Recognition of foreign family foundations in Switzerland

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Abstract

Swiss Family Foundations are not commonly used for asset protection or estate planning purposes due to a de facto prohibition of family maintenance foundation. Since families are often spread over different countries and continents and assets are located in various jurisdictions, contributions of assets to a foundation may very well be an optimal solution, also because these assets no longer fall within the scope of the estate. For this purpose, foundations are set up in jurisdictions like Liechtenstein.

Introduction

The Swiss Civil Code provides for a de facto prohibition of family maintenance foundations and therefore limits the use of foundations. Consequently, foundations are settled in other jurisdictions like Liechtenstein or Panama. These jurisdictions provide for flexible rules on the drafting of the foundation purpose as well as on the powers a founder may retain.

Foundations have been more commonly asked for in estate planning in recent years. However, in a pure Swiss estate where the testator, the heirs and most assets are located in Switzerland, the use of a Swiss Family Foundation has rarely been considered.[1] Since families are often spread over different countries and continents and assets are located in various jurisdictions, contributions of assets to a foundation may still be an optimal solution, also because these assets no longer fall within the scope of the estate.[2]

This article is analysing how foreign foundations, using Liechtenstein Foundations as an example, are recognized in Switzerland both for civil and for tax law purposes.

Cross-border recognition of foreign family foundations in Switzerland

Under Swiss law, the recognition of a foreign foundation under civil law is assessed according to the law of the state of incorporation, i.e. the legal system of the state in which it was established (Art 154 para 1 PIL[3]). This so-called "Incorporation Theory" is limited by Art 17 PIL (reservation of the o*rdre public*) as well as by Art 18 PIL (*lois d'application immédiate*). There seems to be a consensus in the literature that foreign foundations, including Liechtenstein family foundations, do not violate public policy and are therefore recognized under Swiss civil law, irrespective of their form. Regarding the applicability of Art 18 PIL to foreign family foundations, various opinions have been expressed in the past. The Swiss Federal Supreme Court ruled in its judgement of 29 October 2009 that the prohibition

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1. N Peter, "Family Foundations in Switzerland" 26(6) Trusts & Trustees (2020) 580–589.
2. BGr 5P.40/2005, E. 3.
3. Bundesgesetz über das Internationale Privatrecht (IPRG), Swiss Private International Law.

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on the establishment of family trusts under Art 335 para 2 Civil Code (CC) does not constitute a *lois d'application immédiate* within the meaning of Art 18 PIL. As a result, it can be assumed that Liechtenstein family foundations and foundation-like legal institutions with legal personality are recognized in Switzerland for civil law as well.

Comparison to Swiss Family Foundation

While foreign jurisdictions are typically more liberal on the purpose of a family foundation, Art 335 para 1 CC is restrictive and permits the establishment of family (maintenance) foundations "*to meet the costs of education, equipment or support of family members or similar purposes*" only. In other words, the permanent accumulation of assets for the benefit of a specific family, combined with unconditional beneficial interests for an unlimited number of generations, is prohibited.[4] The purposes have in common that assistance is to be provided to family members in certain situations, such as in adolescence, when setting up their own household, or living on their own, and in case of need. Similar purposes are also limited to those providing material help to the members of a certain family in situations of life where assistance appears to be necessary or desirable.[5]

Foundations granting beneficial interests without a link to a certain life situation, but simply allowing a beneficiary a higher or more pleasant standard of living are frowned upon. According to Art 52 para 3, CC Swiss foundations seeking to benefit the members of a family in an inadmissible manner are null and void from the outset, even if they have been entered in the Commercial Register.[6] However, they must be declared null and void and therefore non-existent in a formal court proceeding. An originally unlawful or immoral foundation leads to the non-existence of the legal entity and thus to the restitution of the assets concerned to the founder or at most his legal successors.

Liechtenstein foundations

Liechtenstein civil law does not provide for restrictions on the purpose of a private-benefit foundation comparable to those in Art 335 CC. Hence, special purpose assets with a close connection to the family of the creator are widespread.

Pass-through in the context of civil law

In an international context, a foreign foundation is deemed to be an *organized asset unit* and as such a company within the meaning of International Private Law.[7] A Liechtenstein foundation is recognized in Switzerland provided it has been established according to the laws of Liechtenstein ("Incorporation Principle"). Only in case of abuse, a foundation is disregarded, thus a pass-through is an exception and must be assessed on a case-by-case analysis.

Liechtenstein law allows the founder to retain certain powers, such as the power of revocation or the power to change the statutes and by-laws.[8] Such comprehensive control of the founder is not sufficient alone for a pass-through,[9] an abusive invocation of the legal independence of the foundation,[10] i.e. an extraordinary conduct in the sense of an actual involvement and a qualified damage to third parties, must also be present.

