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Swiss Courts Rule on Triangular Personal Tax Residence Case

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With a judgment rendered on 27 November 2020 (case no. 2C_835/2017), the Swiss Federal Supreme Court ("FSC") confirmed a decision by the Federal Administrative Court ("FAC") of 24 August 2017 (decision no. A-1462/2016) concerning an individual tax residence matter that arose in the context of certain dividend withholding tax (WHT) refund requests, which had been raised by the appellant (Mr. A, a US citizen) pursuant to the USA-Switzerland income tax treaty of 1996 (the "US Treaty") with regards to Swiss dividends he had derived in the calendar years 2008-2010. Both Swiss court instances confirmed the decision of the Federal Tax Administration (FTA) to reject the refund request and to claw back a WHT refund that it had already granted to Mr. A on a summary basis, as they concluded in fact that Mr. A failed to meet the tax residence criteria as defined under art. 4 (1)(a) of the US Treaty. The FTA had at some point suggested that Mr. A. should rather seek a partial WHT refund pursuant to the double taxation treaty between Switzerland and the UK (the "UK Treaty"). However, Mr. A maintained that he held a "resident non-domiciled" tax status in the UK, which would effectively preclude him from benefits under the UK Treaty, as he did not remit the dividends in question to the UK and consequently did not owe any UK taxes thereon.

Facts of the Case

During the relevant periods Mr. A apparently lived in the UK, where he was treated as a UK "resident bot not domiciled" taxpayer. Mr. A held shares in several Swiss companies, from which he received substantial dividends, namely an aggregate amount of CHF 22.75 million in 2008 and 2009 and an amount of CHF 5,872,459 in 2010, all amounts before deduction of 35% WHT. Mr. A filed partial WHT refund requests with the FTA by using the Forms 82I, which is foreseen for Swiss WHT reclaims made by individuals pursuant to art. 10 of the US Treaty. The reclaimed amounts corresponded to 20% of the gross dividends received. The FTA first satisfied the WHT reclaims for 2008 and 2009 for an aggregate amount of CHF 4.55 million on a summary basis, even though it had already noted that Mr. A had indicated a residential address in the UK. After receipt of Mr. A's WHT refund request for 2010, the FTA explored further and suggested that Mr. A make a reclaim under the UK Treaty instead. Upon Mr. A's explanation that he could not utilize the UK treaty as he was taxed in the UK merely on a remittance basis, and after Mr. A had filed for a further partial WHT refund for the year 2012, this time indicating a residential address in the USA, the FTA finally rejected the open WHT requests and ordered Mr. A to return the already received WHT refund of CHF 4.55 million with 5% interest per annum. The FTA had concluded that Mr. A did not qualify as a US tax resident in the meaning of art. 4 (1) (a) US Treaty.

Under said provision, any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, nationality, [….] is considered a resident of that State. However, the second sentence of subparagraph (a) provides for a special rule pertaining to *non-Swiss resident US citizens and non-US national green card holders in the United States*: Such persons are considered resident in the United States only "… *if such person has a substantial presence, permanent home or habitual abode in the United States*". Mr. A. had maintained that he had at least a permanent home available to him in the United States, if not also a substantial presence, facts which the FTA had denied, however.

Relevant considerations of the FAC

The key considerations of the FAC focused on whether Mr. A – as a US citizen not resident in Switzerland – met any of the three criteria mentioned in the second sentence of subparagraph a of art 4 (1) US Treaty: having either (i) a substantial presence, (ii) a permanent home, or (iii) habitual abode in the United States. The FAC considered that the notion "substantial presence" derived from US law and referred to the Technical Explanation of the US Treaty by the US Treasury Department and § 7701(b)(3) of the U.S. Internal Revenue Code. On the other hand, the notions of permanent home and habitual abode are not used by US domestic law; hence in the FAC's opinion, they should be construed in an autonomous manner. Those two notions re-appear in the tie breaker provision of art. 4 (3) (a) and (c) US Treaty, which is modeled along the OECD Model Tax Treaty.

