own income tax for the tax paid in State S (either full credit or ordinary credit).

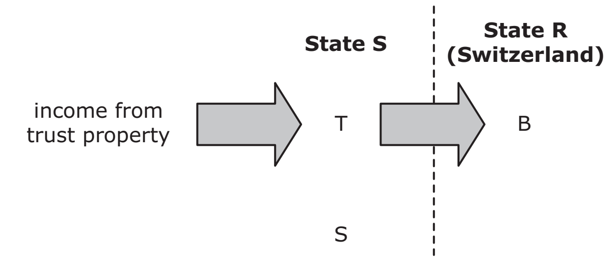
E. Treaty Protection of Trust Income?

Figure 4



In base case 1, a foreign trust directly invests in Swiss assets and obtains Swiss-source income that is subject to Swiss withholding tax.[7] (See Figure 4.) In this case, Switzerland is the source state. The question arises as to whether the recipient of the trust income (settlor, trustee, or beneficiary) is entitled to relief from Swiss withholding tax. As an alternative scenario, the settlor is subject to unlimited tax liability in Switzerland. As another alternative, the beneficiary is resident in a contracting state other than that of the settlor and the trustee (triangular situation). The question then arises as to whether the settlor, the trust, the trustee, or the beneficiary is entitled to relief from Swiss withholding tax. The answer depends on fiscal attribution rules. Attribution conflicts between the source state and residence state may lead to international double taxation of trust income.

Figure 5



In base case 2, a foreign trust directly invests in assets in State S and obtains income that is subject to withholding tax in State S. (See Figure 5.) The settlor and the trustee are resident in State S. The trustee forwards the income from trust property to the beneficiary that is resident in Switzerland. In this case, Switzerland is the residence state. As an alternative scenario, the settlor is subject to unlimited tax liability in Switzerland. As another alternative, the trust may obtain income sourced in another state (triangular situation). The question arises as to whether the Swiss resident settlor or beneficiary is entitled to relief from foreign withholding tax. The question also arises as to whether the Swiss resident settlor or beneficiary is entitled to relief from foreign withholding tax if State T treats the forwarding of trust income as trust distributions that are subject to source taxation (triangular situation). Since treaty relief requires residence of the settlor or beneficiary in Switzerland, this answer also depends on fiscal attribution rules.

F. Issues

The two base cases raise the following questions under Swiss treaty law:

- Does a foreign trust fall under the personal scope of a Swiss tax treaty?
- Is a trust or a trustee resident under a Swiss tax treaty?
- Is trust income fiscally attributed to the settlor, the trust, the trustee, or the beneficiary?
- If trust income is fiscally attributed to the trust or the trustee, is the trustee the beneficial owner of the trust income?

[7] *See* article 4 of the VStG regarding federal source taxation of investment income. Taxable investment income includes (1) interest from bonds and similar debt instruments issued by domestic persons, (2) interest on domestic bank deposits, and (3) dividends and liquidation distributions from shares issued by domestic corporations, limited liability companies, and cooperatives. There are also federal, cantonal, and communal source taxes on interest on debt instruments secured by Swiss immovable property. *See* article 94 of the DBG and article 35(1)(e) of the StHG.

II. Switzerland: Source State

A. Personal Scope of Tax Treaties

1. Trusts Expressly Included in Tax Treaties

Switzerland has concluded tax treaties with the United States and Canada that include trusts in their personal scope. Article 3(1)(a) of the Switzerland-U.S. tax treaty and article 3(1)(c) of the Canada-Switzerland tax treaty state that the term ''person'' includes trusts and any other body of persons. Therefore, a trust falls under the personal scope of these tax treaties.

2. Trusts Not Expressly Included in Tax Treaties

Switzerland has concluded tax treaties with common law jurisdictions that do not include trusts in their personal scope. For example, according to article 3(1)(e) of the Switzerland-U.K. tax treaty, the term ''person'' includes any individual, company, unincorporated body of persons, and any other entity with or without juridical personality. Similarly, article 3(1)(c) of the New Zealand-Switzerland tax treaty states that the term ''person'' includes an individual, a company, and any other body of persons. Therefore, the question arises as to whether a trust falls under the term ''body of persons.''[8]

Switzerland should uniformly apply tax treaties to trusts.

The FTA takes the view that because a trust is not a person under Swiss law, the provisions of Swiss tax treaties cannot be applied uniformly to trusts.[9] Further, the FTA states that only some tax treaties include specific provisions regarding trusts according to which a trust is a person for treaty purposes. The FTA points out that the Switzerland-U.K. tax treaty is applicable to trusts only based on a contextual interpretation of this particular tax treaty.[10]

In the author's view, however, Switzerland should uniformly apply tax treaties to trusts. Switzerland has concluded its tax treaties based on the OECD model. Switzerland also recognizes foreign trusts according to the Hague trust convention. At a meeting of the International Tax Planning Association (ITPA) in 1993, Philip Baker argued that since article 3(1)(a) of the OECD model defines a person as including an individual, a company, and any other body of persons, the term ''body of persons'' also includes the trust. An increasing number of people in international tax law believe the term ''person'' should include a trust.

In the author's view, the meaning of trust should be construed according to the ordinary meaning in a given context, or its ordinary meaning under common law.[11] Under such a contextual interpretation, a trust is considered to be a body of persons and thus falls under the personal scope of Swiss tax treaties.[12]

B. Residence of Trust or Trustee

A tax treaty is applicable only to persons who are residents of one or both of the contracting states.[13] Resident of a contracting state means any person that, under the laws of that state, is liable to tax therein by reason of his domicile, residence, place of management, or any other similar criterion.[14] The question arises as to whether a foreign trust or foreign trustee may be considered liable to tax on trust income.

