SWITZERLAND

Treaty Shopping and the Swiss Withholding Tax Trap

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I. INTRODUCTION

The abuse of international tax treaties or "treaty shopping" was in Switzerland for many years discussed primarily in the context of foreign taxpayers' use of Switzerland's rather favourable tax climate and its extensive international tax treaty network as a basis for their international operations. Under pressure from influential foreign governments, Switzerland introduced unilateral anti-treaty shopping rules as early as 1962. The rules of the Treaty Shopping Decree of 1962 (hereinafter: the 1962 Decree) and the Circulars issued by the Federal Tax Administration (FTA) on that Decree in 1962 and 1998/99[1] are designed to prevent the unlawful and the "unjustified" use of Swiss tax treaties by persons who are not entitled to the benefits of such treaties (i.e. who are not resident in Switzerland or in the relevant treaty partner state). The 1962 Decree and Circulars primarily address foreign-controlled Swiss base companies that are used to derive income from foreign sources which is typically exposed to foreign taxes withheld at source. Swiss base companies are often used with the objective of achieving a reduction or elimination of foreign withholding taxes on dividends, interest, royalties and similar revenues under Swiss tax treaties, whilst the Swiss base company benefits from a rather moderate income taxation in Switzerland.

On the other hand, the FTA is also rather concerned about the "abusive" utilization of Swiss tax treaties by foreign ultimate owners of Swiss companies. This must be seen against the background that any distributions of profits, retained earnings and other equity reserves by a Swiss resident corporate entity are subject to federal withholding tax, which is imposed on the gross amount of distributions at the – significant – tax rate of 35%. Foreign resident shareholders would typically seek to achieve a significant reduction or even full elimination of their exposure to Swiss withholding taxes by holding the Swiss shares indirectly through a corporate entity established in a country that maintains a favourable tax treaty with Switzerland. The "best" Swiss tax treaties for this purpose are the Swiss tax treaties with the Netherlands, Denmark, Sweden, Luxembourg, France and Austria. All these treaties provide – under certain conditions – for a 0% dividend withholding tax rate. The last three treaties mentioned were introduced or amended, from Switzerland's perspective, in order to grant Swiss resident corporate taxpayers indirect access to the tax benefits stipulated in the EC Parent-Subsidiary Directive, i.e. an exemption from source country withholding tax on dividends under certain circumstances. The FTA's precautionary measures described below are intended to prevent foreign resident persons from using in an "abusive" manner the relief from Swiss withholding taxes on dividends and certain types of interest provided under either Swiss tax treaties or Swiss domestic law.

II. THE FEDERAL WITHHOLDING TAX SYSTEM

A. In general

The Swiss withholding tax system establishes a contingent burden of 35% withholding tax on all profits and equity reserves (even those stemming from capital contributions) of Swiss corporate entities. In addition, the 35% withholding tax is imposed on certain types of debt interest paid or credited by a Swiss resident person to a Swiss or foreign resident lender, such as interest paid on "collective" debt (bonds, notes, etc.) and interest paid on Swiss bank accounts.

As a rule, the withholding tax on dividends becomes due whenever the corporation effectively makes a distribution of profits or reserves to its shareholders (or persons close to the shareholders), whether as an openly declared dividend, a constructive dividend or a liquidation distribution. Swiss law treats the company making the distribution as the tax subject and taxpayer for the withholding tax. However, the Swiss payer of the taxable distribution is not supposed to carry the financial burden of the withholding tax. Hence, the dividend payer is legally obliged to charge the burden of the tax to the dividend recipient. Naturally, this obligation is normally discharged by deducting the withholding tax from the gross distribution made to the recipient. Should the Swiss company fail to deduct and withhold the 35% tax, the amount effectively paid to the recipient is regarded as constituting a net-of-tax payment, i.e. 65% of the taxable amount. Accordingly, the withholding tax base is grossed up and the withholding tax is collected from the payer at an effective rate of almost 54% of the payment made. Essentially the same rules apply in the context of federal withholding tax on certain types of debt interest.

B. Functions of the federal withholding tax

In relation to Swiss resident recipients of taxable benefits, the federal withholding tax primarily has the function of securing the recipients' compliance with their own income tax reporting and payment obligations. Provided they duly report the underlying income in their personal tax return or in the financial statements used for income tax purposes, as the case may be, and are the effective beneficiaries of

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1. See Peter Reinarz, "Revised Swiss Anti-Treaty Shopping Rules", 53 *Bulletin for International Fiscal Documentation* 3 (1999), pp. 116-117.

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the income, they are principally entitled to a full refund (or credit against their personal income tax obligation) of the withholding tax. On the other hand, failure to report the underlying income generally results in a forfeiture of the withholding tax.

The securing function of the federal withholding tax is obviously not relevant to foreign resident beneficiaries of taxable dividends (and interest). Hence, the 35% Swiss withholding tax principally constitutes a final tax burden for foreign resident beneficiaries, unless they are entitled to a partial or full relief under an applicable Swiss tax treaty. In that sense, the federal withholding tax is meant to be a source of revenues for the federal government.

