

# The Swiss Business Foundation—a suitable estate planning vehicle for entrepreneurs?

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## Abstract

Swiss 'Business Foundations' are certainly not the most obvious option for entrepreneurs wishing to conduct a business or trade or to set up a holding structure. This article examines selected legal and tax issues that arise when setting up such a Swiss Business Foundation in order to determine in which circumstances these structures are suitable estate planning vehicles for entrepreneurs.

## Introduction

What do the Hotel Beau-Rivage Palace in Lausanne, one of the world's most prestigious luxury hotels, the Manufacture des Montres Rolex S.A., the company manufacturing the Rolex watches, and Panalpina, one of the world's leading providers of intercontinental air and ocean freight services, have in common? The somewhat surprising answer to this question is that all of these businesses are controlled by Swiss foundations.<sup>1</sup>

'Business Foundations' (Unternehmensstiftungen) are not the most obvious option for entrepreneurs wishing to conduct a trade or business or to set up a holding structure. This article, therefore, examines select legal and tax issues that arise when setting up such Swiss Business Foundations in order to determine in which circumstances these structures are suitable estate planning vehicles for entrepreneurs.

## Overview on the characteristics of Swiss Business Foundations and the legal framework in which they operate

### 'Business Foundations' defined

The term 'Business Foundation' is used for foundations pursuant to Article 80 of the Swiss Civil Code (CC),

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1 The 'Fondation Hans Wilsdorf', owns 100 percent of the Rolex Holding, the 'Fondation de famille Sandoz', owns the majority of the shares of several luxury hotels, such as the Beau-Rivage Palace in Lausanne, as well as other participations, including a substantial participation in Novartis, making it Novartis' largest single shareholder, and the 'Ernst Goehner Stiftung', is the majority shareholder of Panalpina.

whose assets consist entirely or at least to a large extent of a business or a substantial participation in a business.<sup>2</sup> Business Foundations are thus characterized not by their purposes but by the fact that they are either directly conducting a trade or business or holding substantial participations in one or more corporations as a holding foundation.

Apart from the fact that they are owning/controlling businesses, Business Foundations are just like all other foundations. They are legal entities constituted by the founder by dedicating assets for a specific purpose.<sup>3</sup> Pursuant to a decision of the Swiss Supreme Court in 2001, Swiss law does not impose restrictions on the founder's freedom to specify the purpose of a foundation, provided the foundation's purpose is not illegal or immoral.<sup>4</sup> Business Foundations may therefore not only be established as charitable, ecclesiastic or family foundations, but also as foundations with purely economic purposes.

## The Supreme Court decision BGE 127 III 337—a litigation tested guideline of how to set up Swiss Business Foundations

This case, decided by the Swiss Supreme Court in 2001, ideally illustrates how foundation law and corporate law may be applied to create a holding structure which provides financial benefits to the members of a family, yet at the same time is strong enough to withstand family disputes and the deadlocks such disputes can create. Prior to this leading case, it was far from certain whether Business Foundations with economic purposes would be considered as valid foundations. The desire of founders to ensure the continuity of their businesses and to appoint family members as beneficiaries, makes matters even more complex, because such foundations run the risk of being treated as 'Familienfideikommiss' and thus as void legal entities. The thorough analysis of the contested Business Foundation by the Supreme

2 See Harold Grüniger, Die Unternehmensstiftung in der Schweiz, Basel 1984, p 7; Roger Schmid, Die Unternehmensstiftung, Zurich 1997, p 5; Meyer-Hayoz/Forstmoser, Gesellschaftsrecht, p 22 n 4.

