Switzerland

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Trusts in International Taxation: New Tax Rules

This article considers the taxation of trusts in Switzerland in various cross-border contexts. In addition to examining the treatment under Swiss treaties, special attention is paid to the impact of the OECD Model Convention and other OECD developments.

1. Introduction

1.1. Trusts and treaties

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

1.2. The Hague Trust Convention

Although foreign trusts were broadly recognized in Switzerland, the former legal situation was still uncertain. On 26 April 2007, Switzerland ratified the Convention of 1 July 1985 on the Law Applicable to Trusts and on Their Recognition (the Hague Trust Convention); it was enacted effective from 1 July 2007.[2] However, a trust is still not a legal body under Swiss law, even after the enactment of the Hague Trust Convention and the amendments to the Swiss Federal Private International Law Act (IPRG) of 18 December 1987, and to the Swiss Federal Debt Enforcement and Bankruptcy Act (SchKG) of 11 April 1989.

Chapter 1, Art. 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 question arises as to whether it affects the treatment of foreign trusts under Swiss national and international tax law.[4]

1.3. Circulars 30 and 20 on Trusts

Domestic tax law contains no specific provisions dealing with the treatment of foreign trusts. The Swiss Tax Conference issued Circular 30 on the Taxation of Trusts on 22 August 2007.[5] It outlines and interprets the Swiss fiscal attribution rules under the Federal Acts of 14 December 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, while 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 30 will harmonize the different practices applied by cantonal tax administrations. Circular 30 does not address cantonal and communal gift and inheritance taxes, as indirect taxes have not been harmonized by virtue of the StHG.

Circular 30 also outlines the practice of the Federal Tax Administration (FTA) regarding relief from federal withholding taxes:

- under the Federal Act of 13 October 1965 (VStG), by Swiss persons that are subject to Swiss tax liability; and
- under treaties by persons resident in a foreign contracting state.

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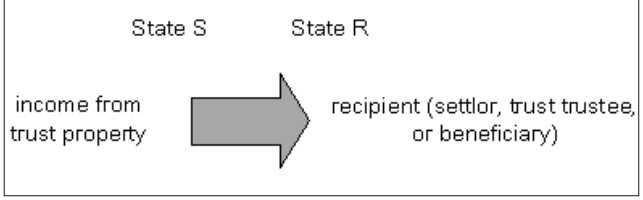
1. See Walter Ryser, "Trusts and Double Taxation Treaties Concluded by Switzerland", *Archiv für Schweizerisches Abgaberecht* (1996-1997), at 309; Robert J. Danon, *Switzerland's Direct and International Taxation of Private Express Trusts* (Zurich/Basel/Geneva: Schulthess, 2004); Robert J. Danon, "L'Imposition 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), at 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, at 1.
2. Convention of 1 July 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 International* (3 September 2007), at 908; Filippo Noseda, "Praktische Auswirkungen des Haager Trust-Übereinkommens für den Schweizer Trustee, Protector, Trust Administrator und Investment Adviser", *Aktuelle Juristische Praxis* (2006), at 482; Filippo Noseda, "Switzerland and the Hague Trust Convention: Where Are We?", *Trust Law International* (2005), at 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), at 2.
4. Art. 19 Hague Trust Convention.
5. See Peter R. Altenburger and Thierry V.A. Boitelle, "Switzerland Issues Guidelines for Taxation of Trusts", *Tax Notes International* (29 October 2007), at 441; Peter Böckli, "Der angelsächsische Trust – Zivilrecht und Steuerrecht", Part I, *SteuerRevue* (2007), at 710, and Part II, *SteuerRevue* (2007), at 774; Filippo Noseda, "Taxation of Trusts in Switzerland: New Clouds on the Horizon", *Trust Law International* (2006), at 8; Philipp Betschart, "Grundzüge der Trustbesteuerung – Dargestellt Anhand der Praxis des Kantons Zürich", *SteuerRevue* (2007), at 158; Danon, 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), at 475; and Toni Amonn, "Trustbesteuerung in der Schweiz – Eine Standortbestimmung", *Archiv für Schweizerisches Abgaberecht* (2008), at 493.

