

NEWSLETTER

April 2007

SCHELLENBERG WITTMER

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Switzerland ratifies the Hague Trust Convention

The Hague Trust Convention will come into effect on 1st July 2007 in Switzerland. Simultaneously, some adaptations of Swiss law will enter into force. Thus, recognition of trusts in Switzerland will be governed by predictable rules and more legal security will be given in this area. In order to further improve the trust's status, the Swiss Tax Conference intends to publish a directive setting the rules for harmonizing the taxation of trusts. It is however not clear yet when such directive will actually be issued.

1 Introduction

The trust has its roots in the Anglo-Saxon legal system. A trust constitutes a legal relationship further to which assets are transferred to one or several persons (*trustees*) who must manage and dispose of them in accordance with the purposes defined by the founder (*settlor*). This purpose can either be of general nature or in favour of specific persons (*beneficiaries*).

Until now, Swiss law did not contain any specific legal provisions on the recognition of foreign trusts. Yet, the trust constitutes an economic and legal reality in Switzerland, especially in international private estate planning for private clients or in business finance. Despite decisions of principle from the Swiss courts, which recognized the trust concept as such, there was a lack of legal security. In particular, there were no clear rules on how to characterize a trust under Swiss law and, as a result, which substantive provisions would apply to trusts in specific circumstances. It was not clear either whether foreign decisions in trust matters could be recognized in Switzerland.

Accordingly, the Swiss Parliament decided on 20th December 2006 to authorize the Federal Council to ratify the Hague Convention on the Law Applicable to Trusts and on their Recognition of 1st July 1985 (**Hague Trust Convention**), which enshrines rules of conflicts applicable to trusts. Simultaneously, provisions were introduced in the Swiss Private International Law Act (**SPILA**), in order to transpose the Convention into Swiss law. Moreover, the Swiss Debt Collection and Bankruptcy Act (**SDCBA**) was amended so as to provide for the

segregation between the assets in trust and the trustee's patrimony in Swiss debt enforcement procedures and for a specific debt collection procedure against the assets in trust.

This newsletter summarizes these developments, by focusing on its practical consequences, and outlines the anticipated developments regarding taxation of trusts.

2 Characteristics of a trust

Unlike a foundation, a trust is not a separate legal entity; neither does it constitute an organized patrimony. Rather, a trust represents a **separate and autonomous unit of assets**. From a private law perspective, the trustee is the owner of the assets in trust, even though he must segregate these from his own patrimony and manage them in accordance with the purpose or in favour of the beneficiaries defined by the settlor. In addition to the trustee, one or several persons are frequently appointed as protectors to supervise the trustee's exercise of powers and his duties, but they are not, contrary to the latter, the owners of the assets in trust.

According to the nature of the beneficiaries' interest, one distinguishes between the *fixed interest trust* – where the beneficiaries' entitlements are pre-determined – from the *discretionary trust* – where the trustee enjoys discretionary powers for managing assets and for deciding on their distribution. If the settlor carves out the right to subsequently liquidate the trust, the trust is said to be *revocable* and, if the settlor does not, the trust is an *irrevocable* one.

3 The Hague Trust Convention and its implementation into Swiss law

3.1 Affected trusts

The new SPILA provisions apply to **all trusts**, whether or not they are evidenced in writing (e.g. in a will). However, following the Hague Trust Convention, the new Swiss provisions do not apply to *constructive trusts*, because these constitute judicial remedies rather than a private arrangement (e.g. a duty based on knowing receipt of misappropriated assets).



3.2 Applicable Law

The new SPILA provisions will grant a **settlor unfettered freedom to choose the law applicable to the trust**. His choice can be either express or implied in the terms of the trust instrument. The settlor can even make different choices of law for severable aspects of the trust. However, because of the obvious risk that the application of several laws to the same trust can cause problems in practice, one should carefully consider whether such a partial election is desirable. In the absence of any valid choice of law, the trust will be governed by the law with which it is most closely connected.

All legal issues regarding the trust's existence and effects are governed by the law applicable to the trust, such as its interpretation, its consequences, its organisation or its administration. Thus, the law applicable to the trust also applies to the trust's internal matters.

3.3 Jurisdiction

According to the new SPILA provisions, the trust instrument can contain a **forum selection**. Such choice of jurisdiction must be evidenced in writing or in any equivalent form. This selection can be made either by the settlor or, after the trust's settlement, by any other person so entitled to do so by the trust instrument. The selected court enjoys **exclusive** jurisdiction, unless stipulated otherwise.

The selected court will have jurisdiction over **all matters concerning trust law**. This covers trust disputes as well as non-litigious matters arising between the settlor, the trustee, the protector and/or the beneficiaries. This also covers a trustee's application to the (Swiss) court for directions as to the interpretation of the trust instrument.