C. Obtaining relief from Swiss withholding tax

As the 35% withholding tax must generally be withheld by the debtor of a taxable benefit irrespective of whether the recipient or beneficiary is a Swiss or foreign resident for tax purposes, relief from the withholding tax is normally achieved through refund of the tax to the beneficiary under a formal refund request. Only under exceptional circumstances may relief from the federal withholding tax be obtained at source and the payment and subsequent refund of the withholding tax is replaced by a mere reporting procedure. The reporting procedure is available, for example, for dividends paid to a Swiss parent company which owns at least 20% of the shares of the dividend payer, for in-kind dividends and stock dividends paid to Swiss resident shareholders if their aggregate number does not exceed 20, and constructive dividends assessed in a tax audit if made to Swiss resident beneficiaries.

An important condition precedent for any Swiss withholding tax relief is that the applicant for such relief must be the effective beneficiary (*Nutzungsberechtigter*) of the taxable benefit. The FTA puts considerable emphasis on this effective beneficiary requirement not only in the domestic context, but also in connection with international withholding tax refund requests received under Swiss tax treaties (see below). Any refund or credit of the withholding tax requires a formal request to be filed by or on behalf of the beneficiary within certain time limits.

D. Anti-abuse rule

Even if all other conditions for a relief or refund of the Swiss federal withholding tax are met, the FTA may still deny such refund or tax relief on the basis of the express anti-abuse rule in Article 21(2) of The Withholding Tax Act (WTA). This rule provides that no refund (or credit) of the withholding tax shall be granted in any case where such relief would result in tax avoidance. As a rule, the "tax avoidance" notion is construed in line with the long-standing practice of the Federal Supreme Court. The Supreme Court's definition of "tax avoidance" includes three cumulative elements:

- the legal form chosen by the taxpayer is unusual or inadequate to achieve the purported goal and contrary to ordinary business practice;
- the taxpayer's primary motive for adopting such legal form is to achieve substantial tax savings; and
- the taxpayer would, in fact, realize considerable tax savings if the legal form chosen were accepted by the tax authorities.

Typical tax avoidance schemes in the context of Swiss withholding tax refunds include, for example:

- foreign resident shareholders of a Swiss corporate entity, which has retained substantial profits in liquid form, sell their shares to another Swiss company, which they have capitalized with nominal share capital and/or shareholder loans. The first company would then distribute its cash reserves to the second company, which receives this payment free of tax and forwards the payment to the foreign shareholders as a tax-free return of equity and debt capital; or
- foreign resident shareholders of a Swiss company, which has retained substantial earnings in liquid form, sell their shares to an independent Swiss corporate entity (e.g. a Swiss bank), which would subsequently proceed to the liquidation of the first-mentioned company. The new Swiss parent would seek full withholding tax relief and could effectively benefit from a corporate income tax exemption in respect of the liquidation surplus received or the gain realized on the liquidation.

III. THE "OLD RESERVES" APPROACH

The "old reserves" approach, as described below, is frequently applied by the FTA in the context of transfers of Swiss corporate shares between international parties. Whilst the "old reserves" doctrine has no express basis in the Swiss tax statutes, it was developed by the FTA as a practical application of the anti-avoidance provision of Article 21(2) WTA. The objective pursued by the FTA with the "old reserves" approach is to maintain the contingent Swiss withholding tax burden on the retained earnings and reserves of a Swiss company, which exist on the day the shares of such a company are transferred by foreign shareholders to one or more foreign resident transferees who, in comparison with the previous shareholders, would be entitled to a more substantial relief from Swiss dividend withholding tax according to the provisions of a Swiss tax treaty applicable to them.

The FTA applies the "old reserves" approach primarily in the context of transfers of holdings in Swiss shares within an international group of companies. In addition, the FTA is taking the view that "old reserves" should under certain circumstances even be applied to transfers of Swiss shares between independent foreign parties. Such may especially be the case when the purchaser, shortly after the acquisition, causes the Swiss company to either pay a substantial dividend out of its cash reserves, or to grant an up-stream loan to the purchaser, who uses the cash so received to refinance the purchase price. The FTA considers such transactions to be unusual and primarily driven by the objective of passing over the Swiss target's cash reserves to the foreign seller, legally in the form of share sale proceeds.[2] Furthermore, the FTA tends to apply "old

2. Recent experience has shown, however, that this abuse approach should not be applicable to a sale of shares of a listed Swiss company with a broad pub-

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reserves" where the sale of Swiss shares is subject to a repurchase option. Finally, the FTA applies "old reserves" when it finds that the Swiss shares are transferred in view of a subsequent liquidation of the Swiss company by the buyer.[3]

