

Swiss American Wealth Advisor Guides for Americans in Switzerland – 2021

Swiss Tax Consequences of Being the Beneficiary of a US Trust

You are a US citizen, and you live in Switzerland. You just learned that you have been named beneficiary of a US trust. Congratulations!

You are happy to be entitled to trust distributions, but you are also worried about the consequences. What are the US and Swiss implications? You wonder....

Let's start from the beginning.

What is a trust?

A trust is a legal vehicle by which a party, the grantor, appoints a second party, the trustee, to manage assets held in trust for the benefit of a third party, the beneficiary.

Grantors set up trusts to ensure that their assets are managed in a certain manner during their lifetime and after their death. The trust document specifies how the grantor wants the assets to be managed and distributed by the trustee to the trust beneficiaries. Trusts are widely used in the USA as estate planning instruments. Trusts avoid probate, protect the privacy of the grantor and beneficiaries, and can also help avoid estate taxes.

What are the most common situations by which US citizens living in Switzerland become beneficiaries of US trusts?

The most common scenario usually involves a Revocable Living Trust. A Revocable Living Trust is when a grantor (usually mom, dad or both parents) set up a trust and name themselves trustees and beneficiaries during their lifetime. During the lifetime of the parents, the trust is disregarded, and the assets and income are treated as if they were still owned directly by the parents. The parents, as grantors, usually retain the ability to modify the terms of the trust if they wish to.

When they pass away, the trust becomes irrevocable, the successor trustee is appointed, and the contingent beneficiaries (usually the children) become the primary beneficiaries. It is typically at this point that US citizen children, usually adult children, living in Switzerland, are informed that they are now the beneficiaries of a US trust.

What are the US tax consequences of being beneficiaries of a US trust?

US beneficiaries of a US trust are typically responsible for income tax on any income that they receive from the trust as a distribution. They do not pay any tax on distributions of trust corpus.

What is trust income?

Trust income is generally interest, dividends, rents, royalties or gains on the sales of appreciated trust assets.

What is trust corpus?

Trust corpus are the assets that were initially contributed to the trust by the grantors.

How do US beneficiaries know if a trust distribution is from income or corpus?

Trust beneficiaries receive a tax form, called [Form K-1](#), that specifies the breakdown of the trust distribution into various different categories such as interest, ordinary and qualified dividends, rental income, long and short-term capital gains, distributions from corpus, etc.

The breakdown shown in the Form K-1 is used to prepare the beneficiary's US income tax return, Form [1040](#), where the beneficiary reports the different amounts and types of income.

What are the Swiss tax consequences of being the beneficiary of a US trust?

Unlike the USA, Switzerland doesn't have its own trust law.

Yet.

On March 13th 2019, the Swiss parliament voted in favor of an initiative that requires the Swiss Federal Council to provide for Swiss trust law. The Federal Council has two years to draft a legislative proposal, which is expected early next year, by March 2021.

In the meantime, as a signatory of the Hague Trusts Convention, Switzerland will generally recognize foreign trusts. A US trust is a foreign trust from a Swiss perspective; therefore, Switzerland will generally recognize a US trust as a foreign trust.

What does this mean for the Swiss resident beneficiaries of the US trust?

The Swiss beneficiaries of a US trust can be liable for Swiss taxation with respect to trust assets, trust income or trust distributions if they are residents of Switzerland when the trust is settled or when a distribution from the trust is received.

The taxation will depend on the type of trust involved.

Administrative Swiss tax guidelines distinguish between revocable and irrevocable trusts. Irrevocable trusts are further classified between discretionary or fixed interest trusts.

How do you know what kind of trust you are dealing with?

A tax ruling from the competent Swiss Tax Authority is usually needed to determine the classification of a foreign trust. Yep, you will likely need to go to your Swiss tax authority and ask for a ruling.

What is a Swiss tax ruling?

A Swiss tax ruling is binding determination issued by Switzerland's tax administration on the tax treatment of a planned or existing tax-relevant situation. Either the taxpayer or the taxpayer's representative can request the tax ruling. The goal of the tax ruling is to ensure the correct assessment of the facts in question. In this case, the tax-relevant situation is the trust. The tax ruling will determine how the treatment that it will receive by the tax authorities and the reporting requirements and resulting taxation to the Swiss trust beneficiary.

Let's go back now to the example of the Swiss resident adult children who are now the beneficiaries of their deceased parents' irrevocable U.S. trust. In most cases, the Swiss tax authorities will agree with the characterization of such a trust also as it being irrevocable from a Swiss perspective.

As we said earlier, irrevocable trusts can be viewed as discretionary or fixed interest.

When is an irrevocable trust viewed as discretionary?

A foreign trust will generally be viewed as a discretionary trust when the trustee has full discretion regarding distributions. Full discretion means that it is up to the trustee, and usually only just the trustee, to decide how and when to make trust distributions. The beneficiaries can request distributions, but they have no power to demand them or force them to be made. Tough luck for them! The decisions regarding distributions are at the discretion of the trustee.

When the trust is classified a discretionary from a Swiss perspective, the trust is not treated as transparent, but rather as opaque.

Opaque? What is that?

An *opaque* trust is a trust that is considered a separate tax person from the Swiss beneficiary. In an opaque trust, the trust assets and income are not attributed to the beneficiary when no distributions are made to the beneficiary in a given year.

The Swiss beneficiary is not required to report trust income from an opaque trust when he doesn't receive any trust distributions, and the Swiss beneficiary is also not required to report the trust assets on his Swiss tax return in such a year.

