

BRIEFING MÄRCH 2024

TAX EXEMPTION FOR CHARITABLE FOUNDATIONS AND ASSOCIATIONS - WHAT DOES THE NEW PRACTICE OF THE CANTON OF ZURICH ACTUALLY MEAN?

In February 2024, the Executive Council of the Canton of Zurich published a change in practice to make Zurich more attractive for nationally and internationally oriented foundations and to position Zurich as the No. 1 location for foundations.¹ The general and specific conditions for tax exemption are open to interpretation, which is why there is considerable discretion for the authorities in their application. Tax measures and ensuring the necessary professionalism of the foundation's activities are the primary factors in facilitating a modern and effective foundation system.² The changes concern the remuneration of the board, the recognition of foreign activities of a charitable foundation according to the same standards that apply to domestic activities, as well as the approval of entrepreneurial funding models within the scope of the foundation's purpose (so-called *impact investing*). The changes adopted by the Executive Council have already been implemented in the relevant practical guidelines of the Canton of Zurich.³ The Cantonal Tax Authority of Zurich (CTA ZH) will have to take these changes into account when assessing applications for tax-exempt status. In practice, the implementation of the revised regime by the municipality in which the foundation is (will be) based will also have a certain significance since the

municipality can give its opinion on each application for tax exemption concerning it.

REMUNERATION OF THE FOUNDATION BOARD

INITIAL SITUATION

Under civil law, a founder may stipulate in the foundation statutes whether the foundation board is remunerated for its activities or acts in an honorary capacity. However, most cantons require that a tax-exempt foundation must be altruistic in the sense of making a certain sacrifice. The Swiss Tax Conference (STC) deduced from this stipulation that the members of the foundation board must perform general foundation board duties in an honorary capacity without compensation,⁴ while appropriate compensation may be awarded for exceptional services.⁵ Cantonal practice is extremely heterogeneous, often accepting no remuneration at all or only very moderate sums,⁶ whereas the Federal Supreme Court's stance

¹ See press release dated February 9, 2024, available at [Zukunftsgeschichte Stärkung des Stiftungsstandorts Zürich | Kanton Zürich \(zh.ch\)](#). Carmen Walker Späh: [Kanton Zürich soll mehr Stiftungen anlocken \(nzz.ch\)](#).

² Information, coordination and advisory services are also being expanded.

³ Praxishinweis Steuerbefreiung wegen Gemeinnützigkeit, ZStB 61.1 vom 1. Februar 2024 (hereinafter "Praxishinweis"), as well as Merkblatt Statutenbestimmungen für steuerbefreite juristische Personen by the CTA ZH, version dated February 2024 (hereinafter "Merkblatt Statuten 2024"). The changes also apply to charitable institutions with a different legal

form, in particular associations, which are not discussed separately below.

⁴ Actual expenses and out-of-pocket expenses may be reimbursed.

⁵ STC, Steuerbefreiung juristischer Personen, die öffentliche oder gemeinnützige Zwecke oder Kultuszwecke verfolgen, Praxishinweise zuhanden der Kantonalen Steuerverwaltungen vom 18. Januar 2008, p. 39 ff (hereinafter "STC, Praxishinweise").

⁶ Voluntary work e.g. in Geneva, moderate/small compensation in Grisons and Basel-Stadt.

around remuneration shows a greater level of acceptance of the practice.⁷

The legislator also appears to be in favour of remuneration, as the new art. 84b of the Swiss Civil Code (CC) clarifies that the remuneration of the foundation's highest governing body must be disclosed annually to the foundation supervisory authority.⁸

NEW ZURICH PRACTICE

The CTA ZH previously required that members of the highest governing body of a charitable institution should work on an honorary basis, while salaried employees were allowed to receive normal remuneration. With the change in practice, members of the foundation or association board may now also receive appropriate compensation, provided that the foundation deed or articles of association include the necessary provision and the specifics of the compensation are outlined in compensation rules.⁹

In the case of foundations, the compensation rules must be reviewed by the competent foundation supervisory authority in accordance with art. 84 para. 2 and 84b CC. The CTA ZH generally assumes that the compensation has been reviewed by the foundation supervisory authority and deemed to be appropriate.¹⁰ With regard to foundations, the CTA ZH would only launch its own investigation if the appropriateness of the compensation is questionable.

EFFECTS

The possibility of appropriately compensating members of the Foundation Board is likely to produce some generally desirable effects, even if it may lead to an aggravation in some areas:

- Professionalisation of foundation board activities by making it easier to find suitable personalities for positions with constantly growing demands on their work and time and increasing regulatory scrutiny
- Easier fundraising through professionalisation of management; in some cases, however, potential donors may also be reluctant to donate due to higher costs ("overhead").

Appropriate remuneration entails the risk of extended liability. A reduction in liability due to honorary work is generally rejected in practice and as a tendency also in doctrine. Nevertheless, the liability of an appropriately remunerated member of the Foundation Board could be assessed more strictly. We recommend considering a D&O insurance.