When the FTA in the context of a transfer of shares in a Swiss company finds that the "old reserves" approach is applicable, it will deny the acquirer of the shares any refunds of Swiss withholding taxes, which become due upon distributions of "old reserves" by the Swiss company to the acquirer, to the extent that the previous shareholder(s) would not have been entitled to such tax refunds. In other words, the equity reserves of the Swiss company existing as of the date of the share transfer remain subject to the previous, higher withholding tax exposure which applied to the previous shareholder, irrespective of the new shareholder's general entitlement to a reduced rate of Swiss withholding tax under the Swiss tax treaty applicable to him. The FTA will allow the withholding tax relief according to the tax treaty applicable to the new shareholder only in respect of profits earned by the Swiss company after the acquisition of its shares by the new shareholder. For these purposes, the FTA applies a "first-in-first-out" approach. Accordingly, the Swiss company is deemed to first distribute all "old reserves" before it can distribute any "new profits" that are not subject to the "old reserves" restriction.

The application of the "old reserves" approach obviously requires a determination of the undistributed earnings and reserves of the Swiss target company as of the date of the share transfer. Generally, the relevant "old reserves" are limited to the open reserves and retained earnings; silent reserves are normally not taken into account. However, experience has shown that the FTA would under particular circumstances even include certain silent reserves in the computation of the relevant "old reserves". Such may be the case, for example, where such silent reserves exist in the book valuation of Swiss or foreign subsidiaries, which in turn hold significant cash reserves. According to a recent (unofficial) clarification,[4] the relevant "old reserves" should be understood to be limited to those earnings and reserves that could be distributed without legal restrictions. Hence, any reserves the distribution of which is subject to restrictions under e.g. banking or insurance regulations are excluded.[5] Moreover, future bona fide losses that subsequently reduce the "old reserves" can be deducted.

The tax effect of the "old reserves" approach materializes only when the Swiss target company makes taxable distributions to its new shareholders. Such distributions trigger the 35% withholding tax liability. The new shareholder who seeks a partial or full refund of the tax withheld at source will be confronted with a refusal of the withholding tax refund. The entire amount of the relevant "old reserves" remains subject to the full 35% withholding tax exposure and no refund whatsoever is granted to the purchaser regardless of any tax treaty entitlement if the previous shareholder was not entitled to any Swiss withholding tax refunds. If the previous shareholder already had a partial refund entitlement and the new shareholder would have an improved refund entitlement under tax treaty applicable to it, the "old reserves" amount may be multiplied with the differential treaty withholding tax rate to determine the aggregate amount of future withholding tax refund denial (alternatively, the previous treaty-based refund rate could be applied until all "old reserves" have been distributed). Under both alternatives, the aggregate amount of "trapped withholding tax" must remain subject to adjustment for subsequent bona fide losses which reduce the "old reserves".

Example

The seller of SwissCo shares was entitled to a 15% treaty withholding tax rate on dividends. The buyer would be entitled to a 5% withholding tax rate under the relevant tax treaty. The FTA determines "old reserves" in the amount of 100.

Solution 1:

The next distributions in the aggregate amount of 100 remain subject to a 15% non-refundable Swiss withholding tax, regardless of the buyer's better entitlement under the relevant tax treaty. Thereafter, the rate of non-refundable withholding tax drops to 5%.

Solution 2:

The old reserves of 100 are multiplied with the differential withholding tax rate (10%), resulting in a "trapped withholding tax" total of 10. Any distributions after the share sale are taxed at the full 35% statutory rate until the "trapped withholding tax" of 10 has been absorbed (this corresponds to aggregate distributions of approximately 28.6).

Tax practitioners have widely criticized the "old reserves" approach for its questionable legal basis in the tax treaty context. However, the FTA feels that all Swiss tax treaties are subject to at least an implied reservation, according to which the contracting states of a tax treaty are not limited by the tax treaty in their capability of adopting suitable measures in their national laws designed to prevent abuses of the tax treaty.

Thus far, the FTA's "old reserves" approach was confirmed by one decision of the Federal Supreme Court in 1996. The decision was rendered under the previous Switzerland–US income tax treaty of 1951. That treaty contained an express treaty-shopping provision as part of the dividend article, to which the Supreme Court decision

lic shareholder base under a public takeover offer launched by an bidder residing a favourable treaty jurisdiction.

3. If by the date of the transfer the Swiss company has already been "economically liquidated", the share transfer itself is treated as a constructive liquidation followed by a re-incorporation of a new company. This triggers an immediate 35% withholding tax on all open and silent reserves and a 1% capital stamp duty on the net stockholders' equity at fair market values.

4. See Anita Burri, "Rückerstattung der Verrechnungssteuer bei internationalen Umstrukturierungen", IFF Forum für Steuerrecht, 3/2001, pp. 204–209. Mrs. Burri is currently the FTA functionnaire primarily in charge of Swiss tax treaty abuse matters.

5. In the author's view, the exclusion from "old reserves" of "restricted" reserves should not be limited to those reserves that cannot be distributed under banking or insurance regulations, but should also include any earnings and reserves which the Swiss company cannot freely distribute to the shareholders under general corporate law, such as the "legal reserves" under Art. 671 of the Code of Obligations and paid-in surplus (agio). The FTA still appears to be hesitant to release such legal reserves and agio from the "old reserves" tax exposure, even though there are rumours about upcoming legislative proposals which would abolish the withholding tax on distributions of contributed surplus.