Common law jurisdictions may treat the trust (or trustee) as a separate taxpayer. In the case of an irrevocable fixed interest trust or an irrevocable discretionary current trust, the trust (or trustee) may be entitled to deduct distributions of trust income to beneficiaries from taxable income.[15] The FTA points out that persons that are not resident in the residence state of the trust (or trustee) may be the ultimate beneficiaries of the Swiss-source trust income.[16]

The Federal Court of Appeal for Taxation issued a ruling on February 28, 2001, in a treaty shopping case. The court considered a company incorporated in Luxembourg to be resident in Luxembourg under the Luxembourg-Switzerland tax treaty, although it passed the Swiss-source income to nonresidents in the form of tax-deductible expenses.[17] However, the refund of Swiss withholding tax was refused because of the lack of beneficial ownership. From this ruling, it cannot be inferred that a trust (or trustee) should be considered resident for treaty purposes even though distributions

[8] *See* article 3(1)(a) of the OECD model.

[9] Para. 8.1 of Circular No. 30.

[10] *See also* Ryser, *supra* note 1, at 313.

[11] Article 3(2) of the OECD model and article 31 of the Vienna Convention.

[12] This interpretation of the term ''body of persons'' is applicable for purposes of Swiss treaty law only, not for purposes of Swiss domestic tax law, specifically not for article 11 of the DBG and article 20(2) of the StHG. According to para. 4.1 of Circular No. 30, a trust does not qualify as a foreign legal entity according to article 49(3) of the DBG or a body of person in the sense of article 11 of the DBG and article 20(2) of the StHG.

[13] *See* article 1 of the OECD model.

[14] *See* article 4(1) of the OECD model.

[15] *See, e.g.,* rules for simple trusts in IRC section 641 and complex trusts in IRC section 661.

[16] Para. 8.2 of Circular No. 30.

[17] Federal Court of Appeal for Taxation, Feb. 28, 2001, *Steuer-Revue* (2002) p. 30, para. 3.c.; *see* unofficial translation in: *International Tax Law Reports* (2002), p. 191.

of trust income to beneficiaries are tax deductible. Insofar as the distributions are tax deductible, the trust is fiscally treated transparent. Therefore, in the author's view, the FTA's practice is correct and a trust (or trustee) is not considered resident for treaty purposes insofar as distributions of trust income to the beneficiary may be deducted from taxable income and the foreign tax law treats the trust as transparent (partial transparency).[18]

Circular No. 30 refers to Swiss private international law and states that a foreign trust should not be treated as a legal entity under Swiss tax law.[19] This approach (in which the common law trust was compared with a civil law foundation) violates the Hague trust convention and is misleading.[20] Swiss tax consequences must be based on the legal relationships created by the settlor. Peter Böckli states that substance over form (*wirtschaftliche Betrachtungsweise*) is in reality contract over form (*vertragsrechtliche Betrachtungsweise*), with the beneficial owner being the person that is given rights from a contract.[21]

In contrast to what is found in some common law jurisdictions, Swiss tax law has no specific provisions in which a foreign trust (or trustee) is treated as a separate taxpayer. For the trustee, Circular No. 30 also bases this conclusion on the ability-to-pay principle. The trustee does not have the power of disposal over the trust property and trust income and is only the legal, not the beneficial, owner of the trust property.

Swiss tax law has no specific provisions in which a foreign trust (or trustee) is treated as a separate taxpayer.

The fiscal attribution rules of Circular No. 30 are correct — trust property and trust income are attributed either to the settlor or the beneficiary, but not to the trust (or trustee), which is also the case in an irrevocable discretionary trust. For Swiss tax purposes, there is neither a contribution to nor a distribution from the foreign trust.[22] The trust has no legal capacity and so cannot own assets.[23] Swiss tax terminology must take into account the legal situation created by the settlor. Tax laws of common law jurisdictions may treat the trust (or trustee) as a separate taxpayer so that trust distributions may be assumed for tax purposes. According to Circular No. 30, the principle of transparency applies for purposes of Swiss direct taxes.[24] The trust (or trustee) may not be subject to limited or unlimited tax liability in Switzerland on trust income.[25] The question of place of effective management of the trust property does not arise in Swiss tax law.[26] However, the remuneration paid to the trustee is subject to Swiss individual or corporate income taxes if the trustee is a Swiss taxpayer.[27]

In light of the Hague trust convention, paragraph 5.11 of the draft for Circular No. 14 proposed a change in administrative practice regarding trusts for purposes of Swiss VAT. Therefore, the place of supply of services (according to article 14(3) of the Swiss VAT Act of September 2, 1999) that are provided by third parties or the trustee in favor of the trust is the place where the beneficiary has his domicile. However, for an irrevocable discretionary trust (the beneficiaries are not yet clearly determinable), the place of incorporation of the trustee is deemed to be the place of supply of services since the trust is the legal owner of the

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[18]*See* Philip Baker, ''The Application of the Convention to Partnerships, Trusts and Other Non-Corporate Entities,'' *GITC Review* (2002), Vol. II, No. 1, p. 23.

[19]Para. 4.1 of Circular No. 30.

[20]*See* Federal Tribunal, Jan. 29, 1970, *Harrison c. Schweizerische Kreditanstalt*, BGE 96 II 88; Urs Landolf and Thomas Graf, ''Der Trust im Schweizerischen Steuerrecht,'' *Archiv für Schweizerisches Abgaberecht* (1994), p. 21; Betschart, *supra* note 5, at 158.

[21]Böckli, *supra* note 5, at 712.

[22]For a different view, see Betschart, *supra* note 5, at 163. According to the practice of the Tax Administration of the Canton of Zurich, trusts that cannot be attributed to the settlor or the beneficiary are treated similarly to foundations. Betschart believes trusts may become subject to unlimited tax liability based on effective place of management. In the author's view, those views are outdated. They do not comply with the Hague trust convention. And they no longer comply with Circular No. 30, which was issued by the Swiss Tax Conference on August 22, 1997, and was confirmed by the FTA for purposes of federal income tax on March 27, 2008.

