The International Tax Letter

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ORIENTA Sagl

International news and analysis to help you in your international tax strategy.

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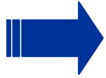

Focus on: Switzerland – Finalization of administrative guidelines concerning taxation of trusts

On 22nd August 2007, the Conference of Cantonal Tax Directors approved the Circular No.30 concerning taxation of trusts in Switzerland. This Circular unifies various current practices of cantonal tax authorities and provides a helpful guideline.

Taxation of trust
Chapter 4 of the Circular describes the taxation of the trust, the trustee, and the protector. The Circular treats the trust as transparent entity, i.e. not as legal entity in Switzerland. The trustee shall not be taxed on the trust assets based on the lack of economic power of disposal. The trustee, who is subject to taxation in Switzerland, is taxed on any fees that he/she receives for the management of the trust. The same treatment applies to the protector.

Taxation of settlor
Chapter 5 deals with the taxation of the settlor and the beneficiary. The Circular mentions, as a general statement, that the taxation of the settlor and the beneficiary shall be based on the particular circumstances of the case. Generally, the income and wealth of the trust (capital, capital gains and current capital income) shall either be taxed in the hands of the settlor or the beneficiary. All the payments that a beneficiary receives from the trust is generally treated as taxable income unless the payment is qualified as income tax free donation. A donation contains four characteristics:

- allotment *inter vivos;*
- enrichment out of the wealth of somebody else;
- free of charge; and
- *animus donandi*.

The taxation of the settlor depends on whether the trust is revocable or irrevocable. In case of an irrevocable fixed interest trust, assets do not belong to the settlor. In all other cases, trust assets and trust income are taxed in the hands of the settlor. In case of an irrevocable fixed interest trust, trust assets and trust income are taxed in the hands of the beneficiaries in proportion to their interest and it must be determined for each beneficiary whether he/she realizes taxable income or donation. Particularly, in case of an irrevocable discretionary trust, the taxation takes place at the time the beneficiary effectively receives payments from the trust. At that moment, it must be determined whether the beneficiary receives a taxable income or a donation, which is not subject to income tax. The chapter concludes with examples of revocable trust, irrevocable fixed interest trust and irrevocable discretionary trust.

Federal withholding tax
Chapter 7 describes the practice of the Federal Tax Authorities (FTA) concerning the levy of withholding taxes on payments by a trust and the refund of withholding taxes on trust income. Payments by a trust are not subject to withholding taxes. Dividend distributions by Swiss-based corporations and interest payments by some Swiss-based debtors are subject to a 35% federal withholding tax. The trust is not entitled to file a claim for refund for federal withholding taxes levied on trust income.

The Swiss resident settlor is generally entitled to request for a refund of withholding taxes in the case of a revocable trust. In case of an irrevocable fixed interest trust, only the Swiss resident beneficiary is entitled to file a claim for refund of withholding taxes. In case of an irrevocable discretionary trust, a refund for withholding taxes on trust income is only granted to the beneficiary in case of a payment by the trust. In other cases, a refund is granted to the Swiss resident settlor. In case of a non Swiss-resident settlor or beneficiary, the applicable tax treaty determines the right for a full or partial refund.

Opportunities for taxpayers: new opportunities for tax planning.

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GERMANY

The Ministry of Finance published a draft ordinance relating to transfer of functions

The Ministry of Finance recently published a draft ordinance concerning the application of the arm's length principle in the case of a cross-border transfer of functions (*Funktionsverlagerungsverordnung*) and asked trade organizations for their review and comments. Details of the draft ordinance are summarized below.

Section 1 of the draft provides definitions of various terms used in the wording of Sec.1(3) of the Foreign Tax Act ("*FTA*"), such as "function", "transfer of functions", "duplication of functions", "transfer package" and "profit potential":

- the term "function" defines the aggregation of similar operational tasks, including corresponding opportunities and risks carried out by certain departments of a company;
- a "transfer of functions" takes place in case a function, carried out by one firm (*transferor*) is transferred to another firm (*transferee*), even if the transfer is only partial or temporary; however, the mere sale or licensing of assets and the provision of services do not qualify as a transfer of functions;
- the term "duplication of functions" refers to the situation in which an already existing function is also performed by a second firm without changing the initial existing structure of the transferor; in that case, the function will be considered as transferred.

For establishing the transfer price of a transferred function, the whole "transfer package", which contains not only assets and intangibles but also opportunities, risks and advantages, has to be valued on the basis of its profit potential. The "profit potential" is based on the expected after-tax earnings of the involved firms and a functional analysis before and after the transfer, taking into account the actual circumstances.

