

# Switzerland: are charitable trusts an alternative to charitable foundations?

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## Abstract

The article assesses how Switzerland's ratification of the Hague Convention on the Law Applicable to Trusts and on Their Recognition, and the entry into force of the new Swiss collision law provisions on trusts as of 1 July 2007, may possibly change the philanthropic landscape in Switzerland. Whether individuals resident in Switzerland, interested in setting up a charitable entity, will henceforth choose to set up charitable trusts instead of Swiss charitable foundations, depends not only on the advantages and disadvantages of these two different classes of charitable entities but even more so on the treatment of charitable trusts under the new Swiss collision law and on their taxation. Will charitable and purpose trusts henceforth be recognized in Switzerland and will they be granted the same tax exempt treatment in Switzerland like charitable foundations?

## Introductory remarks

Charitable entities in Switzerland are traditionally established in the form of charitable foundations (and, very rarely, in the form of charitable corporations). These foundations can be established for any purpose possible as long as their objects are feasible, legal, and in conformity with morals. Under the new foundation legislation, which became effective as of

1 January 2006, a founder may even reserve the right to change the foundation's purpose. The Committee for Economic Affairs and Taxation of the Council of States ('CEAT'), which was instrumental in the revision of the Swiss foundation law, initially planned to make the Swiss foundations even more flexible. It intended to amend the Swiss foundation law in such a way that a founder would have been allowed to revoke his foundation if a revocation clause had been included in the statutes.<sup>1</sup> The possibility to revoke the foundation, it was argued, would give a founder the comfort that he could access the funds transferred to the foundation for his own needs, if, through the occurrence of unfortunate events, he should find himself in financial distress. However, the concept of revocable foundations did not become part of the new foundation legislation. Concerns that

- the measures necessary to prevent the abuse of such revocable foundations for money laundering or tax avoidance purposes would render the new foundation legislation too complex and
- the reputation of Swiss charitable foundations would suffer from such change, caused the CEAT to drop the idea.

However, the legitimate wishes of many founders to pursue charitable activities while retaining the power to reclaim the funds endowed to the foundation in case of financial distress, did not vanish simply because the foundation law was not amended

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1. Bericht der Kommission für Wirtschaft und Abgaben des Ständerates vom 23. Oktober 2003 zur Revision des Stiftungsrechts, clause 2.3.4.

accordingly. Advisors therefore have to assess whether the same results can be achieved by using other legal instruments, such as, for example, Cayman Island STAR trusts, BVI, or Bermuda purpose trusts. These trusts do not have beneficiaries like traditional trusts. Instead such trusts can, like foundations, be established for specific purposes. The sophisticated trust legislation introduced in several offshore jurisdictions provides a settlor with considerable flexibility as to which purposes shall be achieved with such a trust. Within the limits imposed by the relevant jurisdictions, trusts for a purpose or purposes may be set up for almost any purposes, provided they are specific, reasonable and possible, and are not legally immoral, contrary to public policy, or unlawful.<sup>2</sup>

While the discussion of these structures is outside the scope of this article, there is little doubt, that a talented draftsman could achieve the needs identified by Fritz Schiesser, the member of the Council of States who initiated the Swiss foundation revision, by using one of the aforementioned trusts.

## The impact of the ratification of the Hague Trust Convention

### *Application of the Hague Trust Convention to charitable trusts*

The establishment of trusts by Swiss resident individuals is governed by the provisions of the Swiss International Private Law Act ('IPLA') and the provisions of the Hague Convention on the Law Applicable to Trusts and on their Recognition (the 'HTC'). The term 'trust' in the IPLA includes all trusts created voluntarily by the settlor, which fall within the meaning of the HTC, irrespective

of whether these trusts are evidenced in writing or not.<sup>3</sup>

Considering that the essence of a trust relationship lies in the fiduciary relationship between the trustee and the beneficiaries,<sup>4</sup> the question arises as to whether the provisions of the HTC also apply to charitable trusts, ie to trusts which are established for charitable purposes such as for the relief of poverty, for the advancement of education, for the advancement of religion, or for other purposes beneficial to the community.<sup>5</sup> As there are no individual beneficiaries in the trust law sense, these charitable trusts have no nexus between trustee and beneficiary<sup>6</sup> and thus lack what Prof. Alfred E. von Overbeck described as the very essence of a fiduciary trust relationship. Will the new provisions of the IPLA and HTC thus not apply to charitable trusts?

