Journal of Economics and Business Review
ISSN 3065-176X
Vol. 2, No. 1, 2025
Published by STSL Press

Original Paper

Navigating Trusts in Switzerland: Tax Challenges and Opportunities

Francois-Serge Lhabitant

Hong Kong University of Science and Technology, Finance Department, Hong Kong, China

Abstract

Switzerland, a global wealth management leader, does not recognize trusts under its civil law yet interacts with foreign trusts via the 2007 Hague Convention. This duality complicates taxation for settlors, trustees, and beneficiaries with Swiss ties. This memo examines these tax rules, focusing on practical outcomes for residents.

Keywords: Trusts, Tax law, Wealth planning

1. Introduction

A trust is a legal arrangement where one party, known as the settlor, transfers assets to another party, the trustee, to manage for the benefit of a third party, the beneficiary. The trustee holds legal title to the assets but is bound by fiduciary duties to manage them in the best interests of the beneficiary. The concept of trusts originates from the practical needs of medieval landowners and the subsequent development of English common law and equity principles. It has evolved over centuries to become a fundamental tool in estate planning, asset management, charitable giving and wealth preservation. Today, trusts are recognized in many jurisdictions, although the specific laws governing them can vary. In particular, the tax treatment of trusts is not fully harmonized across different jurisdictions, as tax laws and regulations vary significantly from one country to another. Each country has its own set of rules and principles governing the taxation of trusts, which can lead to complexities and inconsistencies in the tax treatment of trusts with cross-border elements.

Internationally, efforts have been made to harmonize certain aspects of trust law through conventions such as the Hague Convention on the Law Applicable to Trusts and on their Recognition (hereinafter: "HCT"), which aims to provide a framework for the recognition and enforcement of trusts across different jurisdictions. The Organization for Economic Co- operation and Development (OECD) has also worked on initiatives to promote transparency and exchange of information regarding trusts, which can indirectly influence tax treatment. Unfortunately, so far, these efforts did not result in a uniform tax regime for trusts across different countries. This creates complexity for settlors, trustees, and beneficiaries, as well as opportunities for tax avoidance or unintended tax burdens.

An interesting case is Switzerland, which is one of the world's leading financial and wealth management hubs. The country's enduring reputation for stability, confidentiality, and expertise in financial services has drawn clients from all corners of the globe. However,

Switzerland does not recognize trusts within its own civil law framework, meaning that Swiss trusts cannot be established. Accommodating trusts established under foreign laws while adhering to Swiss legal and regulatory standards has been exceptionally challenging. For many years, the only viable approach was to treat trusts by analogy with recognized Swiss legal instruments, such as foundations, contracts, or even companies, with the hope that tax authorities would not contest this treatment.

Switzerland’s ratification of the HCT in 2007 has finally enabled the country to recognize and engage with foreign trusts while ensuring compliance with its legal and regulatory standards. To align with this change, Switzerland has also amended its Private International Law Act (PILA) and the Federal Act on Debt Enforcement and Bankruptcy (DEBA). However, from a Swiss tax law perspective, the situation remains intricate. Article 19 of the HCT does not include any tax provisions and explicitly allows each state to regulate the matter independently. To address this complexity and prevent inconsistencies arising from varying administrative practices and cantonal interpretations, the Swiss Conference of Tax Authorities issued Circular No. 30 on August 22, 2007 (hereinafter "CI30"). CI30 outlines the applicable principles for the taxation of trusts. Subsequently, the Federal Tax Administration fully adopted these principles for federal direct tax and withholding tax in its Circular No. 20, issued on March 27, 2008.

The CI30 clarifies that since a trust does not have legal personality in Switzerland, the issue of its tax liability, whether limited or unlimited, does not arise[1]. Consequently, a trust must be treated with complete transparency in the strictest sense. The CI30 also states that no tax should be levied on the trustee or the protector, as they do not have legal and economic control over the trust's assets or income. Therefore, these assets and income must be taxed either to the settlor or the beneficiaries.