OPEN QUESTIONS

The first question arising is what amount is considered to be an appropriate compensation. The examination of adequacy is carried out on a case-by-case basis and lies

with the competent foundation supervisory authority or the CTA ZH. Pursuant to art. 84 para. 2 CC, the foundation supervisory authority is obliged to ensure that the foundation's assets are used for the foundation's purpose. This also includes ensuring that sufficient funds are used for the charitable purpose despite the compensation paid. Factors relating to the foundation, the mandate and the person must be taken into account when assessing the compensation.¹¹ It is assumed and considered desirable that a more established practice or clearer guidelines will emerge on this basis.

Due to the required approval of a foundation's Compensation Rules by the foundation supervisory authority, the CTA ZH reportedly now assumes that approval of the remuneration regulations by the foundation supervisory authority should be obtained before submitting the tax exemption application. Ideally, the approval should be submitted along with the application for tax exemption.

It is still unclear what will apply to established tax-exempt institutions in the Canton of Zurich whose founding documents include, in accordance with the previous requirements set forth by the tax authorities, provisions for the members of their highest governing body to act in an honorary capacity. The CTA ZH has not yet established a practice in this regard. In our opinion, an amendment to the foundation deed is required if the foundation wishes to compensate its foundation board members going forward. Amendments must be approved by the foundation supervisory authority. Where the tax exemption has already been granted, the CTA ZH must also be informed about the change. Upon request, the latter can then confirm that the change has no negative impact on the tax-exempt status of the foundation. In order to avoid putting existing foundations at a disadvantage, we believe that it should be possible to amend foundation deeds quickly and easily in order to allow for appropriate compensation of board members.

ACTIVITIES ABROAD

INITIAL SITUATION

The fact that activities abroad can also qualify for tax exemption is undisputed in principle.¹² However, the waiver of taxation of income must be justified from a Swiss perspective, which is why the STC requires that, if a foundation is predominantly or exclusively active abroad, the activity must also be an expression of Swiss solidarity and appear to be worthy of promotion from a general Swiss social perspective.¹³

Many cantons also impose stricter requirements on foundations that operate primarily or exclusively abroad. Cantonal practices in this regard vary greatly and range from a generous recognition of foreign activities to restrictions that come close to a ban.

⁷ Compare BGer 6B_85/2017 of October 16, 2017, E. 3.4.

⁸ Botschaft zur Änderung des Obligationenrechts (Aktienrecht), BBl 2017 399, S. 629; see also Directorate of Justice and Home Affairs of the Canton of Zurich, joint media release dated February 9, 2024.

⁹ Overall, see Merkblatt Statuten 2024 as well as the previous version from November 2023.

¹⁰ Previously, the competent foundation supervisory authority intervened when the actions of a foundation or its bodies were grossly inappropriate. It remains to be seen whether the foundation supervisory authority will reinterpret its role as a consequence of the new practice of the CTA ZH.

¹¹ Swiss Federal Supervisory Authority for Foundations (FSAF), Questions and Answers, <https://www.edi.admin.ch/edi/de/home/fachstellen/eid-geoessische-stiftungsaufsicht/beratung/fragen-und-antworten.html#:~:q=1586893325>, last accessed in February 2024. According to the FSAF criteria, factors to be considered include the asset situation, the ratio of remuneration to assets, expenditure and funding, the scope, time required and difficulty of the activity, as well as the qualifications of the foundation board member.

¹² FTA, Circular No. 12, p. 3.

¹³ STC, Praxishinweise, p. 17.

NEW ZÜRICH PRACTICE

In the canton of Zurich, the same standard is now applied to activities both in Switzerland and abroad. Foreign activities are therefore possible for tax-exempt institutions, regardless of their type and place, provided they are considered worthy of support from the perspective of Swiss society as a whole and the associated loss of tax revenue therefore appears justified.¹⁴

Despite the parallels with domestic activities, however, it is still required that the foreign activities "reflect positively on Switzerland or are at least perceived as worthy of promotion in Switzerland".¹⁵ The necessary transparency must also be ensured.¹⁶

OPEN QUESTIONS AND PRACTICAL IMPLICATIONS

In principle, the change represents a simplification that greatly increases the attractiveness of Zurich as a location for foundations. The previous, highly restrictive practice of the Canton of Zurich was a problem for large, internationally oriented foundations and could push them to search for an alternative to Zurich as a domicile.

However, it remains to be clarified which foreign activities the CTA ZH considers to reflect positively on Switzerland or are at least perceived as worthy of promotion in Switzerland. Initial indications point to a genuine synchronisation, meaning that the requirement is generally met if the tax exemption were granted for a corresponding activity carried out in Switzerland.

From a civil law perspective, we recommend explicitly stating in the articles of association that the foundation (also) pursues its purposes abroad, provided this is intended or possible.