The question of a pass-through liability of a foundation organized and administered under the law of Liechtenstein is subject to Liechtenstein law,[11] even if the facts of the case may have a much closer relationship

4. HM Riemer, Berner Kommentar zum Schweizerischen Privatrecht, Die Stiftungen, Systematischer Teil und Kommentar zu Art 80–89bis ZGB (Stämpfli, 1981) N154.
5. BGE108 II 393f.
6. BGE 108 II 393.
7. F Vischer, Zürcher Kommentar zum IPRG (Schulthess, 2004), Art 150 IPL, n. 11 f., 1726.
8. Art 552 §30 PGR.
9. HR Künzle, "§3 Vermögensschutz mit liechtensteinischen Strukturen aus schweizerischer Sicht" in F Schurr (ed), *Handbuch des Vermögensschutzes* für Liechtenstein, Österreich und die Schweiz (Stämpfli, 2015) 140.
10. As an example, the assets of the founder and the foundation are not strictly separated.
11. Art 154 IPL BGE 128 III 348, n. 3.1.

to the Swiss legal system. In 2004, the Swiss Supreme Court[12] protected a decision rendered by the Cantonal High Court of Schaffhausen.[13] The Court had to deal with the question of whether the foundation settled by the father was liable for claims the children had against him. The High Court of Schaffhausen applied Liechtenstein law and concluded, that a foundation has its own legal personality and is therefore generally independent and to be regarded as separate legal entity from the founder. It further held that the Liechtenstein jurisprudence assesses the right of recourse considering both good faith and the prohibition of abuse of rights. Accordingly, the legal independence of a foundation shall not be used for abusive purposes. The assumption of a void sham structure may be justified if the founder intended to continue to use the foundation assets for his own benefit and not in the sense of the stated foundation purpose. Based on the facts the High Court concluded that the founder established the foundation primarily to deprive his children of the assets to which they were entitled to and to preserve them for himself and his relatives. This intent contradicted the stated charitable foundation purpose. Accordingly, it concluded that a pass-through on the foundation's assets is permissible under the law and jurisprudence of the Principality of Liechtenstein.

Tax considerations

Recognition or "pass-through" in the context of tax avoidance

A foreign foundation being recognized for civil law purposes is typically also recognized as a foundation for tax purposes.

As early as the 1920s and 1930s, the Federal Supreme Court found in various inter-cantonal double taxation conflicts[14] that the existence of a legal entity under civil law can be disregarded for tax purposes, if

> it can be shown that the sole purpose of the foundation was to avoid the tax liability that would otherwise exist in the other canton, and that the foundation is structured in such a way that in reality, despite the conditions created by the chosen civil-law form, the previous owner of the assets continues to exercise, with regard to the assets in question and their income, the powers that are relevant for the allocation of tax sovereignty.

Only later the Swiss Federal Court dealt with the private-law classification of a foundation and denied a foundation the status as a tax subject based on an established invalidity under civil law.[15] Later the Court concluded that an existing legal entity recognized under civil law may exceptionally be denied the status of a taxable entity in case of avoidance or abuse of rights. Tax avoidance exists if a legal arrangement chosen by the taxpayer appears to be (i) unusual, improper, or abusive, and (ii) it can be assumed that the taxpayer made this choice with the intention of saving taxes that would have been due otherwise, and (iii) the chosen procedure would lead to a significant tax saving if it were accepted by the tax authority.[16] The result of tax avoidance is a "pass-through", i.e. it is fictitiously assumed that the foundation does not exist for tax purposes.

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As a consequence, the assets and income of the foundation are not attributed to the foundation itself for tax

12. 5C.188/2004, dated 27 October 2004.
13. High Court Schaffhausen, 10/2003/11 dated 30 July 2004.
14. BGE 252 I 372; BGE 53 I 440; BGE 5 I 373.
15. BGE 71 I 265.
16. BGE 107 Ib 315, 323; R Matteotti, "Der Durchgriff bei von Inländern beherrschten Auslandsgesellschaften im Gewinnsteuerrecht der Schweiz", Berner Beiträge zum Steuer- und Wirtschaftsrecht (2003), Volume 18 173.

purposes, but to the persons involved who are residents in Switzerland, i.e. the founder on the one hand or the beneficiaries on the other.

Liechtenstein foundations

In case of a Liechtenstein foundation, the Swiss tax authorities typically examine whether the assets and income of the foundation should rather be attributed to the founder or the beneficiaries than to the foundation.