The selected Swiss court can only decline its jurisdiction where it has no sufficient link with the trust, i.e. where neither the trust, respectively the persons involved, are domiciled in Switzerland, nor a substantial part of the assets in trust is located in Switzerland. Case law is left to define what a "substantial part of the assets in trust" means.

To avoid uncertainties with regard to the jurisdiction of (Swiss) courts, the trust instrument should contain an exclusive forum selection clause and should also specify the trust's place of administration.

3.4 Recognition of foreign trust decisions

Foreign decisions relating to matters concerning trust law will be recognised in Switzerland, if they were rendered by a validly selected court or in the country whose law governs the trust or in which the respondent has his domicile, habitual residence or establishment. Provided that the respondent is not domiciled in Switzerland, Swiss courts will also recognize a foreign court decision if it is recognised in the country in which the trust has its seat.

3.5 Publicity

The new SPILA provisions enable the voluntary entry of the trust relation in the relevant Swiss public registries – namely the land, the ship, the aircraft or the intellectual property registries. The trustee will then be registered as owner, but with the mention that his rights are held in trust. Trust relations which are not registered will not be enforceable in Switzerland against bona fide third parties.

3.6 The new SDCBA provisions

The new SDCBA provisions implement the segregation principle into Swiss debt collection, further to which assets in trust are by law **segregated** from the trustee's bankrupt estate in case of his bankruptcy, thus safeguarding them from the trustee's creditors. Furthermore, the SDCBA introduces a specific debt collection procedure for the assets in trust. Thus, claims can be filed against the trustee in his capacity as "trust representative" insofar as the debt is related to the assets in trust. The forum for filing such procedure is located at the trust's seat defined by the trust instrument or its effective place of administration in Switzerland. This procedure leads to bankruptcy, which would however be limited to the assets in trust.

4 Consequences of the ratification of the Hague Trust Convention

4.1 No Swiss trust law

The ratification of the Hague Trust Convention and the related amendments to the Swiss legislation do not mean that there will be a substantive Swiss trust law. Thus, as before the ratification, it will **not be possible to settle a trust under Swiss law**.

4.2 Mandatory provisions of Swiss civil law

The ratification of the Hague Trust Convention **does not supersede the mandatory provisions of Swiss civil law, notably the forced heirship provisions**. If Swiss inheritance law applies to an estate, the eligible heirs will be able to file a claw-back claim against the trust, respectively the trustee. Similarly, if the settlement of a trust infringes on the rights of the settlor's creditors, they will be entitled to assert various claims for fraudulent conveyance provided by the SDCBA. Finally, the seizure of a beneficiary's entitlement from a trust will be governed by Swiss debt collection proceeding.

4.3 Clarification of the trust's legal status

With the enactment of the new provisions, the disputed question whether the trust was compatible with the Swiss legal system will become moot. The ratification of the Hague Trust Convention enables full and complete recognition of foreign trusts in Switzerland. In addition, this Convention constitutes a step forward for **standardization of the applicable law to trusts**, as it prevents to some extent that a trust with links to several countries be governed by different laws in each country.

4.4 Consequence for trustees, especially Swiss ones

Swiss trustees must be aware that it will be **easier to initiate proceedings in Switzerland** against them based upon the new SPILA jurisdiction rules, and that **foreign judgments will be recognized and enforced more easily in Switzerland**. The trust's internal matters will be governed by the (foreign) law applicable to the trust, law which will specify what a trustee can or cannot do. Swiss trustees must therefore have a clear understanding of the law applicable to the trust.

4.5 Trustee's position in civil and bankruptcy matters

Based upon his status of owner under civil law of the assets in trust, the trustee has **standing to sue and to defend** in civil and bankruptcy matters. Thus, to the extent that a Swiss court has jurisdiction (based upon a forum selection clause or further to an objective connecting factor), a trust beneficiary will be able to assert his claims against the assets in trust or claim proper trust administration by the trustee before a Swiss judge. A beneficiary will also be able to assert his right to information against the trustee, subject to the terms of the trust and to the law applicable to the trust.

4.6 Relations with third parties

The trust's external relations, i.e. those existing between the trustee and **third parties**, are not governed by the law applicable to the trust. Rather, these relations are subject to the law designated in the relevant contractual agreement (e.g. asset management agreement) or, for extra-contractual matters, to the SPILA rules (e.g. with respect to torts or unjust enrichment).