The institutions covered by the HTC are identified in its first chapter on the scope of application. Article 2 HTC indicates the characteristics, which an institution must show (whether a trust from a common law country or an analogous institution from another country)—in order to fall under the Convention's coverage.<sup>7</sup> According to this provision, 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.<sup>8</sup> The statement that the assets could be devoted to a specified purpose, was above all added with a thought to charitable trusts,<sup>9</sup> yet the wording includes both charitable trusts and other purpose trusts. What all these trusts have in common is that they have the following characteristics:<sup>10</sup>

- the assets constitute a separate fund and are not a part of the trustee's own estate;

2. See for example s 13 of the Trusts (Special Provisions) Act 1989 of Bermuda.

3. Article 149a IPLA referring to Art 3 HTC.

4. Explanatory Report on the 1985 Hague Trusts Convention by Alfred E. von Overbeck, N. 40.

5. These are the 'charitable purposes' defined in the leading case *Commissioners for the Purposes of Income Tax v Pemsel* [1891] AC 531.

6. Alastair Hudson, *Equity and Trusts*, 5th edn, p 1018.

7. Explanatory Report on the 1985 Hague Trusts Convention by Alfred E. von Overbeck, N. 36.

8. Article 2 HTC.

9. Explanatory Report on the 1985 Hague Trusts Convention by Alfred E. von Overbeck, N. 39.

10. Article 2 HTC.

- the title to the trust assets stands in the name of the trustee or in the name of another person on behalf of the trustee;
- the trustee has the power and the duty, in respect of which he is accountable, to manage, employ or dispose of the assets in accordance with the terms of the trust and the special duties imposed upon him by law.

### ***The scope of the application of the Hague Trust Convention***

The HTC has two objectives: (i) to determine the law applicable to trusts, and (ii) to govern their recognition. An individual setting up a foreign trust instead of a Swiss foundation will, most probably, identify which foreign trust law will be most favourable for his philanthropic endeavour, and therefore provide in the trust instrument that the trust shall be governed by the law so chosen. Article 6 of the HTC respects this choice and provides that the law chosen by the settlor will be the governing law of the trust. Whether there is a substantial connection between the trust and the chosen law, or whether the trust is international in character, is irrelevant because these conditions were deliberately set aside by the experts. An individual intending to set up a charitable trust is thus free to choose the trust law he considers most suitable. A settlor may choose to set up a charitable/purpose trust governed by the law of a Contracting State or another more favourable law.<sup>11</sup> Pursuant to Article 149c paragraph 2 IPLA, the trust law designated by the settlor will even be applied in circumstances where the habitual residences or the nationalities of the persons involved, or the location of property, would connect the trust more closely to one or several States which do not know trusts.<sup>12</sup>

The HTC also contains rules specifying which law would apply, in case no express or implied choice

was made. However, these rules will typically not apply since the establishment of a foreign charitable trust is a deliberate act so that this important aspect will not be left unconsidered in the trust instrument.

The trust law designated by the HTC governs the validity of the trust, its construction, its effects, and the administration of the trust.<sup>13</sup> Pursuant to Article 8 paragraph II HTC the designated law shall govern in particular the following aspects of the trust relationship:

- the appointment, resignation and removal of trustees, the capacity to act as a trustee, and the devolution of the office of trustee;
- the rights and duties of trustees among themselves;
- the right of trustees to delegate in whole or in part the discharge of their duties or the exercise of their powers;
- the power of trustees to administer or to dispose of trust assets, to create security interests in the trust assets, or to acquire new assets;
- the powers of investment of trustees;
- restrictions upon the duration of the trust, and upon the power to accumulate the income of the trust;
- the relationships between the trustees and the beneficiaries, including the personal liability of the trustees to the beneficiaries;
- the variation or termination of the trust;
- the distribution of the trust assets;
- the duty of trustees to account for their administration

While Article 8 HTC specifies which trust issues shall be governed by the trust law designated by the HTC, Article 11 HTC goes a significant step further and provides that signatory states shall recognize trusts which were created in accordance with the law specified by the HTC as such. As a consequence

11. Article 22 HTC provides that any Contracting State may reserve the right to apply the provisions of Chapter III only to trusts the validity of which is governed by the law of a Contracting State. However, Switzerland does not restrict the choice of Swiss settlors as it did not reserve that right.

12. Article 149c para 2 in connection with Art 13 HTC.

13. Article 8 HTC; para 2 of Art 8 HTC contains a detailed but non-exhaustive enumeration of the questions which are subject to the trust law designated by the HTC.

of this provision, charitable trusts, which were established in accordance with the law chosen by the settlor, are recognized as charitable trusts in Switzerland.

