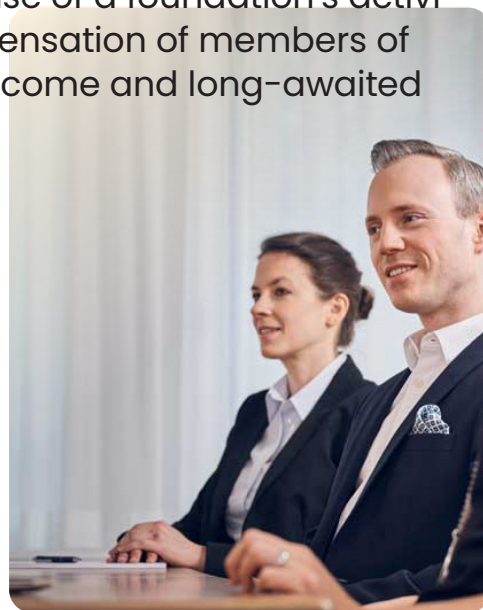




EASING THE TAX EXEMPTION PRACTICE FOR FOUNDATIONS IN THE CANTON OF ZURICH

The Cantonal Tax Office of Zurich is creating more flexibility for tax-exempt foundations in connection with foreign activities, impact investments, and the compensation of foundation bodies.

In connection with the goal set by the Government Council of the Canton of Zurich in 2023 of increasing the appeal of the Canton of Zurich as a location for foundations, a joint press release issued by the Department for Finance and Economic Affairs of the Canton of Zurich on 9 February 2024 states that the Zurich Cantonal Tax Office is improving the tax law requirements for tax-exempt foundations. This change in practice is intended to introduce (more) flexibility, particularly in the case of a foundation's activities abroad, impact investments and the compensation of members of a foundation's governing bodies, marking a welcome and long-awaited innovation.



Tax exemption for foundations

A foundation is essentially granted a tax exemption if it pursues a public or charitable purpose and meets the following conditions:

- exclusive use of funds for charitable purposes
- irrevocability of the commitment to the purpose
- actual activity or fulfilment of the purpose

Charitable purposes include activities that are in the (Swiss) public interest or promote the common good, for example through activities in ecological, humanitarian or scientific fields, that are altruistic and do not involve commercial competition with the aim of making a profit (maintaining competitive neutrality).

The criterion of maintaining competitive neutrality is examined particularly critically by the tax authorities, and applications for tax exemptions have so far not been granted at all or have only been granted very cautiously if there was a chance that a commercially competitive situation could arise. This has not only prevented or hampered impact investments but also, to some extent, asset management.

In addition, opportunities for activities abroad were severely limited, restricting the scope of action for many foundations.

Activities abroad

In principle, charitable activities in connection with a tax exemption must be pursued within Switzerland. However, in view of Switzerland's long-standing humanitarian tradition, a tax exemption has already been possible for activities abroad, provided that the charitable activity was carried out in developing countries or emerging markets and involved one of the following activities:

- development aid;
- refugee aid;
- cultural promotion;
- activities in the field of knowledge and research provided a transfer of knowledge took place between Switzerland and the other country.

In addition, for special categories of activities relating to climate protection, species conservation, humanitarian aid and peace promotion, which constitute global challenges, a tax exemption could be granted irrespective of the location of the activity, provided that these activities were in the Swiss public interest.

Moreover, taking into account the aforementioned conditions, stricter requirements regarding the documentation of activities abroad were applied in order to ensure the promotion of Switzerland's overall interests despite the absence of monitoring mechanisms, and thus to justify the outflow of funds to other countries. When supporting organisations abroad, for example a tax exemption decision issued by the state of domicile had to be submitted. In practice, the tax authorities sometimes went even further and made an exemption for foreign activities generally subject to the existence of a foreign tax exemption.

According to the joint press release from the Department for Finance and Economic Affairs of the Canton of Zurich published on 9 February 2024, charitable activities abroad will now be judged by the same standards as activities in Switzerland, which is intended to make the Canton of Zurich more attractive to internationally active charitable foundations.

This decision by the Canton of Zurich is highly commendable, firstly because many foundations have a strong interest in operating internationally even outside developing countries and emerging markets, and secondly because certain activities that lie in the public interest of Switzerland can be pursued more effectively and efficiently at global level rather than at national level alone. It is to be hoped that the Zurich Cantonal Tax Office will implement the announced change in practice in an effective manner. It can be expected and is understandable that stricter documentation requirements in terms of traceability and transparency will continue to be imposed for activities abroad.