In this article, we will delve into the tax treatment of a trust's assets and income under Swiss tax law. A key area of interest is the scenario involving a private express trust established by a settlor, with either a trustee or beneficiaries who are residents of Switzerland. The discussion should be particularly useful for aids professionals, including lawyers, accountants, and financial advisors, in providing accurate and up-to-date advice to their clients. It is also relevant for domestic and international clients seeking to optimize their financial strategies. Staying informed about the evolving regulatory environment helps all stakeholders adapt to changes and make informed decisions, ensuring long-term financial stability and growth.

The structure of our discussion follows the typical timeline of a trust life. Section 2 covers trust creation, Section 3 analyzes residual tax challenges, and Section 4 offers conclusions.

2. The main event: the divestment by the settlor

Article 2(2) of the HCT 1985, does not provide a standalone definition of a trust in a strict sense. Instead, it delineates the characteristics that identify a trust for the purposes of the Convention. Specifically, Article 2(2) describes a trust as follows: a “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.” The crucial element in the creation of a trust is the divestment by the settlor of the assets transferred to the trustee – see Böckli (2007) and Thévenoz (2007). To determine whether a trust could be recognized under Swiss tax law, one must therefore first examine whether this divestment is effective. To this end, the CI30 distinguishes three categories of trusts: revocable trusts, irrevocable non-discretionary trusts, and irrevocable discretionary trusts[2].

2.1 The Revocable Trust

In a revocable trust, the settlor retains some legal or economic control over the trust and its assets. Specifically, the settlor can revoke the trust later, have the residual assets returned, or allocate them to other beneficiaries. In such cases, the CI30 considers that there has been no genuine divestment and that the assets have not left the settlor's economic sphere as long as the settlor is alive[3]. Consequently:

- The assets and income of the trust remain taxable to the settlor. The fact that the settlor is subject to unlimited or limited tax liability in Switzerland has no influence in this context. Capital gains made by the trust should logically be exempt under the conditions of Articles

[1] A trust is a foreign legal vehicle, but it is neither a foreign legal entity (as addressed in Articles 49(3) of the Federal Direct Tax Act (LIFD) and 20(2) of the Harmonized Tax Law (LHID)), nor a partnership or foreign legal community (as addressed in Articles 11 LIFD and 20(2) LHID). See Ryser (1992), Cretti (2007), and Danon (2003, 2007).

[2] Note that this classification is specific to the CI30 and not universally applicable to the world of trusts. For instance, in certain Anglo-Saxon trusts deemed irrevocable, the settlor may nonetheless retain a right of revocation.

[3] A revocable trust typically becomes irrevocable upon the death of the settlor.

16(3) of the Federal Direct Tax Act (LIFD) and 7(4)(b) of the Harmonized Tax Act (LHID), but the CI30 is silent on this matter.

- Any distributions made by the trust to a Swiss resident beneficiary other than the settlor will be treated fiscally as gifts from the settlor to the beneficiaries and subject to gift tax at the beneficiaries' level. The tax rate will be set by the canton of the settlor.

- Distributions made to the settlor are tax free, since the settlor is considered as still owning the assets.

2.2 The Irrevocable Non-Discretionary Trust

In an irrevocable non-discretionary trust (a.k.a. irrevocable fixed interest trust), the trustee has no discretion regarding the allocation of the trust's assets and income. The beneficiaries and their rights are specifically designated in the trust deed, and they acquire a firm claim against the trust that they can enforce in court if necessary. In such cases, the CI30 recognizes the settlor's definitive divestment and considers that there is an enrichment of the beneficiary, whose position is akin to that of a usufructuary[4]. Consequently:

- The act of establishing the trust is treated fiscally as a gift from the settlor to the beneficiary, with a potential gift tax on the trust's capital. If the settlor is domiciled in Switzerland, there will be a gift tax to be paid on the trust's capital. The tax rate will be fixed by the canton of domicile of the settlor. In the case of a trust created following the death of the settlor (*mortis causa*), the gift taxe will be replaced by an inheritance tax.

- The share of a trust of a beneficiary residing in Switzerland is included in their taxable wealth[5], possibly through the capitalization of future income from that trust.