## Limitations

### Preliminary issues

While the trust law designated by the HTC governs the validity of the trust, its construction, its effects, its administration, and the validity of the act by which the transfer of assets to the trust is carried out, are entirely governed by the law applicable by virtue of the IPLA. The HTC does not apply to preliminary issues relating to the validity of wills, or to other acts by virtue of which assets are transferred to the trustee. As a result, the following preliminary issues, which may arise in connection with the establishment of a foreign trust by a Swiss resident individual, will be subject to the Swiss IPLA and not subject to the trust law:

- the question, whether the settlor has the capacity to transfer assets to a trust at all,
- the contractual aspects of the asset transfer to the charitable trust,
- the succession law issues concerning the validity of a last will, pursuant to which assets shall be transferred to the charitable trust,
- the matrimonial property law issue, whether a married settlor may transfer assets to a charitable trust without the consent of the spouse,
- the property law question, namely which formal requirements must be met to transfer assets (such as e.g. land) to a charitable trust, etc.

### Mandatory rules of the law designated by the conflict rules of the *lex fori*

Moreover, Article 15 HTC preserves the mandatory rules of the law designated by the conflict rules of the forum for matters other than trusts. It states that the HTC does not prevent the application of provisions of the law designated by the conflict rules of the forum, in so far as those provisions cannot be

derogated from by voluntary act, relating in particular to the following matters:

- the protection of minors and incapable parties;
- the personal and proprietary effects of marriage;
- succession rights, testate and intestate, especially the compulsory quota of spouses and relatives;
- the transfer of title to property and security interests in property;
- the protection of creditors in matters of insolvency;
- the protection, in other respects, of third parties acting in good faith.

### *Lois d'application immediate and ordre public—in particular the restrictions of Article 335 of the Swiss Civil Code*

Article 16 HTC and Article 18 HTC are of particular relevance to the establishment of trusts for the benefit of a particular family. Article 16 HTC provides that the HTC does not prevent the application of those provisions of the law of the forum which must be applied even to international situations, irrespective of rules of conflict of laws (so-called 'lois d'application immediate'). Article 18 HTC provides that the provisions of the HTC may be disregarded when their application would be manifestly incompatible with public policy (*ordre public*). The question therefore arises whether the restrictions of Article 335 of the Swiss Code Civil ('CC') will be qualified by the Swiss courts as a 'lois d'application immediate' or even an expression of Swiss public policy, which would override the other provisions of the Convention.

Article 335 paragraph I CC states that 'an estate may *only* be associated with a family in such a way that a family foundation is established for the payment of the costs of education, for the provision of a dowry or for the support of family members or other similar purposes [...]'. Paragraph 2 of the same article states that 'the settlement of property in perpetual trust for the benefit of a family is henceforth prohibited'.

While Article 335 CC does not apply in the case of a trust, the purposes of which are purely charitable, its application to trusts with mixed purposes, ie to trusts which combine charitable purposes with provisions

whereby the settlor and/or his family may also benefit from the trust assets, needs to be examined in more detail. The possibility of combining both charitable and non-charitable purposes is, after all, one of the main advantages of trusts over charitable foundations.

Article 335 paragraph II CC prohibits the establishment of new settlements of property in a perpetual trust for the benefit of a family ('Familienfideikommiss'). The Swiss Supreme Court characterized a Familienfideikommiss as a special estate to which a family member is beneficially entitled; the beneficiary has a duty to preserve the corpus of this estate and to transfer it, after his death and in accordance with a predetermined order of succession, to another person chosen from among the same family and subject to the same conditions,<sup>14</sup> and so forth for unlimited generations. The Supreme Court also held that family foundations, which make the foundation's capital or income available to their beneficiaries, without requiring that the beneficiaries have any special predetermined needs (eg due to their youth, the establishment of their professional existence or their family or also due to their poverty), simply to provide them with a higher standard of living and to improve the standing of the family, are violating the prohibition of Familienfideikommissen.<sup>15</sup> If beneficiaries are able to use the income of a foundation, without having to meet the specific requirements of Article 335 paragraph I CC, then such a foundation is an illegal foundation for the pleasure and maintenance of its beneficiaries. The consequence of such a characterization is that under mandatory Swiss law such an illegal family foundation will be wound up by the court<sup>16</sup> at the request of any interested party.<sup>17</sup>

It is undisputed, that Article 335 CC is a compulsory provision applying to all Swiss family foundations.

However, the question of whether this provision is a 'loi d'application immédiate' or even an ordre public provision, which also applies to legal structures with a similar purposes such as trusts, is not answered unanimously in Switzerland.