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referred. The Supreme Court did not base its decision on the tax avoidance clause of Article 21(2) WTA. The Court held that, even though the factual circumstances did not suggest a tax avoidance scheme, they met the criteria of treaty shopping.

The case involved a US grandparent company, which was controlled by a group of US resident individuals. The grandparent company held a Swiss company with substantial cash reserves indirectly through two wholly owned US subsidiaries. The US subsidiaries directly held 60% and 40% of the share capital of the Swiss company.

In a first stage, the FTA had rejected the requests filed on behalf of the US companies for an application of the 5% dividend withholding tax rate, which applied under the treaty to US corporate shareholders controlling directly or indirectly at least 95% of the voting rights of a Swiss company. The FTA held (and was supported by the Supreme Court) that none of the three US entities was a shareholder with a direct or indirect control of 95% of the voting stock of the Swiss company.

In reaction to this negative response, the US grandparent caused its two US subsidiaries to transfer all of their interests in the Swiss company to the US grandparent. The grandparent then filed a new request for a reduction of the Swiss withholding tax to the treaty rate of 5% in respect of the next Swiss dividend, which was paid to the US grandparent (now the direct 100% parent).

The FTA again rejected the request with regard to the Swiss company's old reserves existing on the date of the share transfer. The Supreme Court confirmed the FTA's view that, at least in respect of the "old reserves", the transfer by each of the two US subsidiaries of their respective interests in the Swiss company to the US grandparent company was principally motivated by the desire to secure the favourable 5% treaty withholding tax rate instead of the 15% rate that would have applied under the treaty to each of the two US subsidiaries. Accordingly, the grandparent's request was rejected in respect of the "old reserves" based on the tax treaty-integrated treaty shopping clause. The FTA was apparently prepared to apply the more favourable 5% treaty withholding tax rate to distributions of profits generated after the transfer of the Swiss shares to the US grandparent.

The FTA generally takes the view that it is entitled to apply the "old reserves" approach based on Article 21(2) WTA even in the absence of an express anti-abuse rule in the relevant tax treaty, at least to the extent that the refusal to refund the withholding tax effectively prevents an abuse of the tax treaty. The lower federal tax court (hereinafter: Tax Appeals Commission) recently upheld the FTA's view in an (as yet unpublished) decision, which it rendered on 28 February 2001 in the context of the Luxembourg-Switzerland tax treaty of 1993 (see VI.).

IV. ANTI-ABUSE APPROACH IN CONNECTION WITH "INBOUND RESTRUCTURINGS"

As a further argument for the "old reserves" approach in the tax treaty context, the FTA uses its tax avoidance practice under Article 21(2) WTA in connection with internal transfers within the group of Swiss subsidiaries by a foreign parent to a Swiss incorporated subsidiary. The approach adopted by the FTA in those situations is quite similar to the "old reserves" approach applied in the tax treaty context. The FTA usually denies the Swiss transferee the refund of the withholding tax on any distributions up to the amount of undistributed reserves of the Swiss target company, to the extent that the foreign transferor was not entitled to such tax refunds.

In the domestic context, the FTA strictly applies the "nominal value principle", i.e. it will impose a non-refundable withholding tax on all equity except for the nominal share capital. Moreover, withholding tax refunds to the Swiss buyer may be denied under Article 21(2) WTA if the Swiss buyer purchases from a foreign seller a Swiss company with significant retained earnings, which are invested in cash or other non-operating assets. Finally, Article 21(2) WTA is also applied if a Swiss company is sold by a foreign resident shareholder to a Swiss company for a subsequent liquidation of the target company.

V. "ABUSIVE" SHAREHOLDING STRUCTURES (TREATY SHOPPING)

Under certain circumstances of fact, the FTA may consider the shareholding structure of a Swiss company to be "abusive" as such and it will consequently deny any Swiss tax treaty-based relief from Swiss withholding tax to the foreign resident shareholders. Generally, the FTA presumes a Swiss tax treaty abuse when the shareholding structure exclusively or primarily serves the purpose of optimizing the Swiss withholding tax relief.

As mentioned above, there are currently six Swiss tax treaties which under certain conditions provide for a 0% withholding tax rate on dividends – which for Switzerland means a full relief, normally through refund, of the Swiss withholding tax. The older Swiss tax treaties including that feature are those with the Netherlands, Denmark and Sweden; more recently, the 0% withholding tax for certain intercompany dividends was provided for in the Swiss tax treaty with Luxembourg as well as in the revised tax treaties with France and Austria.

Some – but not all – of those treaties include specific rules addressing the "treaty shopping" issue. Different types of tax treaty provisions may be distinguished in that respect.