3 Article 80 CC.

4 BGE 127 III 337, E. 2a–d.

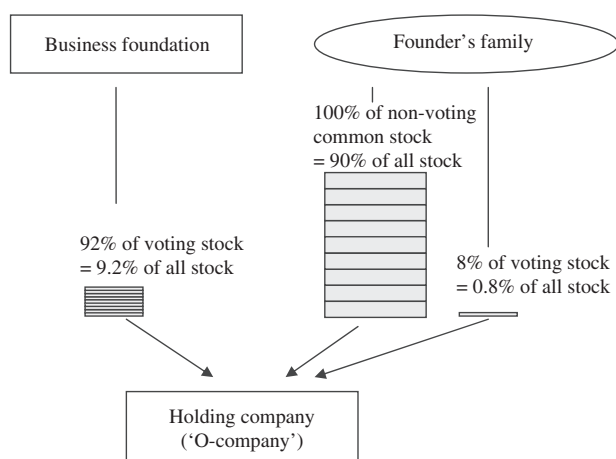
Court provides a detailed guideline of how Business Foundations may be set up safely. The applicable legal provisions are therefore laid out in the context of this leading case.

(i) Rationale for setting up the Business Foundation

According to the explanations of the Court, the founder decided to set up a foundation because he saw his lifework at risk due to discord within the family. He feared that family disputes would not only threaten the existence of his company as a family owned company, but that such conflicts would even threaten the company's existence *per se*, since it would lack a clear orientation. By transferring the voting shares to a foundation, he intended to ensure that the foundation would be managed on the basis of a uniform and consistent business strategy, because the majority of the voting shares would henceforth be controlled by this foundation.

(ii) Structure of the Foundation

The Business Foundation owned 92 percent of the voting shares of a holding company (the 'O-Company'). The O-Company had issued two types of shares: (i) voting shares (Aktien) and (ii) non-voting ordinary shares (Partizipationsscheine). The voting shares, the majority of which was owned by the Business Foundation, represented only 10 percent of the total issued shares. The other 90 percent of O-Company's shares were owned by members of the founder's family (see diagram below).



Since the Holding Company issued two different classes of shares, the founder could transfer the control over the holding company to the Business Foundation by transferring the majority of the voting shares to it, yet at the same time arrange that over 90 percent of

the dividends payable by the O-company would be distributed to his family, which owned all of the non-voting common shares and 8 percent of the voting shares. Consequently, of every CHF 100.00 of dividends paid by the O-company, CHF 90.80 would be paid to the family shareholders and CHF 9.20 would be paid to the Business Foundation to be used in accordance with the foundation's purpose.

(iii) Purpose of the Foundation

Pursuant to Article 2a of its statutes, the purpose of the contested Business Foundation is to preserve and further the O-company as a family company. Article 2 of the statutes also provides that the foundation should make distributions to further the education of highly talented youths and to support them in general (Article 2b), that scientific research should be supported (Article 2c) and that employees of the O-company and their dependants should receive support in case of old age, death, illness, accidents, disability, unemployment and other distress.

After the founder's death, his widow and two other claimants argued that the Business Foundation was void, because the purpose of Article 2a was purely economic and therefore illegal. Their assertion, that a Business Foundation could not pursue purely economic purposes, was, however, rejected by the Supreme Court. The Supreme Court held that since parliament did not impose any restrictions in the Civil Code, it would not restrict the founder's freedom either.

The claimants also argued that the Business Foundation constituted an illegal 'Familienfideikommiss', ie an inalienable estate that was linked with a family in accordance with a pre-defined succession arrangement, set up to ensure the family's standard of living. This argument was based on Article 335 paragraph 1 CC, pursuant to which family foundations are only permitted if they are set up for the purposes specified in this article. What all these specified purposes have in common, is that family members may only receive contributions from a family foundation in certain circumstances, such as for their education, for the furnishing of a new household or a new existence or in case of need. Not permitted are contributions from family foundations which are made outside of these purposes specified by law, simply to increase the standard of living of the recipients. Such family foundations would be treated as illegal 'Familienfideikommiss'.

## Swiss Business Foundation

The Supreme Court, however, also rejected this argument, holding that the Business Foundation was not a family foundation, because its statutes stated that various classes of beneficiaries outside the founder's family should be supported, such as highly talented youths, researchers or employees and their dependants.