On 11th June 2007, the Italian Supreme Court deposited Decision No.13579 having as its object the applicability of the inheritance tax on shares of a non-resident holding company under the assumption that the latter is deemed as resident in Italy.

NETHERLANDS

Publication of the Bill to simplify limited liability company legislation

On 10th May 2007, the Dutch government introduced a Bill aimed at simplifying the Dutch limited liability company (*Besloten Vennootschap (BV)*) legislation. The most important aspects are summarized below.

a) <u>Minimum capital requirement</u>:
The minimum capital requirement of currently EUR 18,000 would be abolished. As a result, it would become possible to incorporate a BV with one share with a par value of EUR 0.01.

b) <u>Contributions in kind</u>:
Under the current legislation, an auditor statement is required
- in case of a contribution in kind for the receipt of shares, and
- when a BV acquires assets from an incorporator or shareholder within two years following its incorporation and registration with the Trade Registry.

The Bill provides that an auditor's statement in both cases would no longer be required.

c) <u>Security for shares acquired by third parties</u>:
Under the current legislation, neither a BV nor its subsidiaries may provide security if a third company wants to acquire shares in the BV's capital. Moreover, the granting of a loan by the BV for this purpose is subject to strict limitations. To increase the possibilities of financing the takeover of a Dutch BV, the Bill would make it possible to provide security to a third party for the acquisition of shares in a Dutch BV. In addition, the limitations for granting a loan would be abolished.

d) <u>Shares and voting rights</u>:
Under the current legislation, each share carries one vote and there are only very restricted possibilities for other voting arrangements. Under the Bill, it would become possible to attach more than one vote to certain types of shares. Furthermore, an arrangement could be made under which major investors would have minimum voting rights. Finally, it would become possible to introduce shares without voting rights or shares, which do not participate in the profits.

e) Repurchase and redemption of shares:

Under the current legislation, a BV may only repurchase 50% of the issued share capital. According to the Bill, this limitation would be abolished. Under the current legislation, only the total amount of shares of a certain type or class of shares held by a BV in its own capital may be redeemed. Under the Bill, individual shares would become redeemable, as long as the BV has at least one shareholder with at least one share.

f) Distribution test:

In the case of a distribution of assets, or the repurchase or redemption of shares of a BV, a distribution test would apply. The directors of a BV would have to assess whether the BV is able to fulfil all its obligations due and payable after the distribution or the repurchase or redemption of shares. If the directors do not fulfil this requirement, they would become personally liable for resulting damages.

INTERNATIONAL MODELS

How to Increase Returns from Property through Captive Insurance

The commission earned from insurance premiums sometimes provides for a reduction in property management costs. Whilst commissions earned may represent a possible cost saving, captive insurance provides an additional potential source of return for property owners and managers.

An Opportunity

To help maintain current income levels, an option for property owners to consider is to consolidate the risk of insuring their properties through the use of captive insurance.

The methodology is fairly straightforward. A UK insurer would issue the policy to the property owner and an element of the premium payment would represent a reinsurance premium paid onwards by them to a captive insurance vehicle, which would cover part of the risk.

If there is a record of low claims, and this situation continues in the future, the majority of the reinsurance premium paid could be profit within the captive insurance vehicle. Risk, of course, will always exist, but in many commercial property portfolios claims are infrequent and it would be the low level risk that would be covered in the captive.

Captive Insurance

A captive insurance mechanism can be arranged through either a captive insurance company owned by the landlord or through a cell in a protected cell captive insurance company owned by a third party. This second option generally involves lower costs and less management time.

A Cell in a Protected Cell Company

Rather than owning an independent captive insurance company, with the costs, disclosure obligations and management time involved, the property owner could own a cell in a protected cell company. It will be with this cell that the insurer then enters into a reinsurance contract, for a specified amount of risk and for a specific amount of premium.

The cell owner would hold a number of redeemable preference shares in the cell, which would provide the mechanism for the extraction of profits as dividends. Each cell owner would need to capitalise their cells either with paid up share capital or an evergreen letter of credit to cover the initial risk.

Standard claims reporting clauses insist that claims are reported within 30 days. This means that within sixty days of the end of the reporting period comprehensive management accounts for the cell can be produced. After allowing for an adequate reserve allocation, a dividend could then be declared on the underwriting profit.

The protected cell company itself will be owned by a third party, independent of any insurance company, to provide maximum autonomy for the future. In this way the principal insurer can be varied from time to time to recognise market opportunities.

Factors to Consider

Property owners should, however, be aware that:

- They will have to wait to the end of the underwriting period to obtain their dividends.
- They will have to inject an element of capital or arrange a letter of credit to cover the initial risk.
- It is possible that if claims accumulate they may lose money-