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Recent decision of the Swiss Federal Administrative Court and its implications for the future of trusts in Switzerland

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Abstract

In its decision dated 18 March 2011, the Swiss Federal Administrative Court delivered a landmark ruling on characterization of rights of beneficiaries of a discretionary trust governed by a foreign law. The Court considered whether a bank account held in the name of trustees with UBS AG was within the ambit of a disclosure request received from the US Government investigating unpaid tax. Notwithstanding the fact that the plaintiff was within the class of objects/beneficiaries named in the trust instrument the court ruled that since the beneficiary/object had no control over the assets and income of the trust, he should not be treated as the beneficial owner of assets owned by the trust. In reaching its conclusion the Swiss Federal Administrative Court relied on the ratification in 2007 of the Hague Convention on the Law Applicable to Trusts and on Their Recognition and confirmed the wide recognition of the institution of trust in the Swiss legal order.

Introduction

In its decision of 18 March 2011, the Swiss Federal Administrative Court delivered a landmark ruling on the rights of a beneficiary/object under a discretionary trust in relation to assets forming part of the trust fund (in this case assets in a bank account held in the name of trustees).[1] The judges concluded that such a beneficiary/object has no power of control over the trust assets and therefore is not a beneficial owner thereof. This decision of principle opens new horizons to the practitioners in the field of structuring of assets in Switzerland.

The facts of the case

The decision of 18 March 2011 addressed an appeal filed by a person who was a beneficiary of a discretionary trust. Trust fund included assets in an account with the Swiss bank UBS SA. The appeal was filed against a decision of the Swiss Federal Tax Authority by which the latter had decided to grant assistance and transfer information to the US Internal Revenue Service (IRS). The information to be transmitted to the IRS related to the bank account of the trust with UBS SA. The request for assistance emanating from the IRS and dated 31 August 2009 purported to obtain information regarding the US tax payers who, during the period from 1 January 2001 to 31 December 2008 had a power of signature or another right to dispose of assets in the bank accounts

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1. Decision of 18 March 2011 in the case No A-7013/2010.

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held with or supervised by a division of UBS SA or its branches or subsidiaries in Switzerland.

The Swiss Federal Administrative Court examined the conditions which have to be met for the Swiss authorities to grant administrative assistance under the Agreement between the Swiss Confederation and the United States on the request for information from the Internal Revenue Service (IRS) of the United States regarding UBS AG and the Protocol relating thereto (a consolidated version of the Agreement and its Protocol are hereinafter collectively referred to as 'Convention 10'). The Agreement governs the enforcement of the existent Convention between Switzerland and the United States for the avoidance of double taxation in matters concerning UBS AG. It takes the form of a tax treaty. Pursuant to the terms of the Convention 10, a request for administrative assistance between Switzerland and the United States is granted in relation to 'US persons (irrespective of their domicile) who beneficially owned ''offshore company accounts'' that have been established or maintained during the years 2001 through 2008 and for which a reasonable suspicion of ''tax fraud or the like'' can be demonstrated'. Thus, one of the conditions for Switzerland to grant administrative assistance is that a request must relate to a US person who is a beneficial owner of 'offshore company accounts'.

In their decision of 18 March 2011, the Swiss judges divided the analysis of the case in three stages before arriving to the conclusion that a beneficiary of a discretionary trust which held a bank account during the relevant period from 2001 to 2008 could not be characterized as the beneficial owner of assets in the account. The three stages of the analysis are the following:

(1) The first question was whether an account in the name of trustees could be treated as an 'offshore account'. With reference to its previous case law, the Federal Administrative Court reminded of the necessity to construe the terms of the Convention 10 pursuant to the general rules of interpretation of treaties contained in Articles 31ff of the Vienna Convention on the Law of Treaties of 1969.[2] Applying the rules contained in the Vienna Convention on the Law of Treaties, the judges stated that term of 'company' had to be understood in its usual sense as reference to an entity of corporate law, which pursuant to the laws of the place of its incorporation has legal personality. However, where a company was characterized as 'offshore', this additional qualification conferred an autonomous meaning to this term, taking into account the subject matter and the purpose of the Convention 10. Thus, the Federal Administrative Court ruled that the notion of '*offshore company accounts*' included bank accounts of entities in a broad sense including offshore entities which were not recognized in company and/or tax law in Switzerland or in the United States as district (tax) subjects. The autonomous meaning of 'company' pursuant to the Convention 10 includes foundations and trusts of foreign law because such entities are able to 'hold assets' and enter into long-term client-relationship with a bank. The judges concluded that the accounts held with UBS SA by trusts constituted 'offshore company accounts' within the meaning of the Convention 10. It is important to stress that the judges insisted on the fact that trusts could be assimilated to 'offshore companies' only within this specific context of the Convention 10 for the purposes of defining entities which may enter into a banking relationship. *A contrario*, the general meaning of 'offshore company' does not include foreign trusts, which do not have a distinct legal personality.

