Foundations And Private Trust Companies In The Context Of International Business Succession

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This article is based on a speech that the author had given in association with the *Institute for Swiss and International Tax Law*, on September 15, 2020 in Zurich. It primarily focuses on families owning business enterprises that are interested in transferring business interests across generations and beyond their domestic borders.

Before looking at cross-border planning options, it is always helpful to look at the current situation in Switzerland with regard to corporate succession planning. This is important because entrepreneurs often consider exporting the change of control to foreign jurisdictions, amid their (mistaken) belief that foreign laws might provide them with a more suitable and flexible planning solution, than their own domestic legal framework. The fact that families, but also companies, have become increasingly more global, and consequently business assets, as well as other tangible assets, are already located abroad before the generational shift takes place, has given cross-border planning strategies further momentum in recent years.

The economic importance of family business succession

With over 500’000 small and mid-size enterprises (SME), business succession in Switzerland is of significant economic importance. In a company with a widely diversified ownership structure, if the managing director leaves the company, a successor must be found only for that very person. This is - at least from a legal point of view - not a problematic process, as long as one can fall back on talented and experienced personalities. In a company, however, where management and ownership are united in one single person, the change of leadership is often associated with the loss of human capital, and in many cases will result in a change of ownership.

The transfer of ownership can take many different forms in day-to-day practice. The requirements of the applicable inheritance laws must be followed, depending on the circumstances of each specific case. For example, there are less difficulties from an inheritance law perspective, if an entrepreneur sold his business during his lifetime to a family member, or to a third party, at market price. In this case, the proceeds of the sale will eventually become part of the seller's estate and are bequeathed after the seller's death according to the applicable rules of Swiss inheritance law.

The case in which the value of the company doesn’t exceed the amount of the available free quota and the compulsory portion of the beneficiary heir, is also considered unproblematic. Consequently, the proposed reduction of the legal compulsory part within the framework of the Swiss succession law reform would allow for more testamentary freedom to dispose of the assets, which may be understood as an implied support for promoting sustainable continuation of family businesses.

However, if a company instead has a disproportionately high value compared to the entire estate, then there will be an increased potential for conflict. In such cases, a successful inter-family transition will become more challenging, as the next generation often will fail to secure sufficient funds to pay the purchase price on the one hand, and to compensate any remaining heirs who’s interests are protected by their compulsory portion

of the inheritance on the other hand. For this reason, the company is often not sold, but transferred to a descendant by way of an advanced withdrawal of his or her share of the inheritance, possibly combined with a (partial) donation. Upon the demise of the testator, the possible gratuitous part of the transfer will then become subject to the ordinary compensation under inheritance law, and the compulsory portions of other heirs must be considered in the distribution of the inheritance. This circumstance can then also lead to compensation payments which may not be easily financed by the new owner.

For this reason, family owned enterprises often have to be dissolved or broken up, which can have negative effects not only on the persons directly affected, but also on the economy at large, as jobs are lost and fiscal revenues decreases.

Expressed in numbers, roughly 80% of the 500,000+ SMEs are family-owned. Of these, around 74,000 will be confronted with succession issues over the next five years; of the latter, approximately 20,000 will fail in the succession process. Amid the ongoing pandemic, the number of failed transitions or defaults might easily increase. Moreover, when observing a longer time horizon, the statistics show that only 4% of all families manage to preserve their businesses successfully up to the 4th generation and beyond.

It is therefore, not surprising that the *ratio legis* of the Swiss inheritance law reform in the context of said business succession is not primarily aimed at protecting heirs, but rather the family owned business enterprises, predominantly because of their indisputable contribution to the overall economy. It is this very economic importance that explains why upon the demise of the testator - contrary to the nature of the Swiss inheritance law - the legislator is proposing an *integral assignment* of the family business to one sole heir, provided the testator didn't explicitly dispose of it: Solely for preventing a fragmentation of the company.

In the Explanatory Report dated April 10, 2019, on the preliminary draft amendment to the Swiss Civil Code (ZGB) in matters of company succession, it was also stated that today, in addition to the aforementioned rights to a compulsory portion and the resulting impossibility of an integral assignment of company shares to an heir, further stumbling blocks make a successful succession process more difficult, provided, of course, that the testator omitted to make the necessary provisions during his or her lifetime (e.g. a cohesive company valuation method, contestability of company law contracts, etc.).

Furthermore, it is regrettable that the consultation report issued at the beginning of the year didn't address fiscal aspects, which constitute an integral part of corporate succession planning. It is also noteworthy that the aforementioned Explanatory Report states that already nowadays inheritance planning could be largely optimized by adopting provisions of the exisiting laws (e.g. shareholders' agreements, succession and compensation clauses in articles of association and corporate restructuring) or alternatively, through the establishment of a corporate foundation ("Unternehmensstiftung") or trust.