The Federal Council expressed doubts about the ordre public character of Article 335 paragraph II CC by stating that this prohibitive rule was inspired to a large part by moral considerations (the prevention of indolence) and ideological considerations (the elimination of feudal structures), which appear rather outdated.<sup>18</sup> Similarly, Prof. Thévenoz argues that Article 335 paragraph II CC is not a rule, the abidance of which is necessary for the protection of the political, social and economical organization of Switzerland.<sup>19</sup> He therefore negates that the recognition of the effects of trusts for beneficiaries, which exclusively belong to the family of the settlor and which receive purely support for their living expenses, would have the effect of 'violating in an indefensible manner the morals of the law in Switzerland'.<sup>20</sup> He concludes that Article 335 paragraph II CC does not have an international ordre public character. The majority of legal scholars shares this view and argues that Article 335 paragraph II CC is also not a 'loi d'application immédiate', which should be applied to trusts—even in situations where they are set up in a domestic context by a Swiss settlor for the benefit of Swiss beneficiaries.<sup>21</sup> However, there are also several legal scholars who endorse the ordre public character of Article 335 paragraph II CC, whenever there is a close link to Switzerland.

## Conclusion

The provisions of the Swiss IPLA and of the HTC permit the establishment of charitable trusts. Purpose

14. Swiss Supreme Court decision 5C.68/2006 of 30 November 2006.

15. Supreme Court decision 2A.457/2001 of 4 March 2002.

16. Article 88 CC.

17. Article 89 CC.

18. Federal decree on the ratification of the Hague Trust Convention of 16 September 2004, p 16.

19. Thévenoz, *Créer et gérer des trusts après l'adoption de la Convention de La Haye*, published in *Journée 2006 de droit bancaire et financier*, p 68.

20. Thévenoz, *ibid.*, with reference to the Supreme Court decision 117 II 494.

21. See Bonnard/Ciola-Dutoit, *Trusts internes Suisses: objectifs recherchés et obstacles juridiques*, *AJP* 2007 p 1512 with a comprehensive overview on the concurring and dissenting authors.

trusts that combine charitable purposes with provisions for the support of members of the family of the settlor<sup>22</sup> may, however, be considered to be the equivalent of foundations for the pleasure and maintenance of their beneficiaries and may thus be violating Article 335 paragraph II CC. While the predominant view of the Swiss legal scholars and of the Federal Council is that the restrictions imposed by Article 335 paragraph II CC should not be applied to trusts, the legislators failed to clarify this issue when the HTC was ratified. Consequently, there remains a risk that the courts would decide that a purpose trust, which is set up by a Swiss settlor for the benefit of his family members, violates the *ordre public* of Switzerland.

## The tax exemption of charitable foundations and trusts

### Requirements for a tax exemption for charitable entities under Swiss federal tax law

#### General requirements

The legal basis for the tax exemption for charitable entities lies in Article 56 lit. g of the Federal Income Tax Act. Pursuant to this provision, legal entities which pursue public or charitable purposes are tax exempt for the income and capital which is exclusively and irrevocably dedicated to these purposes. The legal entity, requesting a tax exemption, has to submit a corresponding application. In this application, the legal entity has to establish that the requirements for a tax exemption are met.<sup>23</sup>

The governing principles for the tax exemption are laid out in the Circular Letter no. 12 of 8 July 1994. According to the Circular Letter the following requirements must be met cumulatively for a tax exemption:

(i) Legal entity

The entity requiring a tax exemption must be a legal entity. Typically this legal entity will be either a

foundation or an association. However, corporations which pursue a charitable purpose may also be tax exempt.

(ii) Exclusive use of the funds

The tax exempt activity must be exclusively dedicated to a public purpose or to the benefit of third parties. The goals of the legal entity may not be combined with gainful activities or other activities which further the interests of the legal entity, its members or associates. If a legal entity partly pursues charitable purposes and partly other purposes, then a partial tax exemption may be possible.

(iii) Irrevocability of the dedication to a specific purpose

The assets dedicated to the tax exempt purpose must be irrevocably transferred to the tax exempt legal entity. It must be ensured that they are forever used for the tax exempt purposes. A revocation or another return of the assets of the founder must be excluded. In case of dissolution of the legal entity, the assets have to be transferred to another tax exempt legal entity with similar purposes. This has to be established by an irrevocable provision in the governing documents.

(iv) Actual charitable activities

The purposes must also be actually pursued. The mere proclamation of a tax exempt activity in the statutes does not suffice.

In addition to these aforementioned general requirements the following additional requirements must be met:

- The activities must be in the public interest;
- The activities must be altruistic;
- The class of beneficiaries must be open, ie distributions shall for example not be restricted to workers in a certain industry;

22. The 2003 Amendment Act of the BVI provides for example that there is, in relation to purpose trusts created on or after 1 March 2004, no longer any requirement that a purpose trust must not be for the benefit of particular persons or aggregate of persons.

23. Decision of the Swiss Supreme Court 92 I 253.

- Activities that exclusively take place abroad must be in the general interest of Switzerland.