[23]Para. 2.2 of Circular No. 30.

[24]Para. 4.2 of Circular No. 30.

[25]Para. 4.1 of Circular No. 30. A trust does not qualify as a foreign legal entity according to article 49(3) of the DBG or a body of person in the sense of article 11 of the DBG and article 20(2) of the StHG.

[26]*Id.* However, the question arises as to whether the administration of an offshore underlying company by a Swiss resident trust company that is a member of the board of directors (and that is also the trustee) is considered to be in Switzerland. According to the FTA's practice, the place of effective management is considered to be abroad if the settlor and the beneficiaries are non-Swiss resident persons and the Swiss resident trust company that provides services to the trust or the offshore company receives remuneration at arm's length. The seat of a trust and the place of its administration or the place of its effective management are not relevant to separate taxation or tax residence of the trust.

[27]Para. 4.2 of Circular No. 30. If the trustee is an individual, he derives income from a self-employed activity.

trust property and thus has the power to control.[28] Conclusively, insofar as the receipt of the supply of services is attributed to the trustee, the principle of transparency does not apply for purposes of Swiss VAT.

C. Personal Attribution of Trust Income

1. Lex Fori Interpretation

Foreign Attribution Rules. As noted above, common law jurisdictions may treat a trust as a separate taxpayer.[29] The place of residence of the trust may be determined by reference to the place of residence of the trustee or the majority of the trustees. Forwarding of trust income may be treated as trust distributions that are subject to withholding tax in the residence state of the trust.

Tax treaties include references to unilateral attribution rules. For example, article 10(7) of the Canada-Switzerland tax treaty states that article 10 will also apply to income obtained by a resident of Switzerland from a trust that is a resident of Canada. Article 4(1)(d) of the Switzerland-U.S. tax treaty has adopted the principle of transparency for purposes of treaty law. It states that the term ''resident of a contracting state'' also means a trust, but only to the extent that the income derived by the 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 beneficiaries. Therefore, a trust may be considered resident in the United States under the Switzerland-U.S. tax treaty if the settlor, the trust, or the beneficiary is subject to tax on trust income as a U.S. resident.

Common law jurisdictions may also treat the trustee as liable to tax on trust income. For example, paragraph 3(b) of the protocol to the New Zealand-Switzerland income tax treaty states that for purposes of articles 10, 11, and 12, in determining whether dividends, interest, or royalties are beneficially owned by a resident of New Zealand, the income on which a trustee is subject to tax in New Zealand will be treated as being beneficially owned by that trustee.

Swiss Attribution Rules. Circular No. 30 is based on the principle of fiscal transparency of the trust for purposes of Swiss direct taxes. Fiscal transparency means the trust property and the trust income are not attributed to the trust or the trustee. Thus, there is no distribution of trust income from the trust. Instead, the trustee forwards the trust property and the trust income to the beneficiary.

The fiscal attribution rules of Circular No. 30 apply if the settlor is alive when the trust is settled. The circular provides for the following fiscal attribution rules: For a revocable trust, trust property and trust income are attributed to the settlor.[30] The forwarding of trust property and trust income to the beneficiary is treated as a gift. If an irrevocable fixed interest trust is settled, there is a gift of trust property to the beneficiary.[31] Accordingly, trust property and trust income are attributed to the beneficiary. For an irrevocable discretionary trust, Circular No. 30 treats differently a settlor that is subject to Swiss unlimited tax liability and a settlor who is not. If the settlor is subject to Swiss unlimited tax liability, the fiscal attribution rules for revocable trusts are applied *mutatis mutandis*. However, if the settlor is not subject to Swiss unlimited tax liability, the transfer of the trust property by the settlor to the trustee is treated as a gift by the settlor.[32] In that case, Circular No. 30 attributes trust property and trust income to nobody (abeyance). The settlor has definitively disposed of trust property, but the trustee is not enriched, and the beneficiary has an expectation right only.[33] Abeyance is a consequence of separation of legal and beneficial ownership in common law. Under applicable Swiss direct tax law, trust property and trust income may not be fiscally attributed to the trust or the trustee.

According to Circular No. 30, only a settlor who lives abroad may definitively shift his wealth to abeyance.[34] The nonrecognition of an irrevocable discretionary trust settled by a Swiss resident settlor raises questions regarding compliance with the Hague trust convention and the constitutional principle of equal treatment. This practice seems to be problematic in

[28]The trustee may be disregarded, according to para. 5.4.4 and para. 5.11 of the draft Circular No. 14, if the settlement has as its only purpose to avoid a look-through approach that may be applied to so-called passive investment offshore companies, *e.g.*, if the trustee abroad exercises the mere function of a passive investment offshore company or the passive investment company is held by a trust.

[29]*See, e.g.,* rules for simple trusts in IRC section 641 and complex trusts in IRC section 661. *See also* John W. Hart, ''How Various Countries Approach Taxation of Trusts,'' in: Michael Cadesky and Richard Pease (eds.), *Trusts and International Tax Treaties* (West Sussex: Tottel, 2006), p. 52.

[30]Para. 5.2.1 of Circular No. 30. Revocable trusts become irrevocable trusts following the death of the settlor unless the right of revocation is exercisable by another person or is transferred to someone else. Para. 3.7.1 of Circular No. 30.

[31]Para. 5.2.2 of Circular No. 30.

[32]Para. 5.2.3 of Circular No. 30.

[33]Para. 5.1 of Circular No. 30.