A. Exclusion of persons or entities with a privileged tax status from treaty benefits

Article 28 of the Luxembourg–Switzerland tax treaty of 21 January 1993 excludes certain holding companies in Luxembourg that are governed by special Luxembourg legislation providing for substantial income tax exemptions (Luxembourg Law of 31 July 1929 and Grand Duchy Order of 17 December 1938) and companies subject to a similar tax regime in Luxembourg from the scope of application of the tax treaty.

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Article XIV (2) of the France–Switzerland tax treaty excludes certain resident Swiss bodies corporate, in which persons who are not residents of Switzerland have a direct or indirect controlling interest as shareholders or otherwise, from French withholding tax relief otherwise available in respect of interest and royalties, if the Swiss company is not subject to the same or a similar tax regime in the Swiss canton in which it has its head office as for the purposes of Swiss federal direct taxes. Similar rules apply under some other Swiss tax treaties (Germany, Italy, etc.). These are, however, "one-way" rules that apply to Swiss companies only, not to companies residing in the relevant tax treaty partner state.

B. Reservation of tax treaty-based withholding tax relief to beneficial owners

More recent Swiss tax treaties (such as the Swiss tax treaties with Luxembourg, Sweden and France) expressly reserve the treaty-based relief from withholding taxes to those recipients of underlying income from capital who are the beneficial owners of such income. However, Swiss legal scholars and practitioners generally consider the "beneficial ownership" of the income to be an implicit condition precedent for treaty benefits under all tax treaties, which does not require any explicit mention in the treaty text.[6]

C. "Limitation on benefits" clauses

The revised Switzerland–US income tax treaty of 3 October 1996 contains a very detailed "limitation on benefits" clause in Article 22, which is similar to comparable clauses included in other recent tax treaties of the United States, such as the US income tax treaties with the Netherlands, Luxembourg and Ireland. The "limitation on benefits" clause imposes significant restrictions on the applicability of the tax treaty to companies residing in one of the two contracting states. Essentially, in order to be eligible for treaty benefits, a company must meet the conditions of at least one out of four different tests, which are generally referred to as the stock exchange test, the predominant interest (or shareholder) test, the headquarters company test and the activity test.[7]

D. Specific "treaty shopping" reservations

The tax treaty between Switzerland and the Netherlands of 12 November 1951 provides in Article 9(2)(a)(i) that taxes withheld by either of the contracting states on dividends by a company in one contracting state to a parent company in the other contracting state are refundable in full if the parent company owns at least 25% of the authorized capital of the company paying the dividends, provided, however, "that the relationship between the two companies was not established, or is not maintained, primarily in order to obtain the benefit of such total reimbursement". A similar reservation was included in the dividend article of the previous Switzerland–US income tax treaty of 1951, which generally provided for a 5% withholding tax rate on dividends paid by a company to a corporate shareholder that directly or indirectly controlled at least 95% of the voting stock of the subsidiary (subject to a "passive income" limitation at the level of the subsidiary).

The Switzerland–France tax treaty contains a treaty shopping reservation in the "resident" definition clause of Article 4. Paragraph 6(a) of Article 4 of the Switzerland–France tax treaty provides that any person who would otherwise meet the "resident" criteria of the treaty shall not be deemed to be resident of one of the contracting states, if it is only the "apparent recipient" of the income, "such income in fact accruing – directly, or indirectly through other individuals or bodies corporate – to a person who cannot himself be considered a resident of the said State within the meaning of this article". Moreover, the Switzerland–France tax treaty, as amended by the protocol of 22 July 1997, provides in the dividend article for an alternative stock exchange test and shareholder test. The dividend article generally allows for a 0% withholding tax rate on dividends paid by a company that is a resident of a contracting state to another company that is a resident of the other contracting state, which is the beneficial owner of the dividends and which owns directly or indirectly at least 10% of the capital of the company paying the dividend (Article XI(2)(b)(i) France–Switzerland tax treaty). However, subparagraph (ii) of that provision stipulates that the 0% withholding tax rate provided under subparagraph(i)

> shall not apply if the beneficial owner of the dividends is a company which is a resident of a Contracting State in which one or more persons who are not residents of that State or of a Member State of the European Union, and has a direct or indirect majority interest in the form of an equity holding or in any other form, and if neither the company paying the dividends nor the company receiving them has its capital represented by listed shares on a regulated stock exchange.

Finally, the Swiss tax treaties with France, Germany, Italy and Belgium include treaty shopping clauses which are essentially modelled along the lines of the Swiss 1962 Decree. These clauses address corporate bodies residing in one of the contracting states, in which persons who are not residents of that state either have a direct or indirect controlling interest as shareholders or otherwise may not obtain relief in respect of withholding tax levied by the other contracting state on dividends, interest and royalties. Such corporate bodies must pass a number of cumulative tests in order to be eligible for withholding tax relief under the relevant treaties. These tests typically include:

- a thin capitalization rule, according to which interest-bearing debt obtained from non-residents may not exceed six times the total equity;
- an interest rate limitation with respect to debt obtained from non-residents;
- a base erosion limitation, according to which not more than 50% of the income for which withholding tax relief is sought may be used to meet obligations to non-residents (interest owed, license fees, all kinds of

6. See Xavier Oberson and Howard Hull, *Switzerland in International Tax Law*, (Amsterdam: IBFD, 1996), p. 101.
7. For a more detailed description of the "limitation on benefits" clause of Art. 22 of the Switzerland-US income tax treaty, see Peter Reinarz, "Swiss/US pact sets strict limitation on benefits", *International Tax Report*, December 1996, pp. 1-6.