ENTREPRENEURIAL FUNDING MODELS

INITIAL SITUATION

For tax-exempt institutions, the foundation assets and the associated investment income are traditionally used for traditional charitable activities. The way assets are invested is typically irrelevant for tax exemption, as the primary objective of the investment activity is the return on investment. Entrepreneurial funding models represent a shift from this, stressing the positive effect (*impact*) of the investment while the return is secondary. In this context, institutions also have the option of making *impact investments* in the form of loans, convertible loans and participations and thus generating a return depending on the performance of the investment.¹⁷

Tax exemption for charitable purposes is generally denied to an institution if it pursues a gainful activity that is of more than minor importance. According to current practice, if the institution holds a significant stake in a corporation, it must not exert any influence on that company.¹⁸

Various cantons generally treat *impact investments* as gainful activity without further differentiating and therefore - at least to date - only permit them to a strictly limited extent.¹⁹

NEW ZÜRICH PRACTICE

Zurich previously had no published practice on the treatment of *impact investments*. According to the new rules, such investments are permitted as part of the funding activities of charitable institutions under the following conditions:

- The funds must be used in an area where no market exists (yet).²⁰
- The investments must be made as part of the foundation's actual funding activities.
- The returned funds must in turn be used for the charitable purpose.²¹

OPEN QUESTIONS AND PRACTICAL IMPLICATIONS

The primary question is in relation to those investments in which there is no market yet. Particularly in the field of research and development, this is often the case in the initial phase, for example with start-up projects in the medical field that are in an early development phase. Although a later inflow of income to the foundation is possible, it is more likely at the time of investment that it will remain an *à fonds perdu* contribution. Under the newly published strict requirements, *impact investments* will likely essentially be limited to high-risk investments. This makes sense in terms of neutrality in competition, as the tax exemption of charitable institutions must not lead to a distortion of the market. It does, however, limit the investment opportunities considerably.

Ultimately, a case-by-case assessment will most likely be necessary to determine whether or not an *impact investment* is compatible with the tax exemption as part of the entrepreneurial funding activity. The burden of proof lies with the foundation. In this respect, the distinction between asset investment and funding activity remains essential, but may not always be easy. In the near future, the range of available *impact investments* as a form of asset investment is likely to grow considerably. In the context of asset investment, it should also be possible for charitable institutions to invest in low-risk *impact investments* in which profit-oriented third parties are also involved (possibly precisely thanks to the initial involvement of charitable organisations). However, according to the new rules, this alone is not considered as a charitable activity and is therefore not sufficient for tax exemption. The boundary between *impact investment* as an investment and as a funding activity is fluid. The practice regarding the compatibility of *impact investments* with a tax exemption has yet to be established. In the future, it will probably be possible under certain conditions for a foundation that invests primarily or exclusively in *impact investments* to fulfil its purpose to meet the requirements for tax exemption.

¹⁴ Overall, see Praxishinweis.

¹⁵ Praxishinweis.

¹⁶ This particularly applies to the tracking of cash flows to the actual recipient.

¹⁷ Compare OECD, Understanding Social Impact Bonds from June 1, 2016, p. 4, 9.

¹⁸ Overall, see FTA, KS No. 12, p. 4.

¹⁹ Andrea Opel, Rechtsgutachten zu den steuerlichen Rahmenbedingungen für ein wirkungsvolles Stiftungswesen im Kanton Zürich, September 2023, p. 52.

²⁰ In other words, it must be an investment that profit-oriented third parties would not make.

²¹ Praxishinweis.

As long as no guidelines are published and no established practice has been established and in view of the existing legal uncertainties, it is advisable to contact the CTA ZH in advance, at least for larger *impact investments*, in order not to jeopardise the tax exemption.

Under civil law, we recommend that the ability to make *impact investments* is explicitly stated in the articles of association, if this is desired. In addition, the compensation rules should be supplemented accordingly. Particular attention should be paid to possible conflicts of interest (e.g. between the founder or individual foundation board members and the recipients of the invested funds) in the case of *impact investments*. It therefore makes sense for the compensation rules to contain provisions which minimise the effects of potential conflicts of interest, as these can also call into question the altruism required for tax exemption.

COMMENT

The previous strict practice of the CTA ZH regarding tax exemption for charitable organizations, in particular the strict adherence to the non-compensation of foundation board members and the restrictive stance regarding activities abroad, was repeatedly criticised by academics and foundations alike and made it difficult for new foundations to set up in the Canton of Zurich. The problem was obviously recognised by the cantonal government, as was the relevance of the topic of *impact investment*. However, the change in practice came as a surprise in view of the strict application of the previous rules by the CTA ZH until the recent publication. The new, liberal stance raises several questions that need to be clarified, but overall, it is warmly welcomed. Initial reactions from the foundation sector have been generally positive and the improved environment for foundations should not go unnoticed internationally either. Further developments, including in other cantons, will be followed with great interest.

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