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The Swiss doctrine and jurisprudence differentiate between so-called "*controlled*" and "*non-controlled*" Liechtenstein foundations.[17] The qualification is based on a case-by-case analysis of the foundation deed, the by-laws, a potential letter of wishes, and possibly a mandate agreement between the (economic) founder and the foundation council as well as on the actual implementation. The principle of "substance over form" is applied.

"Controlled" foundations

"Controlled" foundations" are typically characterized by one or more of the following facts[18]:

- the founder has reserved a right of revocation in the deed of formation,
- the founder has reserved a right to amend the purpose of the foundation in the deed of formation,
- the founder can continue to regularly appropriate the income from the foundation's assets without violating the foundation deed or the foundation's purpose,
- the founder acts as if the foundation assets were still his own personal assets, without regard to statutory powers and their limits,
- the founder is the first beneficiary with unrestricted entitlement to the capital and income of the foundation,
- based on banking powers of attorney, the founder has access to the bank accounts and custody accounts of the foundation and can therefore freely dispose of the assets of the foundation.

Foundation boards had often been bound by "mandate agreements" with the founder retaining a power to give instructions. In such a case, the foundation is deemed to be controlled by the founder.[19]

If the beneficiaries have de facto or de jure control over the assets of the foundation, or if the foundation assets are firmly linked to a family and serve to pay maintenance benefits to the respective beneficiaries in predetermined quotas, the foundation is also deemed controlled.

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In this case, it is however more appropriate to allocate the foundation assets and income to the beneficiaries rather than to the founder.

In summary, to escape tax avoidance the founder may not retain free access to the foundation assets, in particular the possibility of freely using foundation

17. R Hepberger and W Maute, "Die Besteuerung der liechtensteinischen Familienstiftung aus Sicht der Schweiz", StR (2004) 592ff; N Peter, "Die liechtensteinische Stiftung und der Trust im Schweizer Steuerrecht", IFF Forum für Steuerrecht (2003) 164f.

18. BGE 131 II 627 E. 5.2.; BGE 107 Ib 315 or 2C_43/2010, dated 18 June 2010.

19. A Opel, "Steuerliche Behandlung von Familienstiftungen, Stiftern und Begünstigten—in nationalen und internationalen Verhältnissen" (Dissertation, 2009) 61f; A Opel, "Familienstiftung und Trust—Postulat für eine kohärente Besteuerung", ASA 78 (2009/2010) 271.

funds for his own purposes outside the foundation purpose, and he may not be the sole beneficiary or a member of the class of beneficiaries.

"Uncontrolled" foundations

"Uncontrolled" foundations on the other hand have an independent existence and are recognized as a separate legal entity for tax purposes. Thus, only distributions to beneficiaries resident in Switzerland are subject to taxation. The beneficiary must declare the distribution as other income in his or her tax return, irrespective of whether initial capital, capital gains or income is distributed. As far as distributions are paid for the upbringing of children or the alleviation of distress, such payments may qualify as tax-free support benefits. These benefits are typically paid periodically. Distributions cannot be gifts from the foundation to the beneficiary since the foundation is not acting voluntarily but within the framework of the foundation deed and by-laws, fulfilling its legal obligation. The board of the foundation has no *animus donandi*.

The double taxation agreement between Switzerland and Liechtenstein

On 1 January 2017, the double taxation agreement between Switzerland and Liechtenstein (DTA CH-FL) entered into force. In the protocol, being an integral part of the DTA CH-FL, the two States agreed on additional provisions deviating from the OECD standard concerning, among other things, the tax residency of a Liechtenstein foundation.

Liechtenstein foundations are generally considered resident in Liechtenstein for DTA CH-FL purposes, if they are subject to ordinary taxation in Liechtenstein. Foundations opting for a so-called "PVS- status," i.e. they pay an annual lump-sum tax and do not file a tax return, are not deemed resident and cannot apply the DTA CH-FL.[20]

In the Protocol point 2 to Art 4 lit. a (iii) DTA CH-FL it is further agreed that the term "*a resident of a Contracting State*" includes Liechtenstein foundations "*provided that neither the founder nor a beneficiary*" who is "*resident in Switzerland*" nor "*a person closely associated with them*" can factually or legally dispose of the foundation's assets or the income therefrom.[21] Thus, in case of a "controlled" foundation with Swiss a resident founder and/or beneficiaries, the foundation is not deemed resident for treaty purposes and cannot apply the DTA CH-FL by itself.[22] For the determination of whether a person can factually or legally dispose of the foundation's assets, the long-standing jurisprudence of the Federal Supreme Court has been adopted. For a foundation to be "uncontrolled" and, consequently, to be considered resident in Liechtenstein for treaty purposes, the following minimum characteristics must be fulfilled cumulatively:

- the founder has not reserved a right of revocation in the foundation's constitutive documents (the foundation is irrevocable).
- the founder has not reserved the right to amend the foundation documents (e.g. foundation deed (statute) and/or supplementary foundation deed (by-laws)) in the foundation documents (the founder has no right to amend the foundation documents).
- neither the founder nor a person close to him has a right to issue instructions in the sense of a certain influence in or vis-à-vis the foundation council.
- the beneficiaries have no legal claim to benefits from the foundation (the legal relationship between the beneficiaries and the foundation has no benefit-like character).