[34]Tax administrations seem to assume tax avoidance if the settlor is subject to Swiss unlimited tax liability. The settlement of an irrevocable discretionary trust by a settlor who has his domicile in Switzerland was recognized by para. 5.1.3 of the draft of May 26, 2005, for Circular No. 30; however, it was reserved for a tax avoidance scheme. Böckli believes trust property and trust income should be attributed to the settlor in the case of a Swiss resident settlor who transfers assets to no-man's-land (*Niemandsland*). Böckli, *supra* note 5, at 779 and 785. Para. 5.1.1.2 of Circular No. 30 is also based on this approach.

light of the developments in European tax law regarding the principle of equal treatment.[35]

As noted above, Circular No. 30 states that in the case of settlement of an irrevocable discretionary trust, the transfer of the trust property by the settlor to the trustee is treated as a gift by the settlor.[36] Circular No. 30 does not say to whom this gift is made.[37] The question is not one of relevance, because the settlor has his domicile abroad when the trust is settled and, thus, a Swiss gift tax liability is not triggered.[38] However, this transfer only transfers legal ownership to the trustee. It is not to be treated as a gift of trust property to the trustee for purposes of Swiss gift taxes, because the settlor does not want to make a gift to the trustee and the trustee is not enriched.[39] If a revocable trust becomes an irrevocable discretionary trust on the settlor's death and the settlor's last domicile was in a Swiss canton, the cantonal tax administration might not treat the trust as fiscally transparent for purposes of Swiss inheritance taxes and might tax the transfer of trust property to the trustee at a rate for nonrelated persons. It seems that, unlike with Swiss gift taxes, the mere transfer of trust property based on the Swiss law of succession triggers Swiss inheritance taxes. However, according to a ruling issued by the Federal Tribunal, Swiss inheritance taxes implement the ability-to-pay principle together with Swiss income and gift taxes so that the taxpayer is taxed on all income.[40] The tax base of inheritance taxes is the value of the property that the taxpayer receives. Therefore, it seems inheritance taxes may not be triggered until the trust property is forwarded to the beneficiary. And the trust property was most likely already transferred to the trustee when the revocable trust was settled. Consequently, there is no legal transfer of trust property on the settlor's death. Therefore, the principle of transparency is also applicable to Swiss gift and inheritance taxes.

According to Circular No. 30, the later forwarding of trust property and trust income to the beneficiary (who is subject to Swiss unlimited tax liability) is subject to Swiss income tax, unless the beneficiary proves that the trust property was already treated as a gift to the beneficiary when the trust was settled.[41] The term ''gift'' is not to be construed in the sense of the nonharmonized Swiss cantonal and communal gift and inheritance taxes, but is defined according to Swiss harmonized law on direct taxes. It seems the Swiss Tax Conference wants to treat the later forwarding of trust property as being free from income tax, in which case the initial transfer would have been subject to Swiss gift taxes if the settlor had his domicile in Switzerland when the irrevocable discretionary trust was settled. This reservation should also apply regarding Swiss inheritance taxes if the irrevocable discretionary trust is settled on death. Further, forwarding of trust income that stems from capital gains derived from movable private property should also be tax free in the hands of a beneficiary that is subject to unlimited tax liability in Switzerland, similar to an irrevocable fixed-interest trust. A transformation of trust income into other income and thus taxable income as stated in Circular No. 30 is contrary to the principle of transparency of trusts.[42] If the trust (or trustee) was already subject to income tax abroad on forwarded trust income, that trust income should also be treated as being free from income tax in the hands of a beneficiary that is subject to Swiss unlimited tax liability.[43]

The possibility of a tax deferral by virtue of an irrevocable trust when trust property is transferred to abeyance may be counteracted only by a specific statutory provision. For example, trust property might still be fiscally attributed to the settlor for purposes of Swiss direct taxes as well as Swiss gift and inheritance taxes similar to foreign tax laws (so-called grantor trust or settlor rule).[44] A taxable event for purposes of Swiss gift and inheritance taxes might be assumed already when the trust is settled when the tax rate for nonrelated persons is applied, unless the beneficiaries are already clearly determinable. It seems impractical to defer Swiss gift and inheritance taxation until the trustee forwards the trust property or trust income. The

[35]*See* Marcel R. Jung, ''The Switzerland-EC Agreement on the Free Movement of Persons: Measures Equivalent to Those in the EC Treaty — A Swiss Income Tax Perspective,'' *European Taxation* (2007), p. 508.

[36]Para. 5.2.3 of Circular No. 30.

[37]In contrast, para. 5.2.3 of the draft of May 26, 2005, for Circular No. 30 treated the transfer as a gift by the settlor to the beneficiary or the trust itself.

[38]Almost all Swiss cantons levy gift and inheritance taxes. Some Swiss cantons tax the estate without taking account of the heirs (estate tax); most Swiss cantons, however, take into account the relationship for purposes of the tax rate (inheritance tax). In a few cantons, the communes also have the right to levy gift and inheritance taxes. Cantonal and communal gift and inheritance tax liability may be triggered if the donor has his domicile in a Swiss canton, the deceased had his last domicile in a Swiss canton, or if immovable property situated in a Swiss canton is transferred. Almost all cantons have exempted the gift and inheritance tax of spouses and children.

[39]Böckli, *supra* note 5, at 719. Most Swiss cantons interpret the term ''gift'' to have the meaning it has in civil law according to article 239 of the Swiss Federal Code of Obligation of March 30, 1911. Therefore, a gift is an *inter vivos* transfer by virtue of which a person is enriched (*bereichert*) from the wealth of another person.

[40]Federal Tribunal, Nov. 5, 2002, 2P.168/2002, para. 5.2. *See also* Amonn, *supra* note 5, at 493.

[41]Para. 5.2.3 of Circular No. 30.

[42]Böckli, *supra* note 5, at 783.

[43]It seems the FTA applies such a treatment. *See* Ryser, *supra* note 1, at 322.