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expenses, amortization of assets acquired from non-residents, etc.); and
- a minimum profit distribution requirement (at least 25% of the annual receipts for which withholding tax relief is sought).

While the focus of those provisions was mainly on Swiss resident companies when the treaties were negotiated, they principally work in both directions and may consequently be applied to foreign parent companies of Swiss subsidiaries as well.

VI. THE TAX COURT DECISION ON THE INTERPRETATION OF THE LUXEMBOURG–SWITZERLAND TAX TREATY

A. In general

The Swiss Federal Tax Appeals Commission recently had the opportunity to deal with abuse issues under the dividends provision (Article 10) of the Luxembourg–Switzerland tax treaty. Given that this treaty does not include any express anti-abuse rule, the Tax Appeals Commission analysed the treaty shopping issue under the aspect of the "beneficial ownership" requirement.[8]

B. The facts

The case involved a holding company incorporated in Luxembourg (LuxCo), which was subject to an ordinary corporate tax regime in Luxembourg and qualified as a Luxembourg resident entity, entitled to treaty benefits generally. LuxCo had been incorporated by two UK resident companies in early 1995 with a rather small share capital. LuxCo then purchased all shares of a Swiss company (SwissCo) from a US resident individual for approximately CHF 2 million; the aggregate nominal value of the SwissCo shares amounted to CHF 50,000. More than 96% of the purchase price was financed by a loan from the principal shareholder of LuxCo. The investment in SwissCo substantially represented the only asset of LuxCo.

LuxCo caused SwissCo to distribute a first dividend in 1996, which was followed by a second dividend in 1997. SwissCo had to withhold Swiss withholding tax at the statutory tax rate of 35% from the dividends. LuxCo subsequently filed requests to the FTA for full Swiss withholding tax refund, based on the tax treaty. The request in respect of the first dividend was subsequently be reduced by LuxCo to 30% of the gross dividend, reflecting the 5% residual withholding tax rate which applies under the tax treaty during the first two years of shareholding. The FTA sent LuxCo a questionnaire requesting various information from LuxCo, such as:
- a copy of the articles of association;
- an extract of the commercial register in Luxembourg;
- names and addresses of the shareholders of LuxCo and, if SwissCo and LuxCo formed part of an international group, a detailed group chart disclosing the ultimate shareholders;
- the number and functions of people directly employed by LuxCo;
- whether LuxCo maintained its own offices, premises or installations in Luxembourg;
- the balance sheet and profit and loss accounts of LuxCo for the last three fiscal years;
- information on the financing of SwissCo by LuxCo;
- the share purchase agreement concerning the SwissCo shares and, if applicable, disclosure of the persons for whose account the shares were sold and purchased;
- information whether any option agreements existed in connection with the acquisition of the Swiss investment; and
- indication of the business reasons driving the acquisition of the Swiss shares.

In a first stage, LuxCo only provided a copy of its articles, an extract of the company and trade register in Luxembourg and a residence certificate of the Luxembourg tax authorities. For the rest, LuxCo refused to provide any further information and contested the FTA's right to ask for such information. After some exchange of correspondence, LuxCo submitted its memorandum of incorporation, the financial statements at 31 December 1995 and a copy of its Luxembourg tax return for 1995. The FTA finally rejected LuxCo's withholding tax refund requests in full and LuxCo appealed against the FTA's decision.

C. Considerations of the Tax Appeals Commission

Concerning the FTA's right to ask the applicant to submit documents and information supporting its entitlement to tax treaty benefits, the Tax Appeals Commission held that the exchange of information clause of Article 26 of the tax treaty does not deprive the FTA of its right to ask information directly from the foreign applicant. The Tax Appeals Commission referred to the procedural rules of Swiss withholding tax legislation (Article 48(1)WTA) according to which the applicant for a withholding tax refund must provide the competent authority all information in his possession which may have importance for determining the applicant's entitlement to the tax refund. The Tax Appeals Commission held that the specific information asked by the FTA was designed to determine the identity of the beneficial owner (*bénéficiaire effectif*) of the dividends paid by SwissCo. This information was immediately relevant for establishing the amount of withholding tax that could be refunded.

The Tax Appeals Commission then summarized the conditions imposed under Article 10(2)(b) of the Luxembourg–Switzerland tax treaty for a zero withholding tax rate on dividends:
- the beneficiary must be a company that is a resident of Luxembourg;
- the beneficiary must hold directly, for an uninterrupted period of two years preceding the dividend payment date, at least 25% of the Swiss company paying the dividend; and
- the dividend paid relates to the shares held by the beneficiary for the uninterrupted two-year period.