20. Art 64 SteG (Liechtenstein Tax Act).

21. Based on the mutual agreement between FL and Switzerland dated 18 May 2016, the special protocol requirements for residency apply to foundations with founders and/or beneficiaries resident in Switzerland only.

22. Neither the foreign founder nor the foreign beneficiaries are subject to unlimited tax liability in Switzerland in this scenario. Thus, Switzerland is not losing taxes by recognizing a "controlled" foundation as treaty resident. Against this background it is understandable why Protocol provision 2 to Art 4 lit. a(iii) DTA CH-FL does not include foundations with foreign founders and beneficiaries.

If only one of these requirements is not fulfilled, the foundation is deemed de facto or legally controlled by the founder, a beneficiary or a person closely associated with them resident in Switzerland. The foundation is therefore a deemed "controlled" foundation and as such not a "resident person" within the meaning of the DTA CH-FL.

It is important to note that although not explicitly mentioned in the DTA CH-FL, a Liechtenstein foundation may also be viewed as "controlled" by the Swiss tax authorities, if the founder is a beneficiary during his lifetime or even if he is a member of the class of beneficiaries.

The Protocol in point 4 on Arts 10, 11, 12 and 21 DTA CH-FL contains anti-avoidance provisions applying in abusive situations, i.e. the foundation was only established to receive treaty benefits that would not have been available to the founder as he is not a resident of either of the contracting States or could not have applied the preferred withholding tax rates.

Practice of the federal tax administration

In case of a Liechtenstein foundation receiving dividends from a Swiss company, the question arises of whether the 0% withholding tax rate is granted according to Art 10 DTA. The Federal Tax Administration (FTA) recognizes a Liechtenstein family foundation as a "resident person" within the meaning of Art 4 DTA CH-FL, provided it is not a "controlled" foundation and subject to ordinary taxation in Liechtenstein. Based on the mutual agreement between FL and Switzerland dated 18 May 2016, the special protocol requirements for residency do not apply to foundations with founders or beneficiaries resident outside Switzerland.

The FTA determines based on its unilateral practice to whom the dividend shall be attributed to—the foundation or the founder. It examines whether the person to whom the dividend is attributed to has the right to dispose the dividend within the meaning of Art 10 DTA CH-FL. In case of a "controlled" foundation, the right of disposal is likely with either the founder or the beneficiaries.

The Federal Administrative Court already confirmed that the question of to whom a dividend has accrued to is to be assessed according to the law of the country of source, thus according to Swiss law, and not based on Liechtenstein law. Accordingly, the FTA first determines whether the foundation is "controlled" or "uncontrolled."

In the opinion of the Federal Tax Administration, a foundation may be "uncontrolled," if

- there are no rights of control and legal claims of the founder and/or the beneficiaries over the foundation assets,
- the foundation board has exclusive decision-making and administrative authority,
- there is only a class of beneficiaries with no legal claims,
- the founder is not a member of the foundation board and/or a beneficiary.

An "uncontrolled" Liechtenstein foundation with no Swiss founder or beneficiary may apply for a refund of the entire Swiss withholding tax of 35%.

In case of a "controlled" foundation, the dividend is typically attributed to the founder if one or more of the following indications are met:

- the founder is the primary beneficiary or, if applicable, the ultimate beneficiary.
- naming of beneficiaries and clear definition of subscription rights to foundation assets and income
- Identity of persons between founder, foundation board and beneficiaries
- Mandate agreement between founder and foundation board.

In this case, the founder or the beneficiaries may apply the double taxation agreement Switzerland concluded with their country of residence. They can typically receive a refund of 20% of the Swiss withholding tax.

Conclusion

While Liechtenstein foundations are typically respected for Swiss civil law purposes, the tax authorities are likely to applying a substance over form approach, in particular, if the founder is one of or the sole beneficiary or because he retained substantial powers. These foundations are deemed "controlled," and hence ignored for tax purposes. Consequently, the assets and income therefrom are still allocated and taxed at the founder's level. Although there is a different treatment for civil and for tax law purposes, Liechtenstein foundations can set up tailor-made according to the wishes of the founder. Certainty about tax issues can be obtained by applying for tax rulings at the Cantonal tax authorities.

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