It also outlines the practice of the FTA regarding treaty-based relief from foreign withholding tax by Swiss resident persons. The FTA noted in Circular 20 of 27 March 2008 that the rules in Circular 30 are also applicable to federal income and withholding tax.

1.4. Principles of international taxation

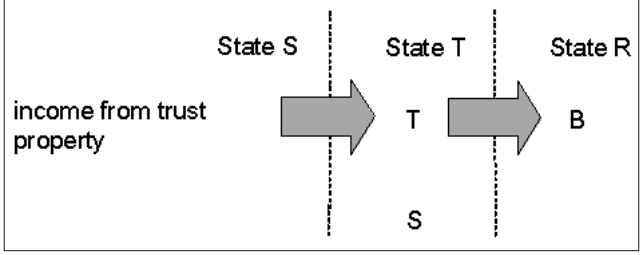
The basic principles of international taxation are briefly outlined below, including source taxation versus residence taxation and the avoidance of international double taxation. See Figure 1.

Figure 1



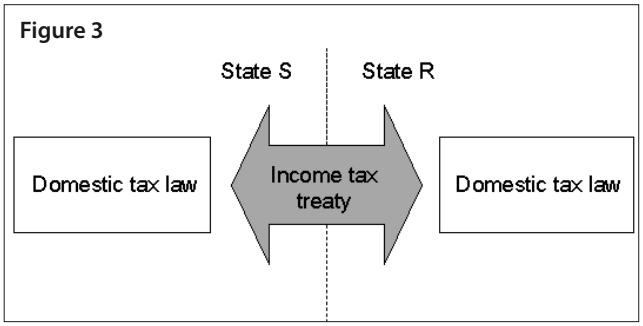
State *S* levies withholding tax on investment income sourced in its own state. The State *R* resident recipient of the trust income is subject to withholding tax in State *S* on the investment income (source taxation). Also, State *R* taxes the recipient of the trust income based on the principle of worldwide income (residence taxation). The recipient of the trust income is subject to double taxation regarding State *S*-source income from trust property. This can be illustrated as follows:

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. This can be illustrated as follows:

Figure 3

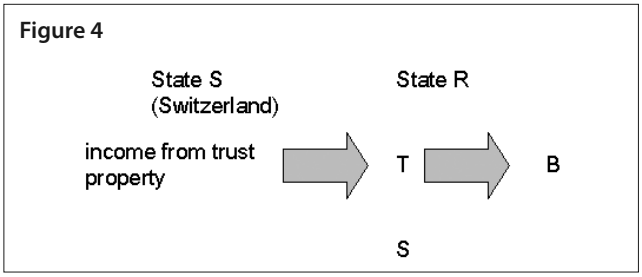


To avoid international double taxation, States *S* and *R* may enter into a treaty. Tax treaties limit the unilateral taxing rights of the contracting states, and a treaty may fully or partially limit State *S*'s taxing right. If State *S*'s taxing right is not fully limited, double taxation may still arise. To avoid that, State *R* may apply two methods:[6] it may either exempt State *S*-source income from its domestic income tax (either full exemption or exemption with progression), or it may tax the State *S*-source income, but allow a deduction from its own income tax for the tax paid in State *S* (either full credit or ordinary credit).

1.5. Treaty protection of trust income?

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 4

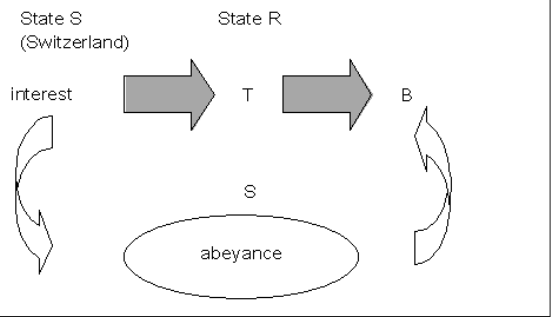


In base case 2, a foreign trust *directly* invests in assets in State *S* and obtains income that is subject to withholding tax in State *S*. See Figure 5. The settlor and the trustee are resident in State *S*. The trustee forwards the income from trust property to the Swiss-resident beneficiary. In 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 sett-

6. See Para. 12 OECD commentary on Arts. 23A and B OECD Model.
7. See Art. 4 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 Art. 94 DBG and Art. 35(1)(e) StHG.

lor 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). As treaty relief requires residence of the settlor or beneficiary in Switzerland, this answer also depends on fiscal attribution rules.