### *Requirements for charitable entities controlling commercial enterprises*

Commercial activities can by no means be qualified as charitable. The acquisition and administration of significant capital participations in enterprises are, however, characterized as charitable if the interest in the preservation of the enterprise prevails over the charitable purpose and provided that no management activities are exercised by the charitable entity.<sup>24</sup>

Section 3 lit. c of the Circular Letter provides that a charitable entity may even hold a majority of the shares of another company which pursues entrepreneurial objectives, provided that the charitable entity does not exercise management in such an entity. For example, it does not actively participate in the management and the business activities of that company. The Circular actually demands, among other things, a clear separation between the persons constituting the governing body of the charitable entity, and the board of directors of the company, in terms of organization and personnel. Merely the presence of a 'liaison officer' is permissible.

Furthermore, the Circular Letter also states that a charitable entity, which holds a participation in a business, must regularly receive dividends from this business and must carry on charitable activities with the income it so receives by annually distributing its income. The accumulation of earnings in such a way that the contributions made to charitable causes would become disproportionately small in relation to the dividends received, prevents the granting of a tax exemption. One Swiss author mentions an example of a foundation holding shares in the value of EUR 66 millions, thereby earning an annual income of EUR 2.7 millions from these shares. The tax authorities did not recognize the foundation as tax-exempt, since it contributed only EUR 0.7 million every 5 years to

charitable purposes, and simply accumulated the rest of its earnings.<sup>25</sup> The basic concept is therefore that a foundation which retains its earnings is in fact not actively pursuing its charitable purposes.

### *The exemption from federal tax for the pursuit of a public interest abroad*

According to the Circular Letter, a legal entity with non-profit objectives has to pursue a public interest. This public interest is not limited to an activity in Switzerland, but it has to be an activity which conforms to the Swiss public interest and is pursued on an altruistic basis even if it is performed abroad. There is no official definition of the term 'public interest'. Whether a specific activity is in the public interest must therefore be determined according to the actual public opinion, which can be identified by interpreting Swiss legislation and court precedents. As a principle, activities abroad are considered in the Swiss public interest, if there is a clear necessity of international cooperation and if they are in accordance with the idea of international solidarity.

In practice, the authorities distinguish between humanitarian and scientific or cultural areas. Humanitarian activities as well as activities of a scientific or cultural nature pursued by organizations of an established reputation (so-called top organizations) can be exempt from Swiss taxes even if there is no such activity performed in the territory of Switzerland. According to Swiss tax law, the term 'humanitarian activities' includes the preservation of human life, the relief of poverty and the support of development aid, ie the alleviation of poverty in the long term. Scientific or cultural activities of less established organizations must, however, be performed to a large extent in Switzerland in order to qualify as being in the public interest. The proportions of such activities which are to be performed in Switzerland are not defined in a formal way, but are determined by the tax authorities on a case-by-case basis. There are, however, no court precedents on

24. Article 56 lit. g of the Federal Income Tax Act.

25. Urs Landolf, *Steuerliche Fragen zur Unternehmensstiftung*, Der Schweizer Treuhänder, 1-2/1991.

this issue. With continuing globalization and the attractiveness of Switzerland for foreign donors, it becomes debatable to which extent actual distributions within the territory of Switzerland are required to meet the 'Swiss public interest' test. Today such a requirement should be dropped entirely, and solely be limited by the extraordinary measure of a situation of abuse of law.

#### **Requirements for a tax exemption for charitable entities under Swiss cantonal and communal tax law**

The principles governing the direct taxation of the Swiss cantons and the Swiss municipalities are outlined in the Federal Tax Harmonisation Act.<sup>26</sup> Pursuant to Article 23 paragraph I lit. f of the Federal Tax Harmonisation Act, the requirements for a tax exemption of legal entities which pursue public or charitable purposes are identical to the corresponding provision of the Federal Income Tax Act. The comments under section 'Requirements for a tax exemption for charitable entities under Swiss federal tax law' above apply therefore for cantonal and communal tax purposes as well.

#### **Double tax agreements**

Some cantons have entered into reciprocity agreements with foreign states and countries, according to which the parties acknowledge their respective tax-exempt institutions. The canton of Zurich has, for example, concluded a reciprocity agreement with the state of California and also with the United States of America.<sup>27</sup> This is pursuant to grants to associations of persons, foundations and establishments, having their seat in the US, and pursuing according to their statutes, or charitable, philanthropic, religious, scientific or artistic purposes, an exemption from estate and gift tax, to the extent that the grants are dedicated to these purposes. The wording of these reciprocity agreements does not extend so far as to include trusts, so charitable trusts may not achieve the status of a

tax exempt entity simply by having their seat in a jurisdiction with which the relevant Swiss canton has a reciprocity agreement.