### (iv) Conclusion

The Supreme Court's decision clarifies that Business Foundations can validly be set up and provides clear guidance on how to establish such foundations. Based on the Court's analysis of the contested foundation, the following conclusions can be made concerning the establishment of a Business Foundation/Holding Company—estate planning structure, which is to ensure both the continuity of a business and financial benefits to family members:

- In order to ensure the continuity of the founder's business, irrespective of family feuds, the control of the business should be in the hands of a professionally managed Business Foundation. As the Supreme Court decision evidences, such a structure can withstand attacks from heirs and even members of the board of foundation.
- Because family foundations, which are set up for the exclusive benefit of family members, are void unless their purpose is in accordance with the rules of Article 335 CC, the structure must be set up in such a way that contributions to family members are not based on their affiliation to a class of beneficiaries of the foundation, but on their share-ownership in the holding company.
- The founder's business should be transferred to a holding company with two classes of shares: voting shares and non-voting ordinary shares. The founder should then transfer the voting shares of the holding company to the Business Foundation, while the non-voting ordinary shares are held by the founder and/or his family.
- To counter the argument, that the Business Foundation constitutes a void family foundation, its beneficiaries should not be family members.
- The statutes should not state that the non-voting ordinary shares of the holding company are inalienable. If these shares could also be sold to non-family members, this will be construed as evidence that the founder did not intend that the assets will forever be owned by the same family.

- The majority of the members of the board of foundation should consist of independent individuals, who are qualified to act as board members and who can thus ensure that the Business Foundation pursues a well considered and responsible strategy.
- The members of the board of foundation should not be appointed by members of the founder's family, but the board should instead by way of co-optation elect and appoint new board members.

## The taxation of Swiss Business Foundations

Foundations are treated as legal entities under Swiss civil law and they are also treated as independent legal entities for tax purposes.<sup>5</sup> Provided they do not meet the requirements for a tax exemption, they are thus subject to tax both on their capital and on their income.

### Overview on the income and capital taxation of foundations

#### (i) Income tax

A Swiss Foundation is subject to the federal income tax at a flat rate of 4.25 percent and income below CHF 5000 is not subject to federal income tax at all.<sup>6</sup> The cantonal and municipal income tax rates vary from Canton to Canton. The starting point for the calculation of the foundation's taxable income is its gross income (including capital gains<sup>7</sup>), from which the allowable deductions (business expenses and Swiss taxes<sup>8</sup>) are deducted. The result so obtained is the foundation's taxable income.

#### (ii) Capital tax

In addition to the cantonal and federal income tax, a foundation is also subject to the cantonal capital tax, which is imposed on the foundation's net assets. The value of the foundation's net assets is determined by applying the rules for natural persons,<sup>9</sup> which means that in principle the fair market value of the foundation's assets determines their value for tax purposes.<sup>10</sup> As an exception to this rule, all intangible assets and personal property, which are business assets, must be valued based on their book value (taking into account certain necessary corrections resulting from the non-recognition

5 Article 49 para 1 lit b DBG; Art 20 para 1 StHG.

6 Article 71 DBG—this is half the tax rate of corporations.

7 Article 18 para 2 DBG.

8 Article 59 DBG and Art 25 StHG.

9 Article 29 para 2 lit c StHG.

10 Article 14 para 1 StHG, the earning power may adequately be taken into account.

of deductions for tax purposes).<sup>11</sup> The value of securities, however, is always their fair market value.<sup>12</sup> Considering that the foundations' assets are typically predominantly invested in securities, the requirement that securities be appraised at their fair market value is a considerable disadvantage for foundations, compared with corporations, which have their securities appraised at book value.

#### Example

If a corporation purchased 10,000 shares of a company listed on the NY stock exchange for US\$ 100 per share 10 years ago, and the shares of that company are now traded at US\$ 250 per share, then the book value of the shares, which determines the corporation's capital tax, is still US\$ 1 million. A foundation, however, has to use the fair market value of its shares for the computation of its capital tax, so that for the foundation the value of its shares is US\$ 2.5 million.