Figure 5



1.6. Issues

The two base cases raise the following questions with regard to Swiss treaties:

- Does a foreign trust fall under the personal scope of a Swiss treaty?
- Is a trust or a trustee resident under a Swiss 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?

2. Switzerland as source state

2.1. Personal scope of treaties

2.1.1. Trusts expressly included

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

2.1.2. Trusts not expressly included

Switzerland has concluded treaties with common law jurisdictions that do not include trusts in their personal scope. For example under Art. 3(1)(e) of the Switzerland–United Kingdom treaty, the term "person" includes any individual, company, unincorporated body of persons, and any other entity with or without legal personality. Similarly, Art. 3(1)(c) of the New Zealand–Switzerland 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]

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

In the author's opinion, however, Switzerland should uniformly apply treaties to trusts. Switzerland has concluded its treaties based on the OECD Model. Switzerland also recognizes foreign trusts under the Hague Trust Convention. At a meeting of the International Tax Planning Association (ITPA) in 1993, Philip Baker argued that because Art. 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 trusts. An increasing number of authors in international tax law literature believe that the term "person" should include trusts.

In the author's opinion, the meaning of "trust" should be construed under 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 treaties.[12]

2.2. Residence of trust or trustee

A treaty is applicable only to persons that are resident in one or both of the contracting states.[13] A resident of a contracting state is any person that, under the laws of that state, is liable to tax therein by reason of that person's 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]

8. See Art. 3(1)(a) OECD Model.
9. Para. 8.1. Circular 30.
10. See also Ryser, note 1, at 313.
11. Art. 3(2) OECD Model and Art. 31 Vienna Convention.
12. This interpretation of the term "body of persons" is applicable for Swiss treaty purposes only, not for purposes of Swiss domestic tax law, and specifically not for Art. 11 of the DBG and Art. 20(2) of the StHG. Under Para. 4.1 of Circular 30, a trust does not qualify as a foreign legal entity under Art. 49(3) of the DBG or as a body of person under Art. 11 of the DBG and Art. 20(2) of the StHG.
13. See Art. 1 OECD Model.
14. See Art. 4(1) OECD Model.
15. See e.g. rules for simple trusts in IRC Sec. 641 and complex trusts in IRC Sec. 661.
16. Para. 8.2. Circular 30.

On 28 February 2001, the Federal Court of Appeal for Taxation issued a ruling in a treaty shopping case. The Court considered a company incorporated in Luxembourg to be resident in Luxembourg under the Luxembourg–Switzerland treaty, although it passed the Swiss-source income to non-residents 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 of trust income to beneficiaries are tax deductible. Insofar as the distributions are tax deductible, the trust is fiscally treated as transparent. Therefore, in the author's opinion, 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 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 under a contract.[21]

In contrast to what is found in some common law jurisdictions, Swiss tax law contains no specific provisions in which a foreign trust (or trustee) is treated as a separate taxpayer. For the trustee, Circular 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 beneficial) owner of the trust property.

The fiscal attribution rules of Circular 30 are correct – trust property and trust income are attributed to either 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. Under Circular 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 under Swiss tax law.[26] However, the remuneration paid to the trustee is subject to Swiss individual or corporate income tax if the trustee is a Swiss taxpayer.[27]

In light of the Hague Trust Convention, Para. 5.11 of the draft of Circular 14 proposed a change in administrative practice regarding trusts for Swiss VAT purposes. Therefore, the place of supply of services (under Art. 14(3) of the VAT Act of 2 September 1999) that are provided by third parties or the trustee in favour of the trust is the place where the beneficiary has its 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, as the trust is the legal owner of the 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 Swiss VAT purposes.