To the extent that the Swiss confederation has concluded double tax treaties ('DTT'), such treaties are considered to be international conventions, which supersede both federal and cantonal tax rules. There are currently 10 DTT in the area of inheritance and estate tax, namely with: Austria (1974), Denmark (1973), Finland (1956), France (1953), Germany (1978), Netherlands (1951), Norway (1956), Sweden (1979), United Kingdom (1956; new treaty in 1993) and the United States (1951). So far, Switzerland has not concluded any DTT in the field of gift taxes so that the taxation of *inter vivos* transfers is not affected by these DTT. The two inheritance and estate tax treaties with common law countries, ie the UK and the US treaties, contain no provisions, which would benefit the tax treatment of charitable trusts in Switzerland.

#### **Application of these requirements to the tax exemption of charitable foundations and charitable trusts**

##### **Foundations**

Foundations are considered to be legal entities under Swiss law. Consequently, if they meet the requirements of Article 56 lit. g of the Federal Income Tax Act, and of Article 23 paragraph I lit. f of the Federal Tax Harmonisation Act outlined under section 'Requirements for a tax exemption for charitable entities under Swiss federal tax law' above, then they are entitled to obtain an exemption from federal taxation.

##### **Trusts**

Article 56 lit. g of the Federal Income Tax Act and the corresponding provision of the Federal Tax Harmonisation Act, provide that an entity requiring a tax exemption must be a legal entity. Prior to the enactment of the new provisions of the Swiss IPLA and

26. Article 1 Federal Tax Harmonisation Act.

27. Gegenrechtserklärung des Regierungsrates des Kantons Zürich über die Befreiung von Zuwendungen an Institutionen mit besonderen Zwecken in den Vereinigten Staaten von Amerika vom 25. Juni 1953.



the ratification of the HTC, a foreign express trust would have been characterized on the basis of its resemblance to a legal institute of the Swiss IPLA. The majority of the legal doctrine<sup>28</sup>—the experts of the Federal Department of Justice and Police<sup>29</sup> and the Supreme Court<sup>30</sup>—qualified express trusts as ‘organized economic units’<sup>31</sup> and applied the company law provisions to trusts by analogy. There was no definition of the term ‘organized economic units’ in the PILA. However, there was a broad consensus among the legal doctrine that a typical irrevocable express trust had a sufficient degree of organization to qualify as an organized economic unit within the meaning of Article 150 PILA, so that the application of the company law provisions was justified.

The ratification of the HTC and the subsequent issuance on 22 August 2007 of the circular Letter no. 30 on the taxation of trusts by the association of the Swiss Tax Authorities (SSK), significantly influence the classification of trusts for tax purposes. Although the Circular Letter on the Taxation of Trusts does not directly apply to charitable trusts, it nevertheless contains important conclusions which affect the characterization of charitable trusts for Swiss tax purposes. The Circular Letter states in its section on the main features of a trust that

even if its structure is similar to a Swiss foundation, the trust does not have separate legal personality.<sup>32</sup>

Furthermore, its section describing the differences between trusts and foundations contains the following statement:

Once set up, the foundation acquires the status of a legal entity. On the other hand, the trust does not have

legal personality. The trust has no legal capacity and therefore cannot own assets.<sup>33</sup>

The tax consequences of the trust’s lack of a legal personality are outlined in section four of the Circular Letter, which clarifies the tax treatment of a trust as follows:

Foreign law does not consider the trust to be a legal entity. Applying Swiss collision law (the incorporation theory of the IPLA), Swiss tax law can also not consider a trust to be a legal entity.

A trust is also not a ‘foreign legal entity’ in the terms of Art. 49 para III of the Federal Income Tax Act and Art. 20 para II of the Federal Tax Harmonisation Act as this statutory provision only covers bodies of persons to which Swiss private law confers legal personality. Swiss private law does, however, not make the trust a legal entity.

The authors of the Circular Letter on the Taxation of Trusts therefore come to the conclusion that under current Swiss tax law, there is no statutory basis which would allow a foreign trust to be treated as a legal entity for tax purposes. Consequently, Article 56 lit. g of the Federal Income Tax Act and Article 23 paragraph I lit. f of the Federal Tax Harmonisation Act can, in light of the Circular Letter on the Taxation of Trusts, not be construed in such a way that these provisions would include trusts. Such an interpretation would be a clear contradiction of the wording of these provisions, which state that an entity requiring a tax exemption must be a legal entity. Charitable trusts may therefore, based on the wording of the relevant statutory provisions, not be exempt from taxation in Switzerland.

28. See the overview in: Vischer: Zürcher Kommentar zum IPRG, p 1726 and Mayer, Die organisierte Vermögenseinheit gemäss Art 150 des Bundesgesetzes über das internationale Privatrecht, p 208.