The latter statement is remarkable in that it highlights the corporate foundation, although according to Art. 335 of the Swiss Civil Code, a (family) foundation may only be established *"in order to meet the costs of raising, endowing or supporting family members or for similar purposes"*. Thus, a family foundation e.g. according to the Liechtenstein model would therefore be regarded as void.

Interestingly, said report also refers to the trust. Could the Explanatory Report be already anticipating the possible introduction of a Swiss domestic trust law, which is currently being finalized by a designated body of experts? Or, was it assumed when

compiling the report that family entrepreneurs are already using, or should be favoring foreign trust structures to legitimately plan for their successions? In any case, it raises the question under which constellations one could imagine that establishing a corporate foundation or trust would be appropriate for succession planning.

Corporate Foundation as a possible Succession Solution

A corporate foundation is a foundation that holds a company (corporation, limited liability company or other legal entities) as part of its foundation assets. It is less important to focus on the nature of the legal relationship, than to ensure that the foundation and the companies are *materially connected*. The purpose of a corporate foundation must correspond to that of an ordinary family foundation, e.g. by aiming at:

- the entrepreneur's wish to provide for long term continuity of the company's management;
- securing the entity's long-term independence, or
- the well-being for their employees.

In recent years, the legality of corporate foundations has also been repeatedly debated in Switzerland, but ultimately recognized by the Swiss Federal Supreme Court (see BGE 127 III 337). A prerequisite for its legality, however, is that the foundation is regularly supported by substantial contributions from the company it owns. Furthermore, the circular letter issued by the Swiss Federal Tax Authorities (Circular Nr. 12) demands for a clear organizational and personnel separation between the Board of Foundation and the Board of Directors, whereby the presence of contact persons is permissible.

Furthermore, a distinction must be made between the *Unternehmerträgerstiftung* and the *Unternehmensholdingstiftung*: In the case of an Unternehmerträgerstiftung, the foundation itself acts directly as a hub for the company. In the case of a Corporate Holding Foundation, on the other hand, the foundation takes a legal interest in the corporate entity. There is no doubt that hybrid constellations are also conceivable in which the legal delimitation can become rather difficult.

The notion of sound family governance, as well as the interrelated aspect of social responsibility, has led to an increasing number of options on how to restructure a company's future by establishing a charitable foundation as ultimate shareholder. However, since the tax exemption for charitable Swiss foundations is subject to high and sometimes incomprehensible hurdles, it is worth considering in such situations whether a foreign foundation statute might be more suitable for long term asset planning. For instance in Austria, there are about 2,900 private foundations within the meaning of the Private Foundations Act of 1993, of which about 60% hold shares in legal entities. Although the tax benefits of Austrian private foundations has been significantly watered-down, other holding privileges still remain.

As practice shows, corporate foundations tend to be more suitable for larger SMEs as a succession solution. In principle, however, holding foundations are to be welcomed if the economic activities primarily serve to realize the foundation's purpose. In this sense, it should be postulated that Switzerland urgently needs to revise its foundation law in order to make it more appealing for company holding structures, but especially for corporate

foundations in particular. Art. 335 of the Swiss Civil Code needs to be abolished, and it might be advisable to take the Austrian Private Foundation Act as a model and to underpin it with a more attractive tax system. As Prof. Andrea Opel righthly stated: "The narrow purpose limitation in family foundations prevents a sensible use of the legal institution, even though it would be in itself an ideal vessel for family asset and estate planning"[1].

The Private Trust Company

Private Trust Company (PTC) is often the mere reflection of a family's desire to establish a bespoke trust instrument that intends to provide a family with a long term sustainable wealth preservation. Consequently, the primary purpose of the Private Trust Company is to act as a trustee for one or more "*connected*" trusts of a family. As a result, this individual trust structure is not used to solicit third party business. Unfortunately, finding a Trustee who is trusted and deeply rooted in a family's affair, as well as understands its values and needs, is in itself very challenging and most difficult when the aim is to keep the family's DNA safeguarded over generations to come.

Often embedded in a sound and comprehensive family governance structure, the PTC aims at creating a common ground for a family's decision-making-process. In principle, it can be said that the advantages of a PTC are most evident, when it lies at the forefront of the inter-relationship of family and corporate governance. Geared towards the individual family relationships, it can positively influence the various stakeholders, which in turn, largely enhances the long term success of a family business.

Although there are many possible applications for such a dedicated trust structure, the main focus is on holding concentrated stock positions, as well as on holding and managing intellectual property and risky investments. In other words, it allows a family to minimize the disadvantages of an individual, not optimally diversified investment strategy and to include assets in an overall portfolio allocation that would generally be unacceptable for a commercial trust company to administer.