2.3. Personal attribution of trust income

2.3.1. Lex fori *interpretation*

2.3.1.1. Foreign attribution rules

As noted above, common law jurisdictions may treat a trust as a separate taxpayer.[29] The place of residence of

17. Federal Court of Appeal for Taxation, 28 February 2001, *SteuerRevue* (2002), at 30, Para. 3.c.; see unofficial translation in *International Tax Law Reports* (2002), at 191.
18. See Philip Baker, "The Application of the Convention to Partnerships, Trusts and Other Non-Corporate Entities", *GITC Review* (2002), Vol. II, 1, at 23.
19. Para. 4.1. Circular 30.
20. See Federal Tribunal, 29 January 1970, *Harrison c. Schweizerische Kreditanstalt*, BGE 96 II 88; Urs Landolf and Thomas Graf, "Der Trust im Schweizerischen Steuerrecht", *Archiv für Schweizerisches Abgaberecht* (1994), at 21; Betschart, note 5, at 158.
21. Böckli, note 5, at 712.
22. For a different position, see Betschart, note 5, at 163. Under 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 the effective place of management. In the author's opinion, those views are outdated. They do not comply with the Hague Trust Convention. And they no longer comply with Circular 30, which was issued by the Swiss Tax Conference on 22 August 1997, and was confirmed by the FTA for purposes of federal income tax on 27 March 2008.
23. Para. 2.2. Circular 30.
24. Para. 4.2. Circular 30.
25. Para. 4.1. Circular 30. A trust does not qualify as a foreign legal entity under Art. 49(3) of the DBG or as a body of persons under Art. 11 of the DBG and Art. 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. Under FTA 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. Circular 30. If the trustee is an individual, he derives income from a self-employed activity.
28. The trustee may be disregarded, under Paras. 5.4.4 and 5.11 of Draft Circular 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 Internal Revenue Code (IRC) Sec. 641 and complex trusts in IRC Sec. 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), at 52.

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 Art. 10(7) of the Canada–Switzerland treaty states that Art. 10 will also apply to income obtained by a Swiss resident from a Canadian-resident trust. Art. 4(1)(d) of the Switzerland–United States treaty has adopted the principle of transparency for treaty purposes; 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–United States treaty if the settlor, the trust or the beneficiary is subject to tax on trust income as a US resident.

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

2.3.1.2. Swiss attribution rules

Circular 30 is based on the principle of fiscal transparency of trusts for purposes of Swiss direct taxes. Fiscal transparency means that 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 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 30 treats differently a settlor that is subject to Swiss unlimited tax liability and a settlor that 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 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 under common law. Under applicable Swiss direct tax law, trust property and trust income may not be fiscally attributed to the trust or the trustee.

Under Circular 30, only a settlor that lives abroad may definitively shift its wealth to abeyance.[34] The non-recognition 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 light of the developments in European tax law regarding the principle of equal treatment.[35]

As noted above, Circular 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 30 does not specify to whom this gift is made.[37] The question is not one of relevance, as the settlor has its 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 Swiss gift tax purposes, as the settlor does not wish to make a gift to the trustee and the trustee is not enriched.[39] If a revocable trust becomes an irrevocable discretionary trust upon 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 Swiss inheritance tax purposes, and might tax the transfer of trust property to the trustee at a rate for non-related persons. It seems that, unlike with Swiss gift tax, the mere transfer

30. Para. 5.2.1. Circular 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. Circular 30.
31. Para. 5.2.2. Circular 30.
32. Para. 5.2.3. Circular 30.
33. Para. 5.1. Circular 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 that has its domicile in Switzerland was recognized by Para. 5.1.3 of the draft of 26 May 2005 for Circular 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 that transfers assets to no-man's-land (*Niemandsland*). Böckli, note 5, at 779 and 785. Para. 5.1.1.2 of Circular 30 is also based on this approach.
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), at 508.
36. Para. 5.2.3. Circular 30.
37. In contrast, Para. 5.2.3 of the draft of 26 May 2005 for Circular 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 its domicile in a Swiss canton, the deceased had his last domicile in a Swiss canton or if Swiss-situs immovable property is transferred. Almost all cantons have exempted the gift and inheritance tax of spouses and children.
39. Böckli, note 5, at 719. Most Swiss cantons interpret the term "gift" to have the meaning it has in civil law under Art. 239 of the Swiss Federal Code of Obligation of 30 March 1911. Therefore, a gift is an inter vivos transfer by virtue of which a person is enriched (*bereichert*) from the wealth of another person.

of trust property based on the Swiss law of succession triggers Swiss inheritance taxes. However, under 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 that inheritance taxes may not be triggered until the trust property is forwarded to the beneficiary. As 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 upon the settlor's death. Therefore, the principle of transparency is also applicable to Swiss gift and inheritance taxes.