29. Botschaft zur Genehmigung und Umsetzung des Haager Übereinkommens über das auf Trusts anzuwendende Recht und über ihre Anerkennung, p 562.

30. Semaine Judiciaire 2000, S. 269 ff.

31. Article 150 par. 1 PILA.

32. Section 2.1 of the Circular Letter no. 30 on the taxation of trusts.

33. Ibid.

### *Consequences of the tax exemption of a charitable entity for the deductibility of the voluntary contributions to this entity*

Voluntary contributions in the form of money or other assets to legal entities, which have their seat in Switzerland and which have been exempt from taxation pursuant to Article 56 lit. g of the Federal Income Tax Act and Article 23 paragraph I lit. f of the Federal Tax Harmonisation Act, may on account of their public or charitable purposes, be deducted by the contributing *individual taxpayers* in Switzerland. But only provided that these contributions reach an amount of at least CHF 100 and do not exceed 20 per cent of the net income of this individual.<sup>34</sup> *Corporate taxpayers* may also deduct voluntary contributions, provided they do not exceed 20 per cent of their taxable earnings.<sup>35</sup>

### *Consequences of the tax exemption of a charitable entity for the taxation of gratuitous transfers to this entity*

Apart from the canton of Schwyz, all Swiss cantons impose estate or gift taxes on gratuitous transfers to unrelated third parties. The mechanism of this regime is subsequently outlined using the canton of Zurich and its Estate and Gift Tax Act as an example.

Paragraph 1 of the Estate and Gift Tax Act provides that the canton of Zurich imposes an estate and gift tax. This tax is imposed when:

- the testator's last place of residence was in the canton of Zurich or the administration of his estate was initiated in the canton of Zurich;
- the donator had his residence in the canton of Zurich at the time of the donation;

- real estate or interests in real estate located in the canton of Zurich are transferred.<sup>36</sup>

While transfers to spouses and children are in many cantons, tax exempt, gratuitous transfers to unrelated persons are subject to estate and gift tax. This tax is levied on the recipient of the transferred asset.<sup>37</sup> If, however, the recipient is a legal entity, which pursues public or charitable purposes and therefore has been exempt from the cantonal and communal taxes, then the legal entity is also exempt from the estate and gift tax.<sup>38</sup>

Gratuitous transfers, either *inter vivos* or upon death, to charitable foundations, are thus not subject to estate and gift tax within a specific canton. Gratuitous transfers to a charitable trust, however, would be considered to be transfers to an unrelated person which, depending on the amount transferred, would be subject to a tax of up to 36 per cent.<sup>39</sup>

### *A doctrinal analysis of the tax exemption of charitable entities*

Prior to the date of publication of the Circular Letter 12 of 8 July 1994, Prof. Reich published a paper on charitable activities as a reason for tax exemption.<sup>40</sup> Prof. Reich stated that the term 'charitable' is an indeterminate legal term which is too abstract to be applied to individual cases. He therefore concluded that the meaning of this term should be determined by the tax administration, the tax courts, and the tax scholars, by virtue of additional values, which are not inherent in the wording. He argues that the person interpreting the provision should take into account the rule making process when trying to ascertain the meaning of this indeterminate term, and establish the

34. Article 33a Federal Income Tax Act and Art 9 para II lit. i of the Federal Tax Harmonisation Act (the Federal Tax Harmonisation Act does not specify the maximum amount of income, which may not be exceeded but leaves this to the discretion of the cantons; in the cantons of Zurich and Zug the maximum amount is for example also 20 per cent).

35. Article 59 para I lit. c Federal Income Tax Act and Art 25 para I lit. c of the Federal Tax Harmonisation Act.

36. Section 2 Estate and Gift Tax Act Zurich.

37. Section 8 Estate and Gift Tax Act Zurich.

38. Section 10 lit. e Estate and Gift Tax Act Zurich.

39. Section 22 in connection with s 23 Estate and Gift Tax Act Zurich.

40. Reich, Gemeinnützigkeit als Steuerbefreiungsgrund, ASA 1990, Bd. 58, p 465 ff.

content and significance of such a term by bearing in mind the legal system in its entirety.

At the core of the Swiss system of taxation lies the principle of economic capacity (*Prinzip der wirtschaftlichen Leistungsfähigkeit*), pursuant to which taxpayers should pay income tax with due regard to their economic capacity. This principle incorporates the notion that all taxpayers should be equally affected by the tax burden, so that they perceive the burden as equally onerous. In other words, the tax shall curtail the benefits provided by the income for all taxpayers to the same extent. This implies that the rich should pay higher taxes than the poor, and it also implies progressive tax rates at both the corporate and individual taxpayer levels.<sup>41</sup> However, it also implies that no tax should be levied where there is no 'potential to satisfy needs' (*Bedürfnisbefriedigungspotential*). The funds a taxpayer must, for example, apply to necessities for himself or other dependant persons, are not available for the payment of taxes and should thus not be considered when measuring the taxpayer's economic capacity.