When a distribution from an opaque discretionary trust is received by Swiss resident beneficiaries, the beneficiaries must report the entire distribution as income, unless they can prove that the distribution is a distribution of trust corpus. Unfortunately, this is a very tall order.

Beyond the difficulty in proving that a distribution from the trust is from corpus, which generally requires having the original trust documentation and being able to trace the assets currently in the trust to the assets initially contributed to the trust by the grantor (exactly!); in the case of discretionary trusts, Switzerland deems distributions to come from income FIRST and corpus *last*. Distributions from trust corpus are only permissible after the entire income from the trust has been completely distributed. Ouch!

As a consequence, many times, distributions from discretionary trusts will be fully considered income subject to income tax at the federal, cantonal and local level by the Swiss tax authorities. The increase in wealth resulting from the distribution is subject to Swiss wealth tax too.

This can be a very costly outcome for the Swiss beneficiaries.....

When is a US trust viewed by Switzerland as a fixed interest trust?

A foreign trust will generally be viewed as a fixed interest trust when the trust documents effectively bound the trustee, and provide him no discretion regarding trust distributions of income or corpus. The trust document itself determines how and when the distributions must be made annually to the different beneficiaries.

Would you like an example?

In the typical example, the trust document will establish that all DNI must be distributed annually to the beneficiaries. What is DNI? Technically, DNI stands for Distributable Net Income. In practical purposes, pretty much the net income from the trust. Additionally, the trust documents establish that the trust must be dissolved and its corpus distributed to the remainder beneficiaries in the year that the youngest beneficiary attains age 35.

As you can see from this example, the trustee must follow the instructions set forth in the trust document, with no discretion to alter the amount or timing of distributions, including the final distribution.

With this type of trust, the Swiss tax guidelines attribute usufruct of the trust assets to the US beneficiaries.

What is usufruct?

Usufruct is not a concept that exist under U.S. law, but in Switzerland, usufruct is the legal right accorded to a person or party (in this case the trust beneficiaries) to use and derive income or to benefit from someone else's property (in this case, the trust assets).

Attributing usufruct is akin to fiscally attribute the assets of the trust for wealth tax purposes and the income from those assets for income tax purposes to the beneficiaries, irrespective of whether there are any distributions. This attribution means that the trust is considered *transparent* for Swiss tax purposes and not an opaque tax person, separate from the beneficiaries.

When fixed interest trust distributions are received, capital gains or corpus are not taxed as income. Dividends, interest and other forms of income will be taxed to the Swiss beneficiary as if they were directly earned. The same applies to the final distribution upon the liquidation of the trust: no income tax will be assessed on the liquidation distribution if it is a distribution from corpus.

One important detail: the trust beneficiary is required to provide supporting documentation to the Swiss tax authorities to determine the extent to which a distribution is from tax free capital gains or corpus, or from taxable dividends, interest, rents, etc.

You may have realized by now that fixed interest trusts are taxed by Switzerland similarly as to how irrevocable trust distributions are taxed in the USA, although applying Swiss tax rules instead of US tax rules. Because Swiss tax rules differ from US tax rules, Form K-1 is not helpful for Swiss tax purposes. Documentation from the trust investments themselves is needed to determine trust income calculated under Swiss tax rules.

Another conclusion you may have reached is that fixed interest trusts are treated similarly as if the Swiss residents had received a direct inheritance: the assets are considered owned by the beneficiary for wealth tax purposes, and the income is subject to Swiss income taxes in the same manner as if the income had been earned directly by the Swiss resident beneficiary.

Confused? Do not worry. I will summarize the general rules in a minute.

I hope that this brief discussion helps provide some initial guidance as to what you can expect as a Swiss resident U.S. beneficiary of a U.S. trust. A Swiss tax ruling is the only way to have certainty regarding the tax treatment of your beneficial interest in the trust. The Swiss tax authorities will base their ruling on your personal circumstances and on the trust's facts and documentation available.

Let's summarize the U.S. trust general rules for Swiss resident beneficiaries we just discussed:

- For US tax purposes, a Swiss resident beneficiary of a US trust who is also a US citizen, is required to report income received from the trust on his personal tax return based on what is reported to him in his Form K-1.
- In Switzerland, a tax ruling by the competent Swiss tax authority will determine the classification of the US trust.
 - If the US trust is classified as an irrevocable fixed income trust, the trust is treated as transparent, the beneficiary is considered to have usufruct of the trust assets, and will generally need to report his share of trust income for income tax purposes and his share of trust assets for wealth tax purposes every year. Capital gains and corpus distributions should not be subject to Swiss income tax, but supporting documentation is required.
 - If the trust is classified as discretionary, the trust is treated as opaque, and the beneficiary is not considered to have usufruct of the trust assets. Generally, no reporting is required by the Swiss beneficiary when no distributions are received. The trust assets are not subject to wealth tax on the beneficiary's tax return. Distributions will generally be taxed as income, including final distributions upon liquidation of the trust, unless the Swiss beneficiary can substantiate that the distributions are from



original contributed corpus. Income from the trust is required to be distributed first, and no distributions from corpus will be permitted until this happens. Many times, the entire distributions received from US trusts treated as opaque for Swiss tax purposes are taxed 100% as income. This is a punitive tax result.

Before signing off, the usual disclaimer: this is not legal tax advice intended for anyone in particular. This is general information to help you understand how to think about things. Do not rely on this information to draw any conclusions about your situation and trust. If you do so, understand that you are doing it at your own risk and that you may reach the wrong conclusion. If you have questions about your situation, you should seek personalized guidance from the competent Swiss tax authorities or from your trusted tax advisor.

Swiss American Wealth Advisors



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