8. Decision of 28 February 2001 concerning the refund of Swiss withholding tax under Art. 10 of the Luxembourg-Switzerland tax treaty. The decision became final as no appeal to the Federal Supreme Court was filed against it.

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The Tax Appeals Commission found that the first dividend fell into the initial two-year period and would thus not be eligible for the full withholding tax relief anyhow; at least a 5% withholding tax would eventually be applicable under the tax treaty if the further conditions for relief were met.

The Tax Appeals Commission then analysed the notion *bénéficiaire* used in the Luxembourg–Switzerland tax treaty. The Tax Appeals Commission referred to Article 31(1) of the Vienna Convention of 23 May 1969 on the law of treaties, according to which a treaty must be construed in good faith according to the usual meaning to be given in the light of the provisions of the treaty in their context, their subject and their objective. The Tax Appeals Commission found this principle to be applicable to the interpretation of tax treaties.

The Tax Appeals Commission held that the ordinary meaning of the notion *bénéficiaire* is the person that in fact has the benefit of an advantage, a performance, etc. The notion *bénéficiaire* means the person who can in reality receive the benefit of a performance, as opposed to the person which just offers to receive the benefit and to transfer it to a third person. Accordingly, the beneficiary of a dividend does not necessarily have to be the formal shareholder, but can be someone else. A company which transfers dividends received to a third person without effectively being in a position to dispose of the benefit would not be considered to be a *bénéficiaire*. Thus, the notion *bénéficiaire* has the same meaning as the notion *bénéficiaire effectif* or beneficial owner/true beneficiary, which describes the person that economically has the benefit of an item of income, as opposed to a "conduit" company which is placed as an intermediary between the payer of the income and the ultimate recipient.

The Tax Appeals Commission further referred to Swiss legal prevailing opinion which considers the beneficial owner requirement to be an implied condition of the tax treaties, which does not require any express stipulation in the treaty text. Hence, it is the beneficial owner only who may be entitled to a refund of tax withheld at source.

The Tax Appeals Commission argued that the applicant (LuxCo) had refused to provide any information as to the application of the dividend received in 1996. Hence, the FTA could not determine whether LuxCo kept the dividend for itself or rather transferred it to a third party. Amazingly, LuxCo had also answered the question about its beneficial ownership negatively. Moreover, it was obvious from LuxCo's 1995 profit and loss account that all revenues received were used for payments of interest and other charges, which were not further specified, such that there was no net profit. Based on these findings of fact, the Tax Appeals Commission concluded that LuxCo was a mere "conduit" which could not be considered to be the effective beneficiary (*bénéficiaire*) of the dividends paid by SwissCo.

The Tax Appeals Commission made a further reference to Article 31 of the Vienna Convention, according to which the interpretation of international treaties must take into account the subject and the objective of the treaty. The Tax Appeals Commission confirmed that the primary objective of the Swiss tax treaties is to avoid international double taxation. However, the tax treaties are only designed to eliminate double taxation affecting residents of the two contracting states. The purpose of these conventions is not to provide the treaty benefits to persons who are not themselves resident in one of the contracting states and who seek to avail themselves treaty benefits through interposition of sham companies ("treaty shopping"). To support this finding, the Tax Appeals Commission referred to the Swiss Supreme Court decision 94 I 665 et seq., ground 4, according to which the utilization of a tax treaty constitutes an abuse when the advantages of a tax treaty effectively benefit residents of third countries. Accordingly, Switzerland may unilaterally adopt anti-abuse measures designed to prevent residents of third countries from taking benefits of Swiss tax treaties to which they are not entitled. It should be mentioned that the latter Supreme Court decision dealt with the legality of the 1962 Decree.

In fact, the Tax Appeals Commission concluded that the identity of the beneficial owner of LuxCo was unknown; it felt, however, that there was clear indication that the beneficial owner of LuxCo was not a resident of Luxembourg. LuxCo had not contributed anything indicating the contrary. The Tax Appeals Commission further ascertained that LuxCo's unspecified expenses exactly matched the dividends received from SwissCo. Accordingly, it was obvious that the dividends derived from SwissCo. would flow through LuxCo with no tax burden attached, while the identity of the true beneficiary was unknown.

In a further consideration, the Tax Appeals Commission held that the interpretation of a tax treaty provision must also have due regard to its context. The context of the zero withholding tax rate stipulated in Article 10(2)(b) of the Luxembourg–Switzerland tax treaty was the intention to allow Switzerland, in its relationships with Luxembourg, to share the benefit of the tax advantages of the EC Parent-Subsidiary Directive. The Tax Appeals Commission referred to Article 1(2) of the Parent-Subsidiary Directive, according to which the provisions of national or treaty law addressing the prevention and combat of fraud and abuse are reserved. The Tax Appeals Commission found that the Parent-Subsidiary Directive does not prevent EU Member States from introducing and maintaining anti-avoidance rules in their national legislation. The Tax Appeals Commission concluded that the interpretation of Article 10(2)(b) of the Luxembourg–Switzerland tax treaty in view of the link with the Parent-Subsidiary Directive allows Switzerland to maintain and apply its domestic rules addressing the prevention of abuse in connection with the application of tax treaties. Such measures are designed to ensure that the reduction of taxes provided under tax treaties is not claimed in an abusive manner. The abuse question must be examined individually in the light of all circumstances of fact.