Legal entities have no needs of their own in the meaning of the tax doctrine. Because the tax burden of legal entities is ultimately always borne by individuals, the taxation of legal entities is conceptually only justified if due regard is taken to the economic capacity of the individuals behind these legal entities. In the case of a charitable legal entity, the recipients of the legal entity's contributions are typically an open class of individuals, which, in light of the charitable nature of these contributions, are characterized by their indigence. A tax exemption of a charitable legal entity is therefore indicated on the basis of the constitutional concept of equality before the law,<sup>42</sup> pursuant to which, taxes are imposed in consideration of the economic capacity of the

taxpayers, so that lack of economic capacity prevents the imposition of taxes.

The taxation of charitable trusts is therefore only conceptually justified, if either the trust itself, or the persons benefiting from a trust, have economic capacity. Provided the same criteria are applied to determine whether a trust is charitable or not, which are applied to determine the charitable nature of foundations, we can see no difference between the economic capacity of a charitable trust and a charitable foundation. Since the activities must in both cases be in the public interest, the individual recipients of the charitable distributions are characterized by their indigence and thus by a lack of economic capacity which should preclude the imposition of taxes. An unequal treatment of charitable trusts and charitable foundations is therefore a violation of the principle of economic capacity.

In the early seventies, the Swiss Supreme Court began to interpret tax provisions according to the economic reality (*wirtschaftliche Betrachtungsweise*), where it was established that they have economic points of reference (*wirtschaftliche Anknüpfungspunkte*).<sup>43</sup> Considering that the tax exemption of charitable foundations is, according to Prof. Reich, justified by the lack of economic capacity of the beneficiaries of the foundation, there is arguably an economic point of reference to these provisions. In such circumstances, the scope of the tax law is not limited to the situations to which it formally refers but, on the contrary, also applies to those which can be considered equal from an economic point of view.<sup>44</sup> On the other hand, Prof. Danon also clearly states that the Federal Tribunal has always excluded the possibility of interpreting federal tax provisions according to the economic reality where they use private law concepts ('*zivilrechtliche Anknüpfung*').

41. Reich, *Das Leistungsfähigkeitsprinzip im Einkommenssteuerrecht*, ASA 53, 5 ff.

42. Article 8 Swiss federal constitution.

43. See Danon, *Switzerland's direct and international taxation of private express trusts*, p 176 with further references.

44. *ibid.*

The requirement that an entity requiring a tax exemption must be a legal entity, is such a private law concept.

The resulting uncertainty, whether the courts would apply the provisions exempting charitable legal entities charitable trusts which are equal from an economic point of view, or whether they would not interpret these provisions according to the economic reality because the term 'legal entity' is a private law concept, shows that the unequal treatment of charitable trusts and foundations may not easily be overcome *de lege lata* by virtue of an interpretation of the relevant provisions. Particularly since the Swiss Supreme Court held that a constitutional interpretation must always respect the clear wording and meaning of a provision.<sup>45</sup>

### **Conclusion**

It is very likely that charitable trusts will not be exempt from federal and cantonal/communal taxation because they are not legal entities and do therefore not meet the statutory requirements for a tax exemption. Contributions to charitable trusts may therefore not be deducted by Swiss resident taxpayers. On the contrary, such contributions are considered

as donations to an unrelated person, and are thus subject to gift or estate tax.

While a transfer to a charitable foundation allows a taxpayer to make a deduction of up to 20 per cent of his net income, the same taxpayer would have to pay a gift tax of up to 36 per cent if the donation were made to a charitable trust instead.

The unequal treatment of charitable trusts and charitable foundations is, in the view of the authors, a violation of the principle of economic capacity, a governing principle of the Swiss tax system. Assessing tax authorities, which are obliged to apply an equal treatment to equal circumstances with the same equally relevant facts, unless a factual reason justifies a different treatment,<sup>46</sup> may, however, argue that a tax exemption is not justified. They may argue that because a charitable foundation is a legal entity, whereas a charitable trust is not, this is a relevant factual difference which justifies an unequal treatment.

From the point of view of an advisor, the tax treatment of charitable trusts impedes the use of these interesting philanthropic structures for Swiss resident clients. Until the legislators amend the relevant tax provisions, a diligent advisor will prefer to use Swiss charitable foundations than charitable trusts.

45. Swiss Supreme Court decision 123 II 9.

46. Swiss Supreme Court decision 125 I 163 E. 3a; 125 IV1 E. 5b; Schweizer, Die Schweizerische Bundesverfassung – Kommentar zur Art. 8, N. 42.