(2) The Federal Administrative Court, relying on legal authors and case law, ruled that the concept of '*beneficial owner*' referred to the economic reality as opposed to the legal form. The judges specifically used the expression 'substance

2. ibid para 5.2, 11 with reference to the decision of 10 January 2011 in the case No A-6053/2010.

over form'[3] and noted that the identification of a person as 'beneficial owner' under the Convention 10 had the purpose of ensuring that banking information relating to a 'US person' be transmitted to the US tax authorities where such person had used an entity in order to avoid declaring his/her assets in a banking account held by the entity or the income resulting therefrom. The term 'beneficially owned' allows in this way to lift the corporate veil and apply the principle of 'substance over form' to the situations where an 'offshore company' is used solely for the purpose of by-passing the obligation to declare assets or income or where an 'offshore company' is used for the purpose of avoiding paying taxes in the United States. Finally, the judges added that it was necessary to take into account circumstances of each particular case in order to determine whether and to which extent the person had power to economically dispose of and control assets in the banking account as well as income resulting therefrom during the relevant period of 2001–2008.

(3) In the third stage of its analysis, the Federal Administrative Court reached the conclusion that a beneficiary of a discretionary trust does not control nor dispose of the assets in a bank account opened in the name of the trust. Applying the principle of 'substance over form', the beneficiary of such trust may not be considered as beneficial owner of the bank account within the meaning of the Convention 10. On this basis, the Court granted the appeal against the decision of the Federal Tax Authority and refused to grant administrative assistance to the United States because the conditions thereof were not met on the facts. This third aspect of analysis of the Swiss Federal Administrative Court is of particular interest for the trust practitioners and will be examined more in detail in the following paragraphs.

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Characterization of the rights of a beneficiary of a trust in Swiss law

The Hague Convention on the Law Applicable to Trusts and on their Recognition concluded on 1 July 1985 (hereinafter referred to as 'The Hague Trust Convention') entered into force in Switzerland on 1 July 2007. Article 2 of the Hague Trust Convention provides that the term 'trust' refers to the legal relationship created *inter vivo* 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. As specifically noted by the Swiss judges in the decision commented in the present article, a trust is constituted in a unilateral manner by the settlor. It is neither necessary that the trustee accepts its duties nor that beneficiaries consent to the appointment of trustee for the trust to come into existence.[4] The Swiss judges continued that what is determining for the constitution of a trust is the transfer of property from the settlor to the trustee.[5] In the same decision, one can read the following:

> [o]riginally, a trust once constituted becomes irrevocable. The assets transferred into a trust no longer belong to the settlor in a final manner. Given that the trust is not a legal entity and does not have a legal personality, the trust is not the owner of the assets in the trust, nor of the income resulting therefrom. The legal ownership of the assets is with

3. See n 1, para 5.2.2, 12 with reference to the decisions of Federal Administrative Court in the case No A-6053/2010 of 10 January 2011, para 7.3.2 and in the case No A-5974/2010 of 14 February 2011, para 3 and in the case No A-6538/2010 of 20 January 2011, para 3.2.1.

4. See n 1, para 6.1 with reference to Peter Böckli, 'Der angelsächsische Trust: Zivilrecht und Steuerrecht' (2007) Steuer Revue (STR) 715ff; Matthias Seiler, *Trust und Treuhand im schweizerischen Recht unter besonderer Berücksichtigung der Rechtsstellung des Trustees* (Schulthess 2005) 13, 43ff.

5. Böckli, 'Der angelsächsische Trust' ibid 714ff; Luc Thévenoz and Christian Bovet (eds), 'Créer et gérer des trusts en Suisse après l'adoption de la Convention de la Haye' in *Journée 2006 de droit bancaire et financier* (Schulthess 2007) 61ff.

> the trustee who can be one or more natural or legal person(s). The assets of a trust are however segregated from the assets of the trustee and constitute a distinct pool of assets.

The judges based their decision on the practice of the Swiss Federal Tax Authority and the opinion of the most authorized Swiss legal authors.[6]

It is submitted that the decision of the Swiss Federal Administrative Court is entirely in line with the Hague Trust Convention, in which the following characteristics of a trust are identified:

(a) the assets constitute a separate fund and are not part of the trustee's own estate;
(b) title to the trust assets stands in the name of the trustee or in the name of another person on behalf of the trustee;
(c) 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 Hague Trust Convention provides that the reservation by the settlor of certain rights and powers and the fact that the trustee may himself have rights as a beneficiary, are not necessarily inconsistent with the existence of a trust.

The Swiss judges in the decision commented in this article examined in detail the rights and the status of the beneficiaries of a trust. The relevant paragraph of the decision reads as follows:

> The beneficiaries of a trust, whether identified or identifiable, are equitable owners of the trust. Nevertheless, they never have a right to administer or dispose of assets of the trust. Their rights are not of proprietary nature, even though they confer upon them a remedy of tracing in relation to third parties to whom assets may have been illegally transferred. Where a trust does not pursue the goal of accumulating assets, the trustee may or has to distribute assets or income resulting therefrom to beneficiaries. In presence of a discretionary trust, i.e. where the trustee has to identify beneficiaries and the extent of the benefit of each of them, the beneficiaries receive their equitable ownership only when the trustee exercises its discretionary power. In the meantime, the beneficiaries only have an expectation to acquire equitable ownership over assets or income resulting therefrom. (free translation from French)[7]