- Any distributions made by the trust to a Swiss resident beneficiary (other than the settlor) are considered taxable income under Articles 16(1) LIFD and 7(1) LHID, unless the beneficiary can prove that it is a capital gain or a repayment of capital, in which case they are not taxable[6]. In principle, capital can only be distributed after all the trust's income has been distributed.

2.3 The Irrevocable Discretionary Trust

In an irrevocable discretionary trust, the trustee has a certain degree of discretion, as defined by the trust deed, to allocate the trust's assets and income, for example, among members of different classes of beneficiaries. The settlor's wishes expressed in a letter of wishes are non- binding. Therefore, the beneficiaries' rights are merely expectations of acquiring equitable ownership of the assets or their income[7]. The CI30 distinguishes two situations in this context.

- If the settlor is a Swiss resident taxed under the ordinary regime, the CI30 considers that the divestment cannot be recognized for tax purposes since no other legal entity has been fiscally enriched. It therefore recommends continuing to attribute the trust's assets and income to the settlor. The tax consequences are then the same as in the case of a revocable trust.

- If the settlor is a Swiss resident taxed based on expenditure (Art. 14 LIFD; Art. 6 LHID) or if the settlor is domiciled abroad at the time of the trust's creation, the CI30 recognizes the divestment[8] and assimilates it to a gift. In this case, the trust's assets and income are attributed neither to the settlor nor to the potential beneficiaries, resulting in a situation of non-taxation. Consequently:

---

4 Archives 55, 657; CCR/VD, StE 1985 B 52.1 no 1.

5 see the Federal Court's judgment of 5 December 1984, Archives 55, 657.

6 art. 16, al. 3 LIFD and art. 7, al. 4, let. b LHID, art. 24 let. a LIFD et art. 7, al. 4, let. c LHID.

7 See Böckli (2007) and Salom (2010).

8 Subject to a verification calculation in the case of taxation based on expenditure, and provided that the trust was not established just before taking up residence in Switzerland.

o A Swiss resident beneficiary is not taxed on the wealth represented by the trust's assets.

o Any distributions made by the trust to a Swiss resident beneficiary (other than the settlor) are taxable as ordinary income at the time of the actual payment of the benefit, unless the beneficiary can demonstrate that it is a distribution of the trust's capital (Art. 24(a) LIFD; Art. 7(4)(c) LHID). It should be noted that any capital gains realized by the trust are taxed as income upon distribution[9], and that, in principle, the trust's capital can only be distributed after all income and capital gains have been distributed.

3. Analysis

3.1 Fiscal Reclassification of the Irrevocable Nature of a Trust

In its approach, the CI30 has adopted a strict interpretation of the definition of an irrevocable trust. It specifically provides for the possibility of deviating from the formal designation made in the trust deed to fiscally reclassify an irrevocable trust as a revocable trust "if there is any possibility of influence by the settlor over the trust, regardless of its nature[10]," or if there are economic or legal indications that the settlor's divestment is not definitive.

For example, the CI30 mentions the following indicators: the settlor has appointed themselves as a trustee or beneficiary, can revoke the trustee and appoint a new one, designate new beneficiaries, replace the protector, modify or have the trust deed modified, revoke the trust, demand its liquidation, or exercise a veto right over the trustee's decisions regarding the trust's assets. The CI30 specifies that any one of these points "tends to fiscally classify the trust as a revocable trust," with the direct consequence that the divestment is not fiscally recognized and that the Swiss resident settlor is fiscally attributed the trust's assets and income.