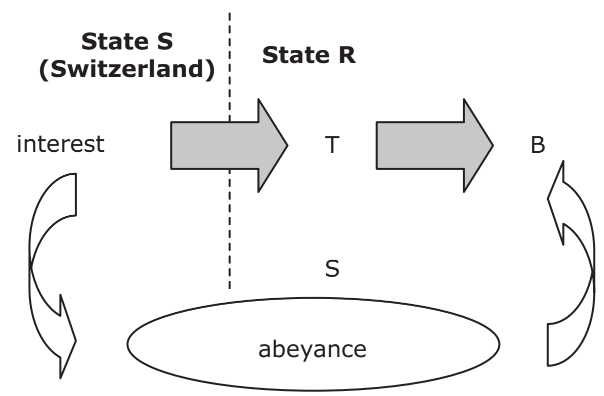
[44]*See* Böckli, *supra* note 5, at 779 and 785.

question of limited tax liability for purposes of Swiss direct taxes by a trust or trustee should also be addressed by statutory law, because this legal uncertainty is unacceptable.

Bilateral Attribution Rules. The treaty attribution rules laid down in articles 5 and 7 (business income), 10, 11, and 12 (dividends, interest, and royalties), 13 (capital gains), 21 (other income), and 22 (capital) of the OECD model are of primary interest here. Articles 10(1) and 11(1) of the OECD model include the term ''paid to'' for the purpose of treaty attribution rules. This term is also included in articles 10(1), 11(1), and 12(1) of the Canada-Switzerland tax treaty and the New Zealand-Switzerland tax treaty. Articles 10(1), 11(1), and 12(1) of the Switzerland-U.S. tax treaty and the Switzerland-U.K. tax treaty include the term ''derived by.'' The following two cases illustrate the Swiss *lex fori* interpretation of treaty attribution rules based on an example of interest income.

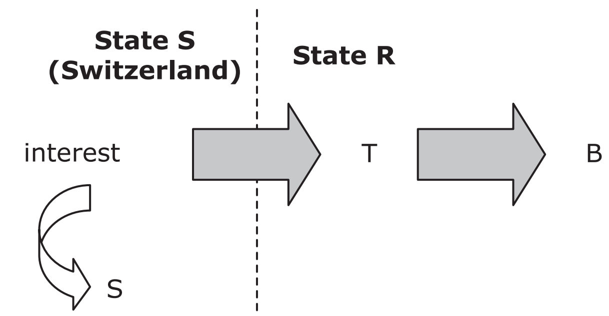
Returning to base case 1 in which Switzerland is the source state, assume an irrevocable discretionary trust was settled by a non-Swiss resident settlor. T is the trust (or trustee) and is resident in State R. S is its settlor and also resident in State R. In year 1 the trust receives Swiss-source interest that is subject to Swiss withholding tax. State R attributes Swiss-source interest to the trust (or trustee) that is subject to income tax in State R. In year 7 the trustee forwards trust income derived from Swiss-source interest to B. The question arises as to whether Switzerland grants relief from Swiss withholding tax in year 1. (See Figure 6.)

Figure 6



Based on the Swiss *lex fori* attribution rules, Swiss-source interest is not yet attributed to someone from a Swiss perspective. Therefore, in year 1 no one has access to the State R-Switzerland tax treaty regarding relief from Swiss withholding tax on the Swiss-source interest. This example illustrates that attribution conflicts between Switzerland as the source state and the foreign residence state may lead to double taxation of trust income. If, however, Swiss-source interest is forwarded to the beneficiary that is resident in State R within the time limit within which a request on relief from Swiss withholding tax may be filed under the State R-Switzerland tax treaty, and such a request is filed by the beneficiary, Switzerland should give treaty relief, provided the beneficiary is able to give evidence about the forwarding.[45] (See Figure 7.)

Figure 7



Let's assume the trust was settled by a Swiss resident settlor. Again the question arises as to whether Switzerland grants relief from Swiss withholding tax in year 1. The Swiss *lex fori* attribution rules attribute the Swiss-source interest to the settlor. Therefore, the settlor is subject to Swiss residence taxation on the Swiss-source interest and is entitled to relief from Swiss withholding tax based on Swiss domestic tax law (VStG).[46] The trust income is subject to residence taxation twice (double residence taxation). This example also illustrates that attribution conflicts between Switzerland as the source state and the foreign residence state may lead to double taxation of trust income.

2. Contextual Interpretation

As illustrated above, Swiss *lex fori* interpretation of treaty attribution rules may lead to double taxation of trust income. However, the main purpose of tax treaties is the avoidance of international juridical double taxation.[47] International (economic) double taxation of trust income does not fall into the definition of international juridical double taxation because trust income

[45]In general, the request must be filed with the FTA within three years after the end of the calendar year in which the taxable income was due.

[46]Para. 7.2.3 of Circular No. 30.

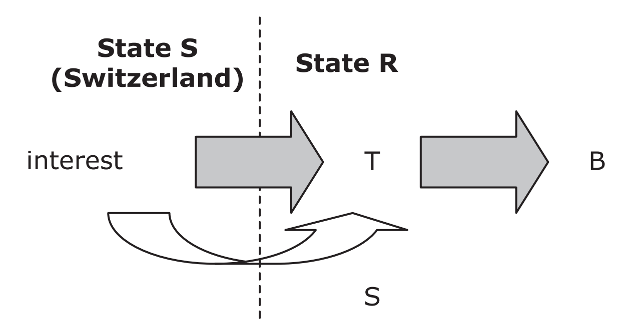
[47]*See* para. 3 of the introduction of the OECD commentary to the OECD model.

is taxed in the hands of two different taxpayers.[48] Nevertheless, such attribution conflicts should be avoided.[49]

Article 3(2) of the OECD model states that any term not defined in the convention will have the meaning that it has at that time under the law of the state applying the convention for the purposes of the taxes to which the convention applies, unless the context otherwise requires. Paragraph 6.3 to article 1 of the OECD commentary to the OECD model refers to the principle that the source state should take into account how an item of income, arising in its jurisdiction, is treated in the jurisdiction of the person claiming the benefits of the convention as a resident. This principle originates from the OECD 1999 Report on the Application of the OECD Model Tax Convention to Partnerships.