### The requirements for obtaining a tax exemption in general

Both the Federal Income Tax Act and the Tax Harmonization Act provide with almost identical words for the following:

*Tax exemption is granted to legal entities that pursue public or charitable purposes if the income and the capital of such entities are dedicated exclusively and irrevocably to these purposes. Business purposes are in principle not charitable. The acquisition and holding of substantial participations in the capital of other companies qualify as charitable if the interest of maintaining the existence of a company is subordinate to the charitable purpose and if no managing activity is executed by the foundation.*<sup>13</sup>

In order to obtain a tax exemption, a foundation must therefore fulfil all the following general requirements<sup>14</sup>:

#### (i) Exclusive use of the funds

A foundation must apply its income and its property *solely* towards the promotion of public or charitable purposes. The law does not require that all activities of the foundation need to be focused on these charitable purposes. It is sufficient, if the foundation's income and capital are exclusively applied for charitable purposes.<sup>15</sup>

If a foundation pursues purposes which are not exclusively charitable, but also include other non-charitable aims, then a partial tax exemption may be obtained,<sup>16</sup> although it would be better to just set up two different foundations.

#### (ii) Irrevocability of the dedication of the assets to a specific purpose

The assets which form an endowment for the tax exempt purposes must be irrevocably dedicated to these purposes. The Circular Letter requires that a return of these assets to the founder must be excluded forever. Moreover, the statutes must provide that upon liquidation of the foundation, its assets must be transferred to another tax exempt legal entity with similar purposes.

We recommend that the intention to irrevocably and exclusively use all of the funds for charitable purposes is affirmed by including provisions in the statutes, according to which (a) membership in the board of foundation shall be a honorary appointment, (b) the foundation is prohibited from transferring any assets to the founder, the members of the board of foundation or to parties related to any of the foregoing and (c) in the event of a liquidation of the foundation, all remaining property shall be given or transferred to another charitable entity to be applied for charitable purposes substantially similar to those stated in the foundation's statutes.

#### (iii) Actual charitable activities

Tax exemption is justified only in cases where a foundation pursues charitable purposes not only according to its constitutional documents but also in fact. Foundations, whose main purpose is the mere accumulation of funds and which therefore allocate funds to reserves to an extent which is not reasonably justified by future tasks, will not be exempt from tax. The foundation's assets and the income generated by its assets must be effectively used for charitable purposes and not only be dedicated so.

Moreover, the Circular Letter requires that legal entities with a charitable purpose meet the following requirements:

#### (iv) Public interest

The activities of the foundation must be in the public interest. The public interest can be supported by activities which are of a charitable, humanitarian,

11 Article 14 para 3 StHG.

12 Article 14 para 3 StHG.

13 Article 56 lit g and Art 23 para 1 lit f StHG.

14 The requirements for a tax exemption have been summarized in circular letter no 12, Steuerbefreiung juristischer Personen, die öffentliche oder gemeinnützige Zwecke oder Kultuszwecke verfolgen, published on 8 July, 1994 by the federal tax administration.

15 Thomas Koller, Stiftungen und Steuern, in Stiftungen in der juristischen und wirtschaftlichen Praxis, Zurich 2001, p 61.

16 Circular letter no 12, p 2.

health supporting, ecological, educational, scientific and cultural nature. This includes in particular the activities in the following areas: social assistance, art and science, education, supporting human rights, protection of nature and wildlife as well as humanitarian aid. Whether or not the specific activity is within the interest of the public is assessed according to the relevant current understanding of the inhabitants of Switzerland. Furthermore, a public interest is usually accepted only if the class of potential beneficiaries, who may be benefiting from the foundation's support, is in principle open. A narrow pool of beneficiaries (eg a limitation to the members of a family, the members of a community or the representatives of a specific profession) precludes a tax exemption based on charitable purposes.