This decision is of some importance not only for the trust law in Switzerland but also for other areas of law such as bankruptcy and inheritance law. The Swiss federal judges seemed to apply established trust principles that unless and until trustees of a discretionary trust exercise their discretions in favour of a specific beneficiary, the beneficiary does not have any rights over the trust assets. The beneficiary has a mere spes—a hope or expectation—that the powers might be exercised in his favour[8]. In other words, the equitable ownership of the beneficiaries over the assets placed in a trust depends on the exercise of the trustees discretionary powers. Therefore, beneficiaries of a discretionary trust may not be assimilated to beneficial owners or even equitable owners of assets in the trust in general. Any equitable ownership rights of the beneficiaries of a discretionary trust crystallize only upon the exercise of their discretionary powers

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6. 'Circulaire no 30 de la Conférence suisse des impôts du 22 août 2007: imposition des trusts' 76 Archives de droit fiscal suisse 76, 531ff ; Böckli, 'Der angelsächsische Trust' (n 4) 715ff; Thévenoz, 'Créer et gérer des trusts' (n 5) 25ff; Jessica Salom, *L'attribution du revenu en droit fiscal suisse et international* (Schulthess 2010) 21ff.

7. Böckli, 'Der angelsächsische Trust' (n 4) 715ff; Luc Thévenoz, 'Créer et gérer des trusts' (n 5) 25ff; Robert Danon, 'Trusts express privés et impôts sur le revenu et la fortune, Analyse du régime actuel et réflexions de lege ferenda' 72 Archives de droit fiscal suisse 262; Alastair Hudson, *Equity and Trusts* (5th edn, Oxon 2007) 50ff; see also Delphine Pannatier Kessler, *Le droit de suite et sa reconnaissance selon la Convention de La Haye sur les trusts* (Schulthess 2011) *passim*.

8. The Honourable Mr Justice David Hayton, Professor Paul Matthews and Professor Charles Mitchell (eds). *Underhill and Hayton: Law of Trusts and Trustees* (18th edn, LexisNexis Butterworth, 2010) para 8.45.

by the trustees, which the latter are free to exercise or not.

On the facts of the case before the Swiss Federal Administrative Court commented here, a trust was created on 24 June 1998 as a discretionary trust. In particular, the trustee had no obligation to distribute in a continuous manner the income of the trust fund to the beneficiaries. On the contrary, the trustee had freedom to decide, with the consent of the protectors, to accumulate income and to distribute the capital pursuant to the declaration of trust. On the basis of these facts, the judges reached the conclusion that the trust was a discretionary trust valid in accordance with its subject foreign law designated as the law applicable to the trust by the settlor. The judges made specific reference to Article 149c of the Swiss Private International Law Act of 18 December 1987, in conjunction with Article 6 of the Hague Trust Convention regulating the applicable law. The judges continued as follows:

> On a discretionary trust, the beneficiaries have no firm right to request distribution of income or capital of the trust by the trustees. The trustees have full freedom in the choice of beneficiaries to whom they make distributions – certainly, in general, within a determined circle of persons – as well as of the amount of such distributions. The beneficiaries of a discretionary trust therefore have nothing else than an expectation, i.e. a sort of future and uncertain interest, which crystallises by the exercise of the prerogatives attributed to the trustee. (free translation from French).[9]

The judges reiterated again that beneficiaries of a trust acquire their equitable ownership only when the trustee exercises its discretionary powers in their favour. Moreover, beneficiaries of a trust do not have an absolute right ('*Vollrecht*') over the assets placed in the trust, nor any claim against trustees for distribution of any assets.[10]

In conclusion and on the basis of the analysis of the facts at hand, the judges accepted that the plaintiff had no power to economically dispose of the assets deposited in the bank account with UBS SA, including the income resulting therefrom. Furthermore, the plaintiff did not control, nor dispose of any other right over the assets and income during the relevant period. From the economic standpoint and in application of the principle of 'substance over form', the assets and income in question could not be attributed to the tax payer. Moreover, the trust in question could not be regarded within the meaning of the Convention 10. The judges concluded that the documentary evidence established that the trust in question was the holder of the account with UBS SA, while the plaintiff was not a beneficial owner thereof. The assets held in the bank account of the trust were not 'beneficially owned' by the beneficiary of this discretionary trust.

Conclusion and implications for the future of the trusts in Switzerland

The decision of the Swiss Federal Administrative Court of 18 March 2011 has implications which go beyond the issues of administrative assistance between Switzerland and the United States. Given the relatively short experience of the use of foreign trusts in Switzerland, the decision of 18 March 2011 is welcome in so far as it draws the clear line and highlights the differences between the notion of 'beneficial owner' and 'beneficiary' of a trust.

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9. Sibilla Giselda Cretti, *Le trust – Aspects fiscaux* (Basel 2007) 20 ff; Salom, *L'attribution du revenu* (n 6) 23ff, 121.
10. Decision of 18 March 2011, para 6.3.2 with reference to Giselda Cretti, *Le trust* ibid 22ff.