The Tax Appeals Commission additionally based its decision on the aforementioned Article 21(2) WTA, which excludes any withholding tax refunds where such a refund would effectively allow "tax avoidance" (see II.D.). The Tax Appeals Commission found that the tax avoidance criteria were met in the case at hand. LuxCo had been formed by two UK companies, one of which was established on

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the Isle of Man. LuxCo immediately acquired the Swiss shares, which substantially constituted the only asset. There was no indication whatsoever in the file for a bona fide business purpose of establishing a company in Luxembourg. Hence, the Luxembourg construction was considered to be unusual and inappropriate. Any motivation other than the intention to save the Swiss withholding tax could not be determined. Finally, it was obvious that the 35% Swiss withholding tax would have been saved if the Luxembourg structure had been accepted, especially in view of the fact that LuxCo reported no net profit, which meant that the Swiss-source dividend could pass through LuxCo without attracting any further tax (corporate income tax or Luxembourg withholding tax).

Effectively, the Tax Appeals Commission used the tax avoidance under Article 21(2) WTA as a supporting argument for the denial of LuxCo's quality of a *bénéficiaire* within the meaning of the tax treaty. The interpretation of the tax treaty provision in the light of the general meaning as well as the objective and the context did not allow the Tax Appeals Commission to consider LuxCo a *bénéficiaire* of the dividends received from SwissCo. Accordingly, no refund whatsoever of Swiss withholding tax could be granted to LuxCo. The Tax Appeals Commission specifically rejected the suggestion that LuxCo might still be eligible for the "second-best" treaty rate of 15%, if it did not pass the beneficiary test as it has to be considered as a conduit company; notwithstanding the contrary practice of the FTA which sometimes allows the application of the second-best treaty withholding tax rate under the Netherlands–Switzerland tax treaty to those Netherlands resident companies which do not qualify for the zero withholding tax rate under the express anti-avoidance reservation contained in Article 9(2) of the Netherlands–Switzerland tax treaty.

VII. CONCLUSION

Since the Luxembourg–Switzerland tax treaty came into force in 1995, there has been an ongoing discussion in Switzerland whether the FTA could apply the same anti-abuse criteria it had developed, with the approval of the Federal Supreme Court, under the Netherlands–Switzerland tax treaty. The Netherlands treaty – contrary to the Luxembourg treaty – contains an express anti-abuse rule in the dividend article, designed to prevent abuses of the zero withholding tax rate on dividends received from a 25% or more corporate participation. The decision of the Tax Appeals Commission has brought some clarity in that respect.

The decision of the Tax Appeals Commission has confirmed the FTA's view that the rules of a tax treaty generally do not prevent the Swiss tax authorities from applying anti-abuse rules developed under national tax laws and practices, so long as the application of such domestic rules is in line with a tax treaty interpretation in accordance with the general meaning, the objective and the context of the relevant treaty provisions.

The Tax Appeals Commission found that the context of the EC Parent-Subsidiary Directive supported the reservation by the EU Member States and by Switzerland on the application of anti-abuse provisions and measures under national laws and practices to ensure that the benefits of the Directive and the relevant tax treaty are not extended to persons who are effectively not entitled to such tax benefits.

The Tax Appeals Commission used the example of the Luxembourg-Switzerland tax treaty to confirm the FTA's general approach to test the treaty shopping issues arising under those Swiss tax treaties which do not include any express anti-avoidance rules by interpreting the "beneficial ownership" requirement – which may be either an explicit or an implicit condition for tax treaty benefits in accordance with the general meaning, the purpose and the context of the relevant tax treaty provisions. The Tax Appeals Commission effectively relied on Swiss domestic anti-abuse rules (tax avoidance concept) as an indicating factor for determining whether the foreign applicant for Swiss withholding tax refunds was to be recognized as being the beneficial owner of the income in question under the applicable tax treaty. The domestic anti-abuse rules essentially adopt a substance-over-form approach.

There remains the question of the effect which the described decision will have on the application of comparable Swiss tax treaties in the future. Whilst it became clear that the absence of express treaty shopping provisions in the tax treaty does not prevent the Swiss tax authorities from raising and examining the treaty shopping issue and eventually denying treaty benefits, the facts of the case decided by the Tax Appeals Commission do not allow any far-reaching conclusions beyond the general and quite unspectacular observation that artificial shareholding structures which lack sufficient economic substance carry the immanent risk of failure of achieving their purported tax objectives.

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