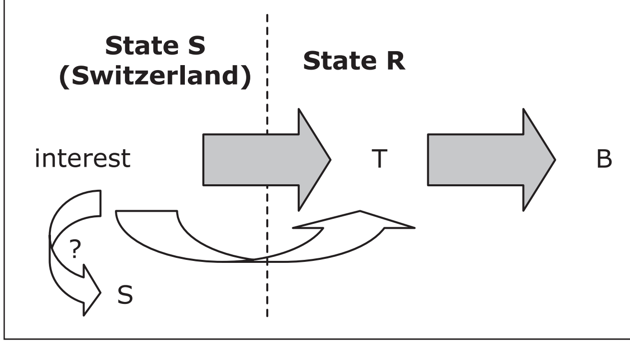
It seems that the FTA (according to paragraph 8.2 of Circular No. 30 regarding refund of Swiss withholding tax by a person resident in a contracting state) applies such a contextual interpretation. Thus, the contextual interpretation of treaty attribution rules for purposes of Swiss withholding tax is not based on the principle of fiscal transparency of Circular No. 30 if Switzerland is the source state. Only paragraph 8.3 of Circular No. 30 regarding relief from foreign withholding tax by a Swiss resident person expressly states that the income must be fiscally attributed according to the attribution rules of Circular No. 30.

Figure 8



Let's apply the contextual interpretation to the example of the irrevocable discretionary trust that was settled by a non-Swiss resident settlor. (See Figure 8.) Switzerland applies the attribution rules of State R. Switzerland attributes Swiss-source interest to T. Therefore, T is entitled to relief from Swiss withholding tax under the State R-Switzerland tax treaty. Conclusively, the contextual interpretation of treaty attribution rules may help avoid attribution conflicts and thus double taxation of trust income.

Figure 9



If we assume the trust was settled by a Swiss resident settlor and Switzerland applies a contextual interpretation, Switzerland attributes Swiss-source interest to T for purposes of relief from Swiss withholding tax. (See Figure 9.) Therefore, T is entitled to relief from Swiss withholding tax under the State R-Switzerland tax treaty. The question is whether a contextual interpretation of treaty attribution rules may limit Switzerland's domestic rights to tax S, who is subject to unlimited tax liability, or whether the Swiss *lex fori* attribution rules of Circular No. 30 are applicable for purposes of residence taxation. If Circular No. 30 was not applicable, S would not be subject to tax on the trust income even though S is subject to unlimited tax liability in Switzerland. However, it seems that a contextual interpretation of treaty law does not limit the unilateral rights of a state to tax its own residents; therefore, double taxation of trust income is not avoided for an irrevocable discretionary trust settled by a Swiss resident settlor (double residence taxation).[50]

D. Beneficial Ownership of Trustee

1. Beneficial Ownership

Treaty relief requires not only residence and fiscal attribution, but also beneficial ownership. Articles 10(2), 11(2), and 12(1) of the OECD model mention the requirement of beneficial ownership. This requirement is also mentioned in articles 10(1) and (2), 11(1) and (2), and 12(1) and (2) of the Switzerland-U.S. tax treaty, Switzerland-U.K. tax treaty, New Zealand-Switzerland tax treaty, and Canada-Switzerland tax

[48] *Id.* at para. 1.

[49] *See* Danon, *supra* note 1, at 316 and 324; *see also* Baker 2002, *supra* note 18, at 1.

[50] *See* para. 6.1 to article 1 of the OECD commentary to the OECD model.

treaty. Nevertheless, under FTA's practice, the beneficial ownership concept is implicitly included in tax treaties and therefore applies even in the absence of a treaty provision.[51] Paragraph 8.1 of Circular No. 30 refers to the requirement of the effective beneficial owner (*tatsächlich Begünstigter*).

The question arises as to whether the meaning of beneficial ownership is to be construed according to the laws of the source state (*lex fori* interpretation), or to a contextual interpretation. And if trust income is fiscally attributed to the trust (or trustee), is the trustee to be considered the beneficial owner of the trust income?

2. Contextual Interpretation

An increasing number of people in international tax law believe the term ''beneficial owner'' should be given an autonomous meaning (international fiscal meaning).[52] In its ruling of February 28, 2001, the Federal Court of Appeal for Taxation referred to a contextual interpretation according to article 31 of the Vienna Convention on the Law of the Treaties and adopted an autonomous meaning.[53] The court held that the beneficial owner is the person that can benefit from a payment, and not one that receives it subject to an obligation to transfer it to a third person.[54] The Federal Tribunal has not yet issued a (published) ruling on the matter.

Paragraph 13 to article 10(2) of the OECD commentary to the OECD model states that agents and nominees do not qualify as beneficial owners. In contrast to the extensive substance-over-form approach in the administrative practice of Swiss withholding tax law (VStG), many believe the term ''beneficial owner'' should be construed so as to exclude agents and nominees only.[55] Robert J. Danon defines beneficial owner as ''the person who legally, economically, or factually has the power to control the attribution of the income.''[56] He notes that beneficial ownership does not require the recipient of the income to be able to receive the economic benefits of the income — the recipient is free to decide whether and to whom the yield is to be distributed, gifted, or passed. Therefore, a trustee should be considered the beneficial owner of the trust income if the trustee has the power to control the attribution of the trust income under common law and thus is neither an agent nor a nominee.[57] Similar views are held by Philip Baker and John Prebble.[58]

A trustee is not to be considered the beneficial owner under articles 10, 11, and 12 of the OECD model in the case of an irrevocable fixed interest trust or an irrevocable discretionary current trust. However, in the case of an irrevocable discretionary accumulation trust, the trustee should be considered the beneficial owner. It seems the FTA treats a trustee as the beneficial owner in the case of an irrevocable discretionary accumulation trust.[59]

A rule is laid down in paragraph 3(b) of the protocol to the New Zealand-Switzerland tax treaty. For the purposes of articles 10, 11, and 12, in determining whether dividends, interest, or royalties are beneficially owned by a resident of New Zealand, such income that a trustee is subject to tax in New Zealand will be treated as being beneficially owned by that trustee. This means that a New Zealand resident trustee is considered the beneficial owner of Swiss-source trust income under articles 10, 11, and 12 of the New Zealand-Switzerland tax treaty if the trustee is subject to tax in New Zealand regarding Swiss-source income. This special treaty provision should also be applicable to an irrevocable fixed interest trust or an irrevocable discretionary current trust.

