

10. Flaws in the Current U.S.-Swiss Estate Tax Treaty and the Need for a Modern Treaty

Marnin Michaels, Baker & McKenzie, Zurich
Jacqueline Hess, Deloitte, Zurich



The United States imposes a tax on transfers of property at death (by bequest or devise) or during life (by gift). This tax is commonly known as the estate and gift tax. U.S. persons (i.e., U.S. citizens and U.S. domiciliaries) are subject to this tax on transfers of property wherever located in the world. Each U.S. person is granted an “exemption amount” that exempts a certain amount of the bequest, devise, or gift from estate and gift tax. The current rate is 35% and the exemption is US\$ 5 million. Non-U.S. persons (i.e., persons who are neither U.S. citizens nor U.S. domiciliaries) are subject to U.S. estate and gift tax only on transfers of “U.S. situs property”. U.S. situs property is generally limited to U.S. real estate, stock of U.S. corporations (for estate tax purposes only, not gift tax purposes), mutual funds organized in corporate form if incorporated in the United States (to the extent that the mutual fund assets are U.S. situs), certain types of debts of U.S. obligors (for estate tax purposes only, not gift tax purposes), and tangible personal property located in the United States. This leaves broad categories of property that are not subject to U.S. estate and gift tax when transferred by a non-U.S. Person, such as foreign stocks, foreign bonds, foreign real estate, and U.S. publicly traded bonds.

There is an Estate Tax Treaty (ETT) between the United States and Switzerland (the “Treaty”) that is intended to mitigate double taxation and it will soon celebrate its 60th birthday. Unfortunately, the Treaty has not aged very well and it is better known for its inadequacies than for its benefits. So instead of a birthday celebration, the Swiss-American business community and private client professionals would not likely shed a tear if the existing Treaty were laid to rest and a new modern ETT was born.

The existing Treaty deals solely with the U.S. Federal estate tax and with estate or inheritance taxes imposed by the cantons of Switzerland (i.e., not with gift taxes) and provides different benefits depending upon the status of the decedent. The principal benefits provided by the Treaty depend upon the decedent’s status as one of the following: (i) a “Solely Swiss Decedent”, that is, a Swiss citizen or domiciliary who is not a U.S. citizen or domiciliary; or (ii) a “Dual Status Decedent”, that is, a decedent who is a citizen or domiciliary of both countries. While the Treaty was an important step to ensure local Swiss inheritance taxes were creditable in the United States, recent talk of a Swiss federal inheritance tax of 20% means that a revision will be needed to ensure this tax is also creditable (although U.S. domestic law may allow a credit in many cases).

For non-U.S. decedents (i.e., a decedent who is neither a U.S. citizen nor a U.S. domiciliary), the U.S. estate tax is imposed on real property located within the United States, and on tangible and intangible property situated within the United States. Importantly, the U.S. estate tax is imposed upon the value of shares in U.S. corporations and debt obligations of U.S. persons, subject to statutory exemptions for U.S. bank deposits and bonds that qualify for the portfolio indebtedness exemption from U.S. withholding tax on interest payments to non-U.S. persons. The classification of investment assets as U.S. or non-U.S. situs for estate tax purposes can in some instances require a subtle analysis and in all cases requires

the attention of clients, professionals, and asset managers in advising upon and in constructing investment portfolios. In the absence of an ETT, there is little margin for error, since the exemption amount provided under U.S. estate tax law for non-U.S. decedents is only US\$ 60,000.

In the case of a Solely Swiss Decedent, the existing Treaty, unlike modern ETTs, does not impose any limitation on the right of the U.S. to tax U.S. situs assets. The situs rules of U.S. estate tax law will apply to the estate of a Solely Swiss Decedent. The situs rules impose U.S. estate tax, subject to certain statutory exceptions, on assets situated in the United States, whether real or movable property, and whether tangible or intangible. Thus, despite the statutory portfolio indebtedness exemption, professionals and asset managers must remain vigilant in constructing investment portfolios for Swiss clients so as to minimize the risk of making investments that expose their clients to U.S. estate tax, especially investments in U.S. equities.

If a Solely Swiss Decedent owns U.S. situs assets at death, the Treaty provides an enhanced exemption amount in computing the U.S. estate tax liability on those taxable assets. As mentioned above, in the absence of an ETT, a non-U.S. decedent would be allowed an exemption which protects only US\$ 60,000 worth of U.S. situs assets from U.S. estate tax, while the estate of a U.S. citizen or domiciliary would be allowed an exemption amount of US\$ 5 million (at least for 2010, 2011, and 2012). The Treaty allows to the estate of a Solely Swiss Decedent a percentage of the exemption amount available to U.S. citizens and domiciliaries, based upon the ratio of the decedent’s U.S. situs assets to worldwide assets. Thus, if a Solely Swiss Decedent dies in 2011 having a worldwide estate of US\$ 50 million of which US\$ 5 million consists of U.S. situs assets (e.g., shares in U.S. corporations and U.S. real estate), the estate would be allowed an exemption amount of US\$ 500,000 (10% of the exemption amount available to U.S. persons). In this example, the remaining U.S. taxable estate (e.g., US\$ 4.5 million) would be subject to U.S. estate tax at the rate of 35% (effective for 2010, 2011, and 2012). If the Solely Swiss Decedent resided in a canton which also imposed an estate tax on the decedent’s world-wide assets (except perhaps non-Swiss real estate), the U.S. situs assets would be subject to double taxation, absent any credit relief which might be provided under the inheritance tax laws of the decedent’s canton. The Treaty does not provide any relief in the form of a credit for U.S. taxes paid.