This systematic reclassification is, in our opinion, questionable because the forms of civil law—and therefore, in particular, the stipulations contained in the trust deed—should be determinative, except in two specific cases. The first is the case of simulated stipulations ("sham trust") that would not be recognized by the foreign law applicable to the trust. The second is the case of abuse of law, such as tax evasion. According to the jurisprudence of the Federal Tribunal[11], tax evasion refers to a situation that is "unusual, inappropriate, or strange, and in any case, unsuited to the economic purpose pursued," chosen "solely for the purpose of saving taxes that would be due if the legal relationships were appropriately arranged," and effectively resulting in "a significant tax saving to the extent that it would be accepted by the tax authority." When these three conditions are met, the jurisprudence of the Federal Tribunal acknowledges that taxation should be based not on the form chosen by the taxpayer but on "the situation that would have been the appropriate expression of the economic purpose pursued by the interested parties." This has indeed occurred in practice and has led to the fiscal reclassification of the nature of the trust in question[12]. However, this does not justify systematic fiscal reclassification, especially since some of the indicators mentioned by the CI30 are integral to Anglo-Saxon property and trust law, are frequently used in practice, and are even described in Article 2 of the HCT: "The fact that the settlor retains certain prerogatives (...) does not necessarily preclude the existence of a trust." It therefore seems difficult to qualify them as unusual and, by extension, to refuse the divestment by arguing that it constitutes tax evasion.

3.2 The Case of Irrevocable Discretionary Trusts

The case of a Swiss resident settlor, taxed under the ordinary regime, creating a genuine irrevocable discretionary trust poses the most significant problems. The settlor has effectively divested themselves of

[9] The principle upheld by the CI30 is that the trust assets have not been allocated to the beneficiary, which prevents an exemption from capital gains tax on private wealth.

[10] CI30 para 3.7, p 5.

[11] Federal Court's judgment 131 II 627 (635 s.) section 5.2. = RDAF 2005 II 532 (539 s.) This definition is used in several following court decisions.

[12] See for example the Federal Court's judgment of 19 December 2003, FI.2003.0019, confirmed in the Federal Court's judgment 2A.67/2004 et 2P.34/2004, dated 17 February 2005.

their assets and become impoverished, but the beneficiaries have only expectations of distributions. Therefore, there is no one left to tax. To fill this void, the CI30 introduces the requirement of corresponding enrichment, does not recognize the divestment, and treats the trust as if it were revocable, attributing the income and wealth to the settlor. This, in our opinion, violates several fundamental principles of law.

Principle of Ability to Pay: One can imagine a scenario where the settlor has genuinely divested themselves of their assets in favor of a trust and has neither economic nor legal enjoyment nor control over them, yet still finds themselves taxed on both the wealth and income of the trust. Imagine a settlor who transfers $5 million to a trust, loses all control, yet faces a $100,000 tax bill with no income to pay it. By what means will the settlor pay these taxes? The refusal to recognize the divestment leads to a violation of the principle of ability to pay, which is guaranteed by Article 127(2) of the Constitution.

Principle of Legality: By fiscally attributing the assets and income of an irrevocable discretionary trust to its Swiss resident settlor without verifying that the latter has a legal claim to their restitution under civil law, the CI30 chooses to ignore the rules of private law regarding the realization and attribution of income and wealth. Specifically, under Swiss law, wealth is taxable to the person who can economically dispose of the asset in question, and income is taxable only when it is realized, i.e., paid in cash or when the taxpayer has a firm claim that they can effectively dispose of. These principles have been reiterated by the Federal Tribunal on numerous occasions[13].

Principle of Equal Treatment: Consider the case of two identical irrevocable discretionary trusts, the only difference being that one is created by a foreign resident who subsequently decides to establish residence in Switzerland, and the other is created by a Swiss resident. Ultimately, both settlors are taxed in Switzerland under the ordinary regime. The wealth and income of the first trust will escape taxation since they will not be attributed to the settlor, while the wealth and income of the second trust will be fully attributed to the settlor and taxed. Thus, we have a situation where two settlors are in the same tax position (unlimited tax liability) but are taxed differently based on their residence at the time the trust was established. However, the principle of equal treatment is explicitly stated in Article 8 of the Constitution.