(v) Altruism

The Circular Letter no 12 requires that a foundation's activities are unselfish and altruistic. It is not sufficient that the activities are in the public interest, it is also required that the activities are exclusively in the public interest and that the foundation devotes itself to the common welfare. The foundation may not pursue its own interests concurrently, for example by pursuing profit purposes as well as self-help purposes.

### **The requirements for obtaining a tax exemption in case of Business Foundations holding substantial participations in one or more corporations**

(i) Overview on the requirements pursuant to the Circular Letter no 12

The Circular Letter no 12 gives the following guidance on the tax exemption of Business Foundations:

*Pure capital investments, even if they result in the foundation owning in excess of 50% of the shares of a participation, do not preclude a tax exemption, provided the foundation may not control the management of the company whose shares it owns. This would be the case if, for example, the voting shares were controlled by another entity. No control may be exercised via the equity participation on the business activities of the company and there must be a clear organisational and personal separation between the board of the foundation and the*

*board of directors, with just one liaison officer being permitted.*

*In case of significant participations, the preservation of the companies must be subordinate to the charitable purpose. This requires that the foundation is regularly receiving substantial contributions from the companies, the shares of which it is holding, and that these funds are used to pursue altruistic charitable purposes.*

The three main requirements of the Circular Letter are:

(ii) Subordination of the business interests

The requirement that the business interests must be subordinate to the charitable purposes of the foundation is at the heart of the requirements pursuant to Circular Letter no 12. Should the interest of the foundation to control the underlying company outweigh its charitable interests, then this rule would be broken.<sup>17</sup> The acquisition and the management of participations in companies may only be a means for the pursuit of the charitable purposes. Compared with the charitable purpose, the foundation's interest in the preservation of the underlying company must be of secondary importance. The preservation of the underlying company may not be a purpose of its own.

(iii) Current allocation of a substantial part of the income for charitable purposes

It is required that a substantial part of the income resulting from the holding of the participations is applied for the charitable purposes. While a re-investment of the investment income might be in accordance with a diligent investment management strategy, it would only be acceptable if the goal is not simply to increase the foundation's assets, but to sustain the future income from that source.

Considering that a holding foundation's assets consist of significant participations in one or more operating companies, the foundation should bear in mind the profit position of these operating companies before distributions are made.<sup>18</sup> A foundation should not burden its companies by insisting on distributions, if this would adversely affect the financial situation of these companies. Foregoing dividends under such circumstances would not mean that the foundation no longer subordinates the business purpose to its

<sup>17</sup> Marco Greter, in: Kommentar zum Schweizerischen Steuerrecht, Band I/1, Bundesgesetz über die Harmonisierung der direkten Steuern der Kantone und Gemeinden, Basel 2002, Art 23 n 34.

<sup>18</sup> Marco Greter, in: Kommentar zum Schweizerischen Steuerrecht, Band I/1, Bundesgesetz über die Harmonisierung der direkten Steuern der Kantone und Gemeinden, Basel 2002, Art 56 n 34.

charitable purpose, as such considerations are necessary to ensure a sustainable return on the foundation's investments.

The Circular Letter also states that the charitable purpose of the foundation must be pursued *currently*. That is, accumulating assets is only permitted to the extent that this is necessary for a sustainable pursuit of the foundation's purpose. Otherwise, the cantonal tax authorities require in our experience that the dividends received from the foundation's underlying company are distributed *within a foreseeable time period (e.g. 2–4 years, depending on the size of the funds involved)*.

(iv) Organizational and personal separation between the board of foundation and the board of directors

The legal provisions governing the tax exemption of foundations holding substantial participations in the capital of other companies state that such foundations may not undertake managerial activities.<sup>19</sup> The underlying rationale for this provision is that the business interests must be subordinate to the charitable purposes of the foundation.

The Circular Letter therefore requires a clear organizational and personal separation between the board of foundation and the board of directors of the underlying company. In order to comply with this requirement, the statutes should ideally provide that, with the exception of one liaison officer, *all of* the members of the board of foundation shall consist of persons who are neither members of the management nor of the board of directors of the underlying company.