The direct involvement of family members and/or their family officers in the management of the trust, enables lean and efficient decision making. It also allows the governance guidelines to be applied in a straightforward and goal-oriented manner. It is important to note that the workings of the PTC do not compromise the legal validity of the trust(s) in any way. On the contrary, PTCs are becoming increasingly important in association with the establishment of Single Family Offices for larger family groups. Especially the connection of private trust companies with family governance, and the coordination of work processes and centralization of legal entities through a Single Family Office is self-contained and economically efficient. Transparent tax optimization and asset protection are just a few of the other advantages that can be realized with careful planning.

It should be noted, however, that trusts are not widely accepted in many of the European jurisdictions. Therefore, they are particularly suitable for situations that have an underlying connection to the Common Law, or to Civil Law jursidictions that have ratified the 1985 Hague Trust Convention.

Apart from the fact that some EU countries do not accept the trust, the legitimate protection of privacy rights has become an increasing challenge. The alleged scandals brought about by the *Paradise* and *Panama Papers* have left their mark on the socio-political

[1] Andrea Opel, ASA 78, p. 265 seq.

landscape, coupled with the tax authorities' general lack of expertise on how to distinguish a sham trust from a genuine estate planning tool.

Regulation and licensing requirements

The licensing requirements for Private Trust Companies vary depending on the jurisdiction. For example, in some jurisdictions, PTCs must apply for their own license, or be under the existing license of another "licensed trust company". Furthermore, in certain jurisdictions, such as the BVI, there is a requirement to include in the Articles of Incorporation a reference to the nature of the entity: *"Private Trust Company"* or *"PTC".*

As a glance across the border to Liechtenstein reveals, the right to constitute a Private Trust Company is derived from PGR Art. 897, according to which a "firm or association person" can be considered a trustee. Unfortunately, there is no lex specialis for PTCs in Liechtenstein. This was explicitly stated in *Liechtenstein 42/2013 Berichte und Anträge* and justified by the fact that *de lege lata* no special requirements for the PTC were deemed necessary. Therefore, there is no license requirement if no businesslike activity is intended. However, it should be noted that the nature of a family trust (i.e. a limited number of persons) must be enshrined in the trust deed. I personally would have welcomed a designated regulation of the PTC in Liechtenstein. This would have been advantageous for Liechtenstein as a jurisdiction, and could have enhanced the legal framework, thus increasing the notion of Liechtenstein as primary location for foreign family businesses. For further information on this topic, I would like to refer to the excellent article by my colleague Dr. Veit Frommelt, which appeared in the *Liechtenstein Journal* in 2014.

Tax aspects

The Hague Trust Convention came into force in Switzerland on 1 July 2007. Art. 19 of the Hague Convention states, however, that the Convention does not prejudice the powers of the Contracting States in fiscal matters. The adoption of the Hague Convention therefore has no effect on the tax treatment of trusts in Switzerland.

Without going into further details, the trust is not recognized as a taxable entity in Switzerland, as it lacks legal personality under foreign law and can't be classified as a "foreign commercial company" or "foreign group of persons without legal personality" according to today's doctrine and practice. Furthermore, Swiss law does not contain any legal norms which could be referred to for the tax assessment of trusts. Finally, there is a lack of a nationwide practice, since the competence of levying the relevant taxes - analogous to the treatment of family foundations - lies either with the cantons (inheritance and gift tax, cantonal wealth and income tax) or are assessed by the cantons.

For understanding the taxation of foreign trusts in Switzerland, we must turn to the Circular letter No. 30 (2007), where a distinction is made between the revocable and irrevocable trust, as well as between the fixed interest and discretionary trust. Accordingly, the proprietary rights and income of the trust are attributed to the beneficiaries or the settlor, depending on the type of trust: Assets continue to be attributed to the settlor for the purposes of current taxation in the case of a revocable trust. This makes sense in so far as in a revocable trust the property is transferred to the trustee under civil law, but the settlor

retains power of disposal after the transfer of ownership. The right to revoke the trust, therefore, justifies the fact that the settlor continues to be regarded as the taxable person.

In the case of an irrevocable fixed interest trust, on the other hand, recourse is taken to the beneficiary. Thus, the attribution to the settlor is excluded due to the fully vested interest. According to the aforementioned Circular letter, the beneficiaries are to be treated as usufructuaries.

The difficulty of attribution lies primarily in the ongoing taxation of the irrevocable discretionary trust: The rights of the beneficiaries are of a purely prospective nature. The timing and scope of any distributions, as well as the completion of the transfer of ownership, are only defined by the discretionary nature of the trustee's decision. Consequently, the Law of Equity also speaks of "contingent interest". Under current tax laws, attribution to the trust is not possible due to a lack of legal personality, and attribution to the trustee due to a lack of economic justification. As a consequence, the Circular letter proposed an unsatisfactory solution, according to which the settlor domiciled in Switzerland would have to bear the same tax consequences as correctly provided for in the revocable trust.