Under Circular 30, the later forwarding of trust property and trust income to the beneficiary (which is subject to Swiss unlimited tax liability) is subject to 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 non-harmonized Swiss cantonal and communal gift and inheritance taxes, but is defined under Swiss harmonized law on direct taxes. It seems that 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 tax if the settlor had its 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 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]

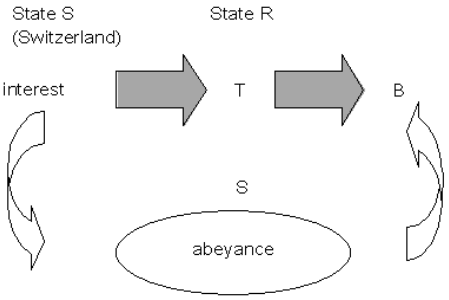
The possibility of a tax deferral by virtue of an irrevocable trust when trust property is transferred to abeyance may be counteracted only by a specific statutory provision. For example trust property might still be fiscally attributed to the settlor for purposes of Swiss direct taxes as well as Swiss 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 non-related 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 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.

2.3.1.3. Bilateral attribution rules

The treaty attribution rules laid down in Arts. 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. Arts. 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 Arts. 10(1), 11(1) and 12(1) of the Canada–Switzerland treaty and the New Zealand–Switzerland treaty. Arts. 10(1), 11(1) and 12(1) of the Switzerland–United States treaty and the Switzerland–United Kingdom 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. This can be illustrated as follows:

Figure 6

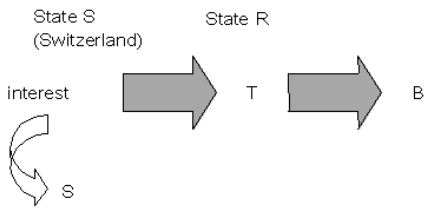


Based on the Swiss *lex fori* attribution rules, Swiss-source interest is not yet attributed to someone from a Swiss perspective. Therefore, in year 1 no one has access to benefits under the State *R*–Switzerland treaty regarding relief from Swiss withholding tax on the Swiss-source interest. This example 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*

40. Federal Tribunal, 5 November 2002, 2P.168/2002, Para. 5.2. See also Amonn, note 5, at 493.
41. Para. 5.2.3. Circular 30.
42. Böckli, note 5, at 783.
43. It seems that the FTA applies such a treatment. See Ryser, note 1, at 322.
44. See Böckli, note 5, at 779 and 785.

within the time limit within which a request on relief from Swiss withholding tax may be filed under the State *R*–Switzerland treaty, and such a request is filed by the beneficiary, Switzerland should give treaty relief, provided that the beneficiary is able to give evidence regarding the forwarding.[45] See Figure 7.

Figure 7



Assume that 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.

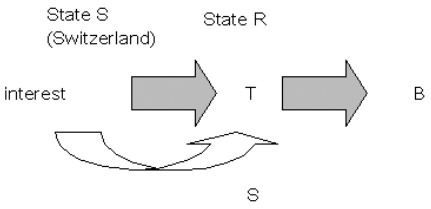
2.3.2. Contextual interpretation

As illustrated above, Swiss *lex fori* interpretation of treaty attribution rules may lead to double taxation of trust income. However, the main purpose of 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 is taxed in the hands of two different taxpayers.[48] Nevertheless, such attribution conflicts should be avoided.[49]

Art. 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. Para. 6.3 to Art. 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.

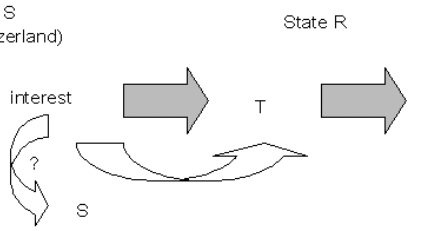
It seems that the FTA (under Para. 8.2 of Circular 30 regarding refund of Swiss withholding tax by a person resident in a contracting state) applies such a contextual interpretation. Thus, the contextual interpretation of treaty attribution rules for Swiss withholding tax purposes is not based on the principle of fiscal transparency of Circular 30 if Switzerland is the source state. Only Para. 8.3 of Circular 30 regarding relief from foreign withholding tax by a Swiss resident person expressly states that the income must be fiscally attributed under the attribution rules of Circular 30.