Principle of Legality (revisited): De facto, the CI30 does not recognize an internal Swiss trust, even though the Swiss legislator has explicitly waived the right to invoke the exception clause of Article 13 of the HCT. The CI30 attempts to justify this by invoking Article 335(2) of the Civil Code on the prohibition of the establishment of family trusts, as well as the reservation of tax evasion. The first argument seems difficult to sustain, as the Federal Tribunal has confirmed that an entity violating Article 335(2) of the Civil Code must still be recognized fiscally until its nullity is pronounced by a civil judge[14]. The second argument is also questionable. In particular, one would need to prove the "inappropriate" nature of the economic purpose pursued by the internal Swiss trust, which seems difficult to do a priori in all cases of asset and succession planning. Moreover, the unusual nature of such a trust for the CI30 seems to stem solely from its lack of foreignness, as its settlor was a Swiss resident at the time of its creation.

4. Conclusions

The CI30 was designed to address the legal void surrounding the tax treatment of trusts, particularly those with connections to Switzerland. While it has largely succeeded in clarifying the tax treatment of revocable trusts and irrevocable non-discretionary trusts, the handling of irrevocable discretionary trusts remains a contentious issue. The conditions for divestment, especially in cases involving a Swiss settlor, appear to be overly restrictive and seem primarily aimed at preventing the loss of a taxable base. These conditions are not only difficult to justify but also blatantly violate several fundamental principles of law. Switzerland could have adopted a ‘look-through’ rule taxing beneficiaries only on distributions, aligning with OECD transparency goals.

---

[13] Federal Court's judgment 105 Ib 238 section 4a p. 242; Federal Court's judgment on 15.7.1955, RDAF 1956 141, 143; Federal Court's judgment on 3.12.1954, RDAF 1956 131, 133; RDAF 2001 347 ; RDAF 2001 347 ; RDAF 2003 II 343.

[14] Federal Court's judgment 108 II 398, section 4; Federal Court's judgment of 22.4.2005, 2A.668/2004, section 3.4.2.

Critics argue that the stringent requirements for recognizing the divestment of assets in irrevocable discretionary trusts are disproportionate and create unnecessary complexity. The current framework imposes significant burdens on settlors and trustees, often leading to uncertainty and potential legal challenges. Moreover, the restrictions can deter individuals from establishing trusts in Switzerland, potentially driving them to seek more favorable jurisdictions.

This not only undermines Switzerland's position as a leading financial center but also raises questions about the fairness and effectiveness of the current tax policies.

CI30 clarifies taxation for revocable and non-discretionary trusts but falters with discretionary trusts, imposing rigid divestment rules that clash with constitutional norms. This rigidity risks driving trust business to jurisdictions like Jersey or Singapore. A beneficiary-focused reform could balance fairness and competitiveness, strengthening Switzerland’s fiscal framework

References

Böckli P. (2007). The Anglo-Saxon Trust: Civil Law and Tax Law, Steuer Revue p. 714.

CI30 (2007). Circular No. 30 of the Swiss Conference on Taxation of August 22, 2007, Taxation of Trusts, Archives 76 p. 531.

Cretti S. (2007). The Trust - Tax Aspects, Helbing Lichtenhahn, Bâle.

Danon R. (2003). Private Express Trusts and Income and Wealth Taxes, Archives 72 p. 257.

Danon R. (2007). Note on the Status of Trusts in Swiss Tax Law, Steuer Revue p. 376.

Danon, R. (2008). The Taxation of the Private Express Trust. Critical Analysis of the CSI Circular of August 22, 2007 and Proposal for a Taxation Model, Archives 76 p. 435.

Oberson X. (2008). The Tax Treatment of Trusts in Swiss Law. The Limits to the Application of General Tax Principles, Archives 76 p. 475.

Oberson X., Maraia J.F. (2007). Trusts: Final Version of the Circular from the Swiss Conference on Taxation, News from the Center for Banking and Financial Law, www.unige.ch/cdbf, No 547.

Ryser W. (1992). Trust Relationships and Direct Taxes, Archives 61 p. 749.

Salom J. (2010). The Attribution of Income in Swiss and International Tax Law, Schulthess Verlag, Zurich.

Thévenoz L. (2007). Creating and Managing Trusts in Switzerland After the Adoption of the Hague Convention, in Notes from the 2006 Banking and Financial Law Day, Geneva/Zurich/Basel.