E. Limitation on Benefits

Article 22 of the Switzerland-U.S. tax treaty provides a specific treaty provision for limitation on benefits. Article 22(1)(f) includes a predominant interest test.[60] According to this test, a person that is a resident of a contracting state may claim treaty benefits only when that person is a trust, unless one or more persons that are not entitled to the treaty benefits are, in the aggregate, the ultimate beneficial owners of a predominant interest in the trust. The predominant interest test requires that no more than 50 percent of the treaty-protected income can be paid to persons that are not treaty protected.[61]

If the Swiss-source trust income is fiscally attributed to the settlor or the beneficiary from the U.S. point of

[51]FTA guidelines of July 15, 2005, on article 15(1) of the EC-Switzerland savings tax agreement, para. 10(a).

[52]The U.K. Court of Appeal referred in its *Indofood* ruling on March 2, 2006, to Philip Baker's definition of beneficial ownership. *See Indofood International Finance Ltd. v. JP Morgan Chase Bank N.A.*, [2006] EWCA Civ 158, para. 37. *See also Prevost Car Inc. v. The Queen*, 2008 TCC 231.

[53]Federal Court of Appeal for Taxation, *supra* note 17, at para. 7.b; *see also* Philip Baker, ''Beneficial Ownership: After Indofood,'' *GITC Review* (2007), Vol. VI, No. 1, p. 15.

[54]Federal Court of Appeal for Taxation, *supra* note 17, at para. 7.b.aa.aaa.

[55]*See* Baker 2007, *supra* note 53.

[56]Danon, *supra* note 1, at 339.

[57]*Id.* at 340.

[58]Baker 2002, *supra* note 18, at 17; John Prebble, ''Accumulation Trusts and Double Tax Conventions,'' *British Tax Review* (2001), p. 76.

[59]*See* Ryser, *supra* note 1, at 315.

[60]*See* Markus F. Huber and Matthew S. Blum, ''Limitation on Benefits Under Article 22 of the Switzerland-U.S. Tax Treaty,'' *Tax Notes Int'l*, Aug. 8, 2005, p. 547.

[61]*Id.* at 558. *See also* para. 22 of the U.S. Treasury Department technical explanations to article 22.

view, there is no application of the predominant interest test at the trust level. The settlor or the trustee satisfy the test in article 22(1)(a) of the Switzerland-U.S. tax treaty if they are individuals. However, if the Swiss-source trust income is fiscally attributed to the trust itself, the trust must fulfill the predominant interest test. The predominant interest test should be met if the beneficiaries do not receive and do not have the right to receive trust income from the trust.

III. Switzerland: Residence State

A. Principle of Fiscal Transparency

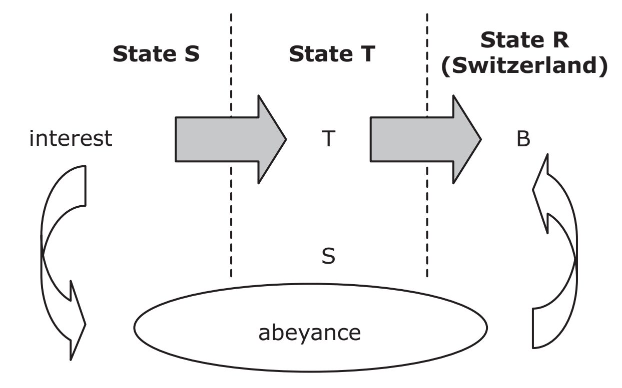
As mentioned above, paragraph 8.3 of Circular No. 30 regarding relief from foreign withholding tax by a Swiss resident person states that the income must be fiscally attributed according to the Swiss attribution rules of Circular No. 30. Thus, the FTA applies a Swiss *lex fori* interpretation of treaty attribution rules when Switzerland is the residence state. In the author's view, this administrative practice complies with an autonomous interpretation of the treaty attribution rules. According to the Swiss attribution rules, trust income is fiscally attributed either to the settlor or the beneficiary, but not to the foreign trust (or trustee). Therefore, only a Swiss resident settlor or a Swiss resident beneficiary is subject to income tax liability in Switzerland (residence taxation) on trust income. If an irrevocable discretionary trust was settled by a non-Swiss resident settlor, the Swiss resident beneficiary is not immediately subject to income tax liability in Switzerland on the trust income. According to Circular No. 30, later forwarding of trust property and trust income to the beneficiary are subject to Swiss income taxation, unless the Swiss resident beneficiary shows that the trust property was already treated as a gift to the beneficiary when the trust was settled.[62]

Switzerland as the residence state applies the Swiss attribution rules of Circular No. 30.[63] If there is no attribution conflict between Switzerland and the foreign contracting state, the Swiss resident recipient should be entitled to treaty relief from foreign withholding tax according to the State S-Switzerland tax treaty. The Swiss resident recipient should also be entitled to a Swiss foreign tax credit regarding any residual foreign withholding tax.[64]

B. Foreign Withholding Tax on Trust Income

Let's return to base case 2, in which Switzerland is the residence state. An irrevocable discretionary trust was settled by a non-Swiss resident settlor. T is the trust (or trustee), and in the alternative scenario is resident in State T (triangular situation). S is the settlor and is also resident in State T. In year 1 the trust receives interest sourced in State S that is subject to withholding tax. State T attributes the interest to the trust (or trustee) that is subject to income tax in State T. In year 7 the trustee forwards trust income to B. The question is whether Switzerland issues a residence certificate for relief from foreign withholding tax in year 1. (See Figure 10.)