Figure 8



Now 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 treaty. Conclusively, the contextual interpretation of treaty attribution rules may help avoid attribution conflicts and thus double taxation of trust income.

Figure 9



If one assumes the a 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 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 30 are applicable for purposes of residence taxation. If Circular 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

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. Circular 30.
47. See Para. 3 of introduction of OECD commentary to OECD Model.
48. Id. at Para. 1.
49. See Danon, note 1, at 316 and 324; see also Baker 2002, note 18, at 1.

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]

2.4. Beneficial ownership of trustee

2.4.1. Beneficial ownership

Treaty relief requires not only residence and fiscal attribution, but also beneficial ownership. Arts. 10(2), 11(2) and 12(1) of the OECD Model mention the requirement of beneficial ownership. This requirement is also mentioned in Arts. 10(1) and (2), 11(1) and (2), and 12(1) and (2) of the Switzerland–United States treaty, Switzerland–United Kingdom treaty, New Zealand–Switzerland treaty and Canada–Switzerland treaty. Nevertheless, under FTA practice, the beneficial ownership concept is implicitly included in treaties and therefore applies even in the absence of a treaty provision.[51] Para. 8.1 of Circular 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 under 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?

2.4.2. Contextual interpretation

An increasing number of sources in international tax law believe that the term "beneficial owner" should be given an autonomous meaning (international fiscal meaning).[52] In its ruling of 28 February 2001, the Federal Court of Appeal for Taxation referred to a contextual interpretation under Art. 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 the person that receives it subject to an obligation to transfer it to a third party.[54] The Federal Tribunal has not yet issued a (published) ruling on this matter.

Para. 13 to Art. 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 under Swiss withholding tax law (VStG), many believe that 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 Arts. 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 that 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 Para. 3(b) of the protocol to the New Zealand–Switzerland treaty. For the purposes of Arts. 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 Arts. 10, 11 and 12 of the New Zealand–Switzerland 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.

2.5. Limitation on benefits

Art. 22 of the Switzerland–United States treaty contains a specific treaty provision regarding limitation on benefits. Art. 22(1)(f) includes a predominant interest test.[60] Under 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 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% of the treaty-protected income may be paid to persons that are not treaty protected.[61]

50. See Para. 6.1 to Art. 1 OECD commentary to OECD Model.
51. FTA guidelines of 15 July 2005, on Art. 15(1) of the to the settlor or the beneficiary from the US position regarding the EC–Switzerland savings tax agreement, Para. 10(a).
52. In its *Indofood* ruling on 2 March 2006, The UK Court of Appeal referred to Philip Baker's definition of beneficial ownership. *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, see note 17, at Para. 7.b; see also Philip Baker, "Beneficial Ownership: After Indofood", 6 *GITC Review* 1 (2007), at 15.
54. Federal Court of Appeal for Taxation, see note 17, at Para. 7.b.aa.aaa.
55. See Baker 2007, note 53.
56. Danon, note 1, at 339.
57. Id. at 340.
58. Baker 2002, note 18, at 17; John Prebble, "Accumulation Trusts and Double Tax Conventions", *British Tax Review* (2001), at 76.
59. See Ryser, note 1, at 315.
60. See Markus F. Huber and Matthew S. Blum, "Limitation on Benefits under Article 22 of the Switzerland-US Tax Treaty", *Tax Notes International* (8 August 2005), at 547.
61. Id. at 558. See also Para. 22 US Treasury Department technical explanations to Art. 22.

If the Swiss-source trust income is fiscally attributed to the settlor or the beneficiary from a US perspective, there is no application of the predominant interest test at the trust level. The settlor or the trustee satisfies the test in Art. 22(1)(a) of the Switzerland–United States treaty if they are individuals. However, if the Swiss-source trust income is fiscally attributed to the trust itself, the trust must fulfil 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.