In summary, in the case of a Solely Swiss Decedent, the Treaty neither precludes the U.S. from taxing the U.S. situs movable property (e.g., shares in U.S. corporations), nor requires Switzerland to grant a credit for any U.S. estate tax imposed upon U.S. situs assets.

The case of the Dual Status Decedent is perhaps even more disappointing. For example, a U.S. citizen domiciled in Switzerland will be subject to U.S. estate tax on the decedent’s worldwide assets based upon U.S. citizenship (subject to the exemption amount available to U.S. citizens, now US\$ 5 million), while the Swiss canton in which the U.S. citizen was domiciled could tax based upon domicile. The Treaty does not assign the pri-

mary right of taxation to either country. Unlike modern ETTs, the existing Treaty does not have a “domicile tie-breaker” article. Instead, the Treaty seeks to avoid double taxation on assets located within the U.S. or Switzerland through a reciprocal credit mechanism, while permitting double taxation of assets located elsewhere.

For example, if a U.S. citizen dies domiciled in the canton of Zurich having an estate valued at US\$ 50 million, consisting of shares in a U.S. corporation and in a Swiss corporation, valued at US\$ 25 million each, both the United States and the canton of Zurich would tax the worldwide estate of US\$ 50 million (less any exemption amounts available under local law). Under the Treaty, the United States would allow as a credit against U.S. estate tax, the estate or inheritance tax paid to Switzerland with respect to the Swiss shares. Conversely, Switzerland would allow as a credit against Swiss estate or inheritance tax, the U.S. estate tax allocable to the U.S. shares.

In contrast, if a U.S. citizen dies domiciled in the canton of Zurich and owns shares in a German corporation, the U.S. may tax the value of German shares based upon the decedent’s U.S. citizenship and the canton of Zurich may tax the value of the German shares based upon the decedent’s domicile, but neither the Treaty nor the domestic tax laws of the United States or Switzerland would allow a credit for estate taxes paid to the other jurisdiction on the value of the German shares.

If the above inadequacies were not enough, the Treaty might also be responsible for contributing to conjugal tension in Swiss-American households by failing to address the estate taxation of inter-spousal transfers. Under U.S. estate tax law, a full marital deduction is allowed for transfers to a U.S. citizen spouse on the theory that estate tax will be collected upon the death of the surviving spouse based upon his or her status as a U.S. citizen. However, where the surviving spouse is not a U.S. citizen, estate tax could be avoided if the surviving non-U.S. citizen spouse were not domiciled in the United States at the time of death and did not own U.S. situs assets. Thus, the marital deduction is denied unless the assets are held in a special form of trust for the benefit of the non-U.S. citizen surviving spouse, called a “qualified domestic trust”. For example, a bequest by a U.S. citizen to his Swiss surviving spouse (not a U.S. citizen) would not qualify for the marital deduction even if the surviving spouse were domiciled in the United States. Thus, absent the implementation of a qualified domestic trust, a U.S. estate tax would be imposed on this inter-spousal transfer (after the exemption amount provided by U.S. estate tax law, currently US\$ 5 million). Most modern ETTs would provide for a limited marital deduction in these circumstances.

We believe the Treaty should match the modern ETTs of Switzerland’s neighboring countries: Germany, Austria, and France. Each of these jurisdictions has a modern ETT that addresses all of the issues discussed above. Austria’s inheritance tax has even been abolished, yet it still has a modern ETT in force. The current Treaty is ineffective.

We do, however, believe that there should be one modification to the standard “new modern treaty” and that is with respect to the issue of statutory executorship. The standard model treaty on estate tax only addresses issues such as the liability of people domiciled in the country. Given the size and global nature of the Swiss wealth management industry, the biggest risk on this issue will come from people who keep their funds in Switzerland, but are not domiciled therein. Most financial institutions believe that they do not have obligations for reporting or paying tax for those non-U.S. persons who die owning U.S. situs assets, such as U.S. shares, but do not pay the estate tax. However, guidance regarding statutory executorship is in many instances, at best, murky. This

is particularly the case in the area of fiduciary relationships. Thus, we suggest a modification to the Treaty providing clarity on this issue.

In 2001, members of the SACC, made a first attempt to revise the Treaty. At that time, members of the U.S. Treasury suggested that this was not necessary since the estate tax was going to be repealed. Later in the decade, a second attempt was made but was rebuffed by U.S. Treasury because the United States was seeking a new Article 26 on Information Exchange. Since both of these issues have now been resolved, it is the perfect time to revive treaty discussions. The SACC Tax Chapter has again started the process of attempting to obtain a new ETT in view of the new spirit of cooperation between Switzerland and the United States on tax-related matters.

About the authors:

Marnin Michaels is Partner at Baker McKenzie, Zurich. He is also a member of the Tax Chapter Board of the Swiss-American Chamber of Commerce.

Jacqueline Hess is Partner International Tax at Deloitte, Zurich. She is also a member of the Tax Chapter Board of the Swiss-American Chamber of Commerce.

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