The Circular Letter also mentions another way of ensuring that a foundation may not control the management of a company whose shares it owns: the voting shares of this company could be controlled by another entity. Alternatively, the voting shares could also be controlled by one or more individuals. If they were to be controlled by a group of individuals, then the articles of association of the company controlled by the voting shareholders should contain detailed provisions specifying whether these shares should be transferable in accordance with the last will of a deceased shareholder (or by the rules of intestacy in the absence of a last will) or whether they should be automatically redeemed at the death of a shareholder so that the surviving shareholders would choose a new voting shareholder in accordance with the criteria specified in these articles of association.

A foundation owning solely non-voting shares of a company has no legal power to control this company. If the members of the board of foundation and the board of directors were, however, identical, then there would be a risk that such an organizational and personal unity could be treated by the tax authorities as a factual control of the underlying company by the foundation. Consequently, it would be advisable to state in the statutes of the foundation that *the majority* of the members of the board of foundation shall consist of persons who are neither members of the management of the board of directors of the underlying company, *nor voting shareholders of this underlying company*.

## Conclusion

It is estimated that approximately 1000 Business Foundations are in existence in Switzerland.<sup>20</sup> As this number indicates, Business Foundations are common, yet they are far from being popular succession planning vehicles. The main reason for their lack in popularity is the restriction imposed by Article 335 CC, which precludes the use of family foundations for the transfer of business assets from one generation to the next, unless the statutes provide that the beneficiaries may only receive benefits in the limited circumstances specified by this article (ie for their education, for the furnishing of a new household or a new existence or in case of need).

A Business Foundation is, however, a very interesting structure for the type of family situation described in the above-mentioned Swiss Supreme Court case (BGE 127 III 337). With a Business Foundation a founder can ensure that a company remains manageable despite family disputes, because the voting rights are held by a foundation and not by family shareholders with conflicting views on how the company should be run. Entrepreneurs, whose main concern is that their company continues to be managed in accordance with their guidelines, will regard a Business Foundation as an attractive holding structure. By transferring the voting shares of the company to a Business Foundation and the non-voting ordinary shares to family members, it is even possible that family members participate in the financial success of the company.

Probably the most common reason for setting up Business Foundations is to apply the income from an existing business to the pursuit of charitable purposes. Since charitable foundations may be exempt from

19 Article 56 lit g and Art 23 para 1 lit f StHG.

20 Roger Schmid, Die Unternehmensstiftung, Zurich 1997, p 45.

income and capital tax, 100 percent of the income that they receive can be applied for the charitable purposes, which the founder specified. Moreover, such foundations are also subject to governmental supervision.<sup>21</sup> The prime function of this supervision is to ensure that the foundation's assets are used for the purposes specified in the constitutional documents.<sup>22</sup> The supervisory authority, which intervenes upon complaint or *ex officio*, has the responsibility of monitoring the management of the foundation, of rendering decisions on complaints and of suspending or dismissing the administrative bodies.<sup>23</sup> The existence of a highly qualified federal supervisory authority, which will intervene, if a foundation with international or Swiss-wide activities should fail to adhere to the statutes and by-laws, make Switzerland a particularly attractive jurisdiction for the establishment of major Business Foundations, because the founder has the comfort that the foundation will be monitored by a supervisory authority.

Apart from their use as succession planning structures or for the pursuit of charitable purposes, Business Foundations are also used as holding structures for businesses, which need to be independent, such as for example audit firms.<sup>24</sup>

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21 Article 84 para 1 CC.

22 Article 84 para 2 CC.

23 Thomas Sprecher/Ulysses von Salis-Lütolf, *Die Schweizerische Stiftung*, Zürich 1999, p 278.

24 Alexandra Zeiter, *Errichtung einer Unternehmensstiftung - Attraktive Option in der Nachlassregelung*, *Der Schweizer Treuhänder* 2004, p 842.