5 Taxes

5.1 In General

The Hague Trust Convention does not deal with taxation of trusts. The Swiss Tax Conference has nevertheless, for quite some time now, been working on a directive on trust taxation. Because the various cantonal tax authorities currently deal with trusts in very different ways, the drafting of this **directive** has been difficult and frequently interrupted. To date, only an (unofficial) draft of 16 March 2006 gives an indication on where the Swiss Tax Conference is heading to. It is likely that the various current cantonal practices on trust taxation in respect of income and wealth tax will eventually be harmonized under the directive (although the cantons have apparently not yet reached an agreement with respect to trusts created by Swiss resident settlors).

Now that the Hague Trust Convention has been ratified, it is expected that the directive will be finalized soon, but no date has yet been set.

5.2 Current status of the draft directive

According to the draft directive, trust would be taxed according to the following rules:

- I In the case of a **revocable trust**, the assets in trust will be attributed to the **settlor**, who will be liable for income tax and wealth tax. The trust beneficiaries will not be liable for income tax and wealth tax. Trust distributions in favour of beneficiaries will be treated as gifts made by the settlor.

The revocable nature of a trust will be determined **from an economic standpoint**. Thus, a formally irrevocable trust could be re-characterized into a revocable trust if the settlor is as a matter of fact administering the trust, for instance in the capacity of protector enjoying vast powers over the trust.

- I Based upon the draft directive, an **irrevocable fixed interest trust** must be treated like an **usufruct**. Thus, the assets in trust will not be attributed to the settlor, but rather to the beneficiaries. The settlement of a trust constitutes a **gift** from the settlor to the trust beneficiaries. To the extent that the draft directive does not deal with cantonal gift taxes (but only with income tax and wealth tax), it is important to note that the degree of kinship between the settlor and the beneficiary is a decisive factor in calculating the cantonal gift tax owed.

Beneficiaries resident in Switzerland will be liable for income tax on **distributions of trust income**. **Distributions of capital gains or of trust capital** remain non taxable, insofar as the beneficiary can evidence their source to the tax authorities.

The tax authorities will take into account all the circumstances, and not only the black letter of the trust instrument, when determining whether a trust is a fixed interest trust or a discretionary trust. Thus, regular and unconditional trust distributions, presumably made in accordance with a Letter of Wishes, could result into re-characterizing a discretionary trust into a fixed interest trust.

- I In the case of an **irrevocable discretionary trust**, the settlor's transfer of assets to the trustee in trust will be viewed as a **gift**. This characterization does not create any problem from a Swiss tax perspective, when the settlor is resident abroad and no real estate located in Switzerland is transferred into trust. Otherwise, the relevant canton could levy a gift tax in accordance with the relevant cantonal practice, because the directive does not intend to harmonize cantonal gift taxes.
- I From the trust beneficiary's perspective, distinction must be made between **distributions of trust income** on one hand and **distributions of capital gains or trust capital** on the other. Distributions of trust income to a Swiss resident beneficiary will be subject to income tax. Distributions of



capital gains or trust capital are tax neutral operations, insofar as the beneficiary can evidence their source to the tax authorities.

| With regard to the reimbursement of **Swiss federal withholding tax on dividends and interest payments**, the current solution proposed by the draft directive is not convincing. In the case of an irrevocable discretionary trust, nobody would be entitled to claim a refund of the Swiss federal withholding tax according to the draft directive, because the assets in trust are attributable neither to the settlor nor to the beneficiaries. This is obviously an unsatisfactory solution and it is to be hoped that the Swiss Tax Conference will reconsider the issue. It would for instance be more convincing to apply the proposed rules for income tax by analogy. Thus, a trust beneficiary, upon receiving a distribution, would be entitled to claim a refund of the withholding tax, insofar as he can evidence that the trust distributions come from pre-taxed assets in trust.

6 Conclusions

Ratification of the Hague Trust Convention and its implementation into Swiss law will certainly **increase Switzerland's attractiveness for settling and administering trusts**, because trusts and their effects will be fully recognized in Switzerland. These developments strengthen the Swiss financial system, as trusts can be used more reliably in financial transactions.

Trusts which have links to Switzerland (e.g. the trustee is domiciled or the assets in trust are deposited in this country) **should be reviewed** to ensure that they fully comply with the new provisions, especially with the court jurisdiction rules and with the faculty to register a trust in the relevant Swiss registries.

From a tax perspective, one must be particularly cautious upon settling a trust, if the settlor is domiciled in Switzerland or if the real estate transferred into trust is located in this country. If the beneficiaries, but not the settlor, are domiciled in Switzerland, one must pay specific attention to trust distributions, by distinguishing between distributions of trust income, capital gains or trust capital.

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The content of this Newsletter does not constitute legal or tax advice and may not be relied upon as such. Should you seek advice with regard to your specific circumstances, please contact your Schellenberg Wittmer liaison or any of the following persons:

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