3. Switzerland: Residence State

3.1. Principle of fiscal transparency

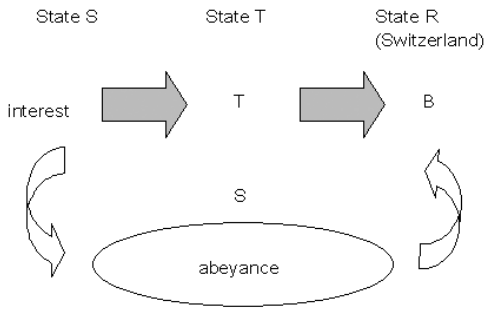
As mentioned above, Para. 8.3 of Circular 30 states that the income must be fiscally attributed under Swiss attribution rules in Circular 30. Thus, the FTA applies a Swiss *lex fori* interpretation of treaty attribution rules when Switzerland is the residence state. In the author's opinion, this administrative practice complies with an autonomous interpretation of the treaty attribution rules. Under the Swiss attribution rules, trust income is fiscally attributed to either 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. Under Circular 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 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 under the State *S*–Switzerland treaty. The Swiss-resident recipient should also be entitled to a Swiss foreign tax credit regarding any residual foreign withholding tax.[64]

3.2. Foreign withholding tax on trust income

Again consider 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. This can be illustrated as follows:

Figure 10

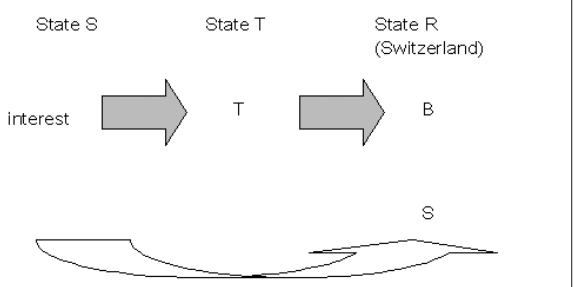


Under Para. 8.3 of Circular 30, a residence certificate is issued only if the trust income is fiscally attributed to a Swiss-resident person. In an irrevocable discretionary trust that was settled by a non-Swiss resident settlor, the trust income is not yet fiscally attributed to the Swiss resident beneficiary. Accordingly, the Swiss resident beneficiary will not receive a Swiss residence certificate and thus will have no access to benefits under the State *S*–Switzerland treaty. Attribution conflicts between Switzerland (the residence state) and the (foreign) source state may also lead to double taxation of trust income. However, the 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 treaty, and that request is filed by the beneficiary, Switzerland should issue a residence permit, provided that the beneficiary gives evidence regarding the forwarding.

Assume the irrevocable discretionary trust was settled by a Swiss resident settlor. See Figure 11. In that case, trust 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* under the State *S*–Switzerland treaty. Double taxation may still arise if State *S* attributes the interest income to *T* (attribution conflict between the (foreign) source state and Switzerland as the residence state) or State *T* attributes interest income to *T* (double residence taxation).

62. Para. 5.2.3. Circular 30.
63. Para. 8.3. Circular 30.
64. See Art. 2(1) Ordinance of 22 August 1967, on the tax credit issued by the federal government, SR 672.201.

Figure 11



3.3. Foreign withholding tax on trust distributions

Art. 10(7) of the Canada–Switzerland treaty contains a specific treaty provision for income obtained by a Swiss resident from a Canadian-resident trust. Under this provision, the limitation of Canada's taxing right for dividends under Art. 10 of the Canada–Switzerland treaty is also applicable to income derived from a Canadian-resident trust. 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 Art. 22 of the Canada–Switzerland treaty also includes income derived from a trust that is a resident of Canada.

Under Para. 15 of the OECD commentary to Art. 21 of the OECD Model, the United Kingdom has entered a reservation concerning the right to tax income paid from a trust to a non-resident person. Thus, Art. 21(1) of the Switzerland–United Kingdom treaty states that income paid from a trust may also be taxed in the source state.

4. Conclusion

There is a lack of provisions in Swiss treaties addressing the complex issues of trusts and 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 Swiss withholding tax purposes is not based on the principle of fiscal transparency of Circular 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 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, as the trust income is not attributed to the beneficiary under the Swiss *lex fori* attribution rules of Circular 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 that are resident in common law jurisdictions – no access to Swiss treaties 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 access to treaty benefits might become a disadvantage in the international context.

65. See also Art. 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 Art. 21 of the OECD Model, under which Canada has entered a reservation to tax income arising from sources in its own country.