«IT IS EXPECTED THAT THERE WILL BE A SIGNIFICANT LIBERALIZATION OF THE REQUIREMENTS FOR TAX EXEMPTION REQUESTS.»

Business-related support models

According to the practice specification issued by the Zurich Cantonal Tax Office, the support activities of tax-exempt foundations should no longer be limited to à-fonds-perdu contributions and loans but should also allow e.g. impact investments. Impact investing is subject to two conditions: the investments must be made in an area in which there is not yet a market, i.e. where there is no competition with non-tax-exempt investors, and the returns generated by the foundation must in turn be used for charitable purposes.

It remains to be seen whether, for example, investments in non-tax-exempt start-ups, which engage in an activity of general interest or the financing of research projects by non-tax-exempt companies, which serve the general interest, will be eligible for a tax exemption from the perspective of the Zurich Cantonal Tax Office and how much flexibility or, if need be, restraint will be applied when examining tax exemption applications. It is to be hoped that the previously very cautious practice in the context of impact investments will be relaxed.

Compensation of foundations' governing bodies

Pursuant to the press release of 9 February 2024, the previous requirement imposed by the Canton of Zurich in its information sheet from July 2018, according to which members of a foundation's governing bodies must essentially act on a voluntary basis, has been lifted. In future, adequate compensation for foundations' governing bodies no longer precludes a tax exemption in the Canton of Zurich.

This, too, is a positive development that will enable foundations' governing bodies in future to receive appropriate compensation for their sometimes extremely time-consuming and challenging activities, which will increase the appeal of these roles.

The practice of the supervisory authority will reveal what requirements will be placed on the documentation of the reasonableness of remuneration in view of a tax exemption, taking into account the size and structure of the foundation, the effort, responsibility and expertise involved.

Amendments to the statutes for existing foundations

Introduction of adequate compensation for foundations' governing bodies

Under the previous practice of the Zurich Cantonal Tax Office, the voluntary nature of the activities of foundations' governing bodies was to be ensured by including a clause to that effect in the statutes. With the removal of this requirement, the question arises as to whether the statutes of existing foundations should be amended accordingly.

According to legal scholars, an amendment to the provi-

sion in the statutes concerning the compensation of members of a foundation's governing bodies constitutes a so-called minor amendment of the foundation charter within the meaning of Article 86b of the Swiss Civil Code (ZGB) since it does not fundamentally alter the essence of the foundation. This applies at least insofar as the provision of the statutes concerning the voluntary nature of the activity is not intended to be irrevocable according to the (presumed) will of the founder. Whether this is the case must be determined by interpretation, but is likely to be the exception. For minor changes within the meaning of Article 86b ZGB provides for a simplified procedure: the supervisory authority, after consulting the foundation's supreme governing body, issues the amending order. This is subject to the condition that the amendments to the foundation charter are objectively justified and do not impair the rights of any third party. These two conditions are also usually likely to be fulfilled since, in principle, no third-party rights are impaired is increased.

Foreign activities

If the activity of the charitable foundation was restricted by the statutes to Swiss territory in order to obtain a tax exemption, any expansion of this foundation activity abroad requires an amendment to the statutes.

Since – unlike the introduction of appropriate compensation for the foundation's governing bodies – this is no longer likely to be a minor amendment, it is subject to stricter requirements. A distinction must be made between whether or not the foundation charter provides for a reservation of change of purpose. In the first case, the founder must submit a proposal to the competent supervisory authority. Furthermore, the founder's right to file an application must not have expired, which is the case upon their death or, in the case of legal entities, no later than 20 years after the foundation was established. Finally, at least 10 years must have elapsed since the foundation was established or the last amendment request by the founder. In the second case, i.e. where the foundation charter does not contain such a reservation, the legal hurdles are higher and the permissibility of a change depends upon the specific circumstances of the individual case.

Business support models

The change in practice regarding impact investments does not, in principle, give rise to any need for action provided that the support activities are carried out within the scope of the foundation's purpose.

Conclusion

The direction and measures taken by the Zurich government and the Zurich Cantonal Tax Office to promote foundations in the Canton of Zurich are commendable and represent a step in the right direction. It remains to be seen how the communicated change in practice will be implemented by the tax authorities of the Canton of Zurich, although a significant liberalisation of the requirements for tax exemption applications is expected. Furthermore, it is hoped that other cantons will follow the example of the Canton of Zurich and adapt their practices in relation to tax-exempt foundations.

Keyfacts

- 01** The Cantonal Tax Office of Zurich is creating more flexibility for tax-exempt foundations in connection with foreign activities.
- 02** In the future, impact investments should be possible under certain conditions.
- 03** Governing bodies of charitable foundations may now receive appropriate compensation.



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