However, if the settlor were to reside abroad or were to become subject to a lump-sum taxation regime, the transfer of assets would be considered as a gift by the settlor due to a current loophole. Finding a tax-efficient solution that is consistent with the legal framework has been controversially discussed so far. In my opinion, however, it is evident that the irrevocable discretionary Trust ought be taxed analogous to a legal entity. This would imply that inheritance or gift taxes would be levied when such trust is established, while the amount of tax levied should depend on the relationship between settlor and beneficiary.

Since the trustee has fiduciary power over the assets and thus manages the trust assets separately from his own assets, the trustee would become liable for taxes that arise at the level of the trust. This would result in a treatment similar to that currently provided for irrevocable foundations without a fixed beneficiary: assets and income would be directly attributed to the foundation. Prof. Andrea Opel rightly states on this subject that "*the different treatment of economically similar circumstances or comparable legal institutions is in my opinion not convincing. Rather, a uniform, legal form of neutral taxation, i.e. a distribution of tax burdens that considers the economic realities, is required. Since family foundations and trusts are structured in a comparable way and therefore, appear to be functional equivalents, their tax treatment should be consistent*[2]."

In the context of a possible adoption of a domestic Swiss trust law, it has been documented that the majority of stakeholders (legal and tax advisors, asset managers, banks and associations STEP and SATC) apparently advocate a Swiss trust. At the same time, however, a majority has also spoken out in favor of a reform of the Swiss family foundation. My personal perception is rather that there seems to be a kind of "Röstigraben": The French-speaking colleagues appear rather positive to the request of a Swiss trust law, the German-speaking Swiss colleagues are rather neutral to negative.
Be that as it may, the commission of experts appointed by the Federal Office of Justice worked out some key points, whereby I would only like to emphasize at this point that a Swiss trust for purely charitable purposes will supposedly be excluded. In addition, with the fiscal shortcomings mentioned above, as well as with the uncertainties still existing in my opinion regarding the legality of proprietary right transfers to a trust, there are numerous

[2] Andrea Opel, ASA 78, p. 265 seq.

stumbling blocks that must be removed for a successful introduction of a Swiss trust. For the sake of mitigating possible future discord, it would have been desirable to have taken the lessons learned from the adoption of Liechtenstein trust law more into account.

Trusts and Double taxation agreements (DTAs)

Double taxation agreements play a decisive role in an international tax planning context. As a general statement, it is noteworthy that that trusts do not qualify as "*person*" in the context of Art. 3 para. 1 lit.a of the OECD Model Tax Convention, and therefore do not enjoy treaty protection: *"the term 'person' includes an individual, a company and any other body of persons"*.

The fact that the DTAs entered into by Switzerland do not in principle recognize the trust as a "person" is expressly stated in the Circular letter. This said, however, reference is made to the existing exceptions with the USA, Canada and UK, which contain a reference to trusts. Nevertheless, according to the Circular letter, only persons who are tax resident in the Contracting State and that are considered actual beneficiaries of the income will benefit from treaty protection in these exceptional cases.

Consequently, the doctrine advocates in the case of a discretionary trust that the trustee should be recognized as the beneficiary. In a recent article, my esteemed colleagues Milton Grundy and Paolo Panico have even argued that it ought to be irrelevant whether the trustee is taxable at his domicile or not. Regardless of whether one advocates such an excessive interpretation, it should be undisputed that a trust that is considered a taxable entity in its jurisdiction, should also be recognized as a beneficial owner.

This would have the logical consequence that trusts that are not subject to taxation would continue to be excluded from treaty protection. This is explicitly clarified, e.g. for a tax-exempt, non-resident New Zealand trust in Art. 3 para. 1 lit.c of the treaty between Germany and New Zealand: "the term 'person' means natural persons, companies and all other legal entities which are taxable as such".

In the interest of transparency, I would therefore welcome, if the different treatment of trusts as persons under Art. 3 were abandoned and the irrevocable discretionary trust were in principle to be recognized as a taxable entity and accordingly as a ‘person’ within the meaning of the DTAs. In my opinion, this step would also contribute largely to a successful future introduction of a Swiss domestic trust. Until, however, such Swiss trust law comes into force, the application of foreign trust law will prevail, as stipulated in Art. 6 of the Hague Trust Convention: *"A trust shall be governed by the law chosen. {…} Where the law chosen does not provide for trusts or the category of trusts involved, the choice shall not be effective”*.

This situation regularly leads families owning businesses to "export their taxable event” to other, more accomodating jurisdictions. In connection with my previous remarks on the economic importance of Swiss family businesses, this may not be in Switzerland's best future interest. Rather, the aim should be to strengthen Switzerland as a prime location for entrepreneurial families, and make Switzerland more attractive for foreign family businesses.

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