Figure 10



According to paragraph 8.3 of Circular No. 30, a residence certificate is issued only if the trust income is fiscally attributed to a Swiss resident person. In an irrevocable discretionary trust that was settled by a non-Swiss resident settlor, the trust income is not yet fiscally attributed to the Swiss resident beneficiary. Accordingly, the Swiss resident beneficiary will not receive a Swiss resident certificate and thus will have no access to the State S-Switzerland tax treaty. Attribution conflicts between Switzerland (the residence state) and the foreign sourced state may also lead to double taxation of trust income. However, the tax treaty concluded between State S and State T as the residence state of the trust (or trustee) might be applicable. Double taxation may also arise if the later forwarding of trust income to the beneficiary is liable to income tax in Switzerland (double residence taxation). As noted above, that forwarding should be tax free in Switzerland if the trust (or trustee) was already subject to income tax abroad on this trust income. If the foreign-source interest is forwarded to the Swiss resident beneficiary within the time limit within which a request on relief from foreign withholding tax may be filed under the State S-Switzerland tax treaty and that request is filed by the beneficiary, Switzerland should issue a residence permit provided the beneficiary gives evidence about the forwarding. (See Figure 11.)

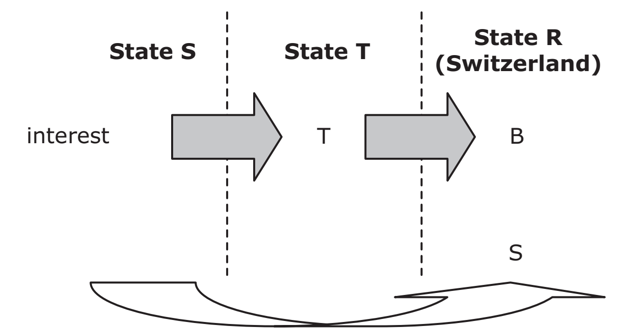
Let's assume the irrevocable discretionary trust was settled by a Swiss resident settlor. In that case, trust

[62]Para. 5.2.3 of Circular No. 30.

[63]Para. 8.3 of Circular No. 30.

[64]*See* article 2(1) of the ordinance of August 22, 1967, on the tax credit issued by the federal government, SR 672.201.

Figure 11



income is attributed to the settlor, and the settlor will receive a Swiss residence certificate. From a Swiss perspective, the Swiss resident settlor should be entitled to relief from withholding tax levied in State S according to the State S-Switzerland tax treaty. Double taxation may still arise if State S attributes the interest income to T (attribution conflict between the foreign sourced state and Switzerland as the residence state) or State T attributes interest income to T (double residence taxation).

C. Foreign Withholding Tax on Trust Distribution

Article 10(7) of the Canada-Switzerland tax treaty provides for a specific treaty provision for income obtained by a resident of Switzerland from a trust that is a resident of Canada. According to this provision, the limitation of Canada's taxing right for dividends in article 10 of the Canada-Switzerland tax treaty is also applicable to income derived from a trust that is a resident of Canada. This provision secures Canada's taxing right for trust distributions from a Canadian resident trust.[65] To avoid double taxation in Switzerland as the residence state, the term ''dividend'' in article 22 of the Canada-Switzerland tax treaty also includes income derived from a trust that is a resident of Canada.

According to paragraph 15 of the OECD commentary to article 21 of the OECD model, the United Kingdom has entered a reservation concerning the right to tax income paid from a trust to a nonresident person. Thus, article 21(1) of the Switzerland-U.K. tax treaty states that income paid from a trust may also be taxed in the source state.

IV. Conclusions

There is a lack of provisions in Swiss tax treaties addressing the complex issues of trusts and tax treaties. Attribution conflicts between Switzerland and foreign contracting states may lead to double and multiple taxation of trust income. That may be avoided through tax planning. As a basic rule, the foreign trust should not directly invest in foreign assets if the foreign-source income is not subject to foreign withholding tax. Therefore, trusts often indirectly invest through an underlying company. However, the offshore underlying company raises questions about place of residence and access to the treaty network.

If Switzerland is the source state, Swiss-source trust income may be attributed to the trust (or trustee) resident in the foreign contracting state based on a contextual interpretation of treaty attribution rules. If Switzerland is the source state, contextual interpretation of treaty attribution rules for purposes of Swiss withholding tax is not based on the principle of fiscal transparency of Circular No. 30. A trustee should be considered the beneficial owner of the Swiss-source trust income if the trustee has the power to control the forwarding of the trust income.

The Swiss attribution rules of Circular No. 30 for irrevocable discretionary trusts may lead to attribution conflicts and double (or multiple) taxation. Even if Switzerland as the source state applies a contextual interpretation of the treaty attribution rules, there may be double taxation of Swiss-source trust income if the trustee is subject to tax in a foreign state and the settlor is subject to tax in Switzerland (double residence taxation). A Swiss resident beneficiary is not entitled to relief from foreign withholding tax since the trust income is not attributed to the beneficiary according to the Swiss *lex fori* attribution rules of Circular No. 30. Further, double taxation may arise if the trustee is subject to tax on trust income abroad, and either the beneficiary, upon the later forwarding of trust income, or the settlor, upon the later forwarding of trust income, is subject to Swiss income tax (double residence taxation).

A Swiss resident trustee has *de lege lata* — in contrast to trustees who are resident in common law jurisdictions — no access to Swiss treaty law and is not entitled to relief from foreign withholding tax or Swiss withholding tax. In light of the increasing importance of onshore financial services, a Swiss trustee's lack of treaty access might become a disadvantage in the international context. ◆

[65] *See also* article 21 of the OECD model regarding other income that may be taxed only in the state of residence; and para. 13 of the OECD commentary on article 21 of the OECD model, according to which Canada has entered a reservation to tax income arising from sources in its own country.