Remarkably, the FAC considered that the second sentence of art. 4 (1) (a) US Treaty means in fact that a US citizen or green card holder (thereby automatically a US resident for US income tax purposes) who is not also a Swiss tax resident must prove *particular ties* to the United States in order to qualify as a US resident for purposes of the US Treaty. The FAC went even as far as questioning whether the criteria of substantial presence, permanent home or habitual abode are really to be construed as strictly alternative criteria, as the literal wording of the provision (expressed by the word "or") would suggest. The FAC considered that in light of the tie breaker rule of art. 4 (3) US Treaty that uses similar criteria as well, it is important to stress that art. 4 (1) (a), 2nd sentence in any case requires a strong personal nexus with the United States of such category of US taxpayers in order to qualify as US resident under the US Treaty. The FAC in that sense rejected a merely literal interpretation of that treaty provision solely based on the word "or". In the FAC's opinion, such a literal interpretation would deprive the criterion of "substantial presence" of any meaning; the FAC feels that it was not the intention of the Contracting States to grant access to the tax treaty benefits just to any persons with only minimal ties to a Contracting State. It appears that the FAC gives the notion of permanent home in art. 4 (1) (a), 2nd sentence the meaning of a mere tie-breaker, which becomes relevant only where the taxpayer is treated as a resident under the domestic laws of two states, namely the United States and a third country (in the case at hand, the UK). In the case at hand, as Mr. A did not meet the substantial presence test of US income tax law, nor did he have habitual abode in the United States, the FAC concluded in fact that Mr. A. had stronger ties to the UK than to the United States and discarded Mr. A's argument that he had a permanent home in the United States available to him. The fact that Mr. A had indicated his UK address on two of his WHT reclaim forms seems to have played a certain role. Furthermore. Mr. A also had a permanent home in the UK where he was active as a trader. Even though Mr. A. had insisted that he also possessed one or more homes in the United States available for his private use, the FAC expressed doubts as to whether Mr. A. used those homes permanently. On those grounds the FAC refused to acknowledge that Mr. A met the US residency criteria of the US Treaty.

Moreover, the FAC pointed to a letter by Mr. A's counsel to the FTA, in which such counsel had indicated that art. 27 (1) of the UK Treaty was applicable to his client. Under that rule, a UK resident who would principally be entitled to a (partial) relief from Swiss WHT pursuant the provisions of the UK-Switzerland treaty and who is not taxed in the UK, under UK domestic rules, on the full amount of such Swiss revenues, but only on such portion thereof that is received in, or remitted to the UK shall only be entitled to the Swiss tax relief for the fraction received in, or remitted to, the UK. The FAC stressed that reference to that provision of the UK Treaty implied that Mr. A was in fact a UK tax resident in the meaning of art. 1 and art. 4 of the UK Treaty. The FAC referred to the FSC decision 2C_436/2011 of 13 December 2011, according to which a UK resident taxpayer who is merely taxed on a remittance basis in the UK is principally considered as a UK tax resident under art. 1 and art. 4 of the UK Treaty. The FAC considered that Mr. A. would likely have been able to obtain a partial Swiss WHT refund pursuant to the UK Treaty, had he chosen to remit the relevant dividends to the UK; he should not be allowed to effectively circumvent that remittance requirement for benefits under the UK Treaty by invoking the US Treaty instead.

Considerations of the FSC

The FSC essentially based its judgment on the factual conclusions of the FAC. The FSC held that, given that Mr. A neither met the substantial presence test in the United States, nor had his habitual abode in the United States, the key question was whether Mr. A could successfully claim that he had a permanent home in the United States. This led the FSC to a somewhat surprising consideration (cons. 3.2): The FSC found that the issue that had been debated at length before the FAC, whether the provision of art. 4 (1) (a), 2nd sentence US Treaty provided for alternative criteria to establish the residence in the United States under the US Treaty, or rather established a "tie-breaker" rule could be left open, "… as the sole final question is whether the appellant possesses a permanent home in the United States for the purpose of obtaining the relief from [Swiss] tax provided under art. 10 (2) (b) US Treaty and art. 2 (3) (c) of the Ordinance under the US Treaty, i.e. to be eligible for a refund of withholding tax".

The FSC then goes on (in cons. 4.1) referring to the FAC's consideration that the notion of permanent home used in the 2nd sentence of art. 4 (1) (a) US Treaty is almost identical to the same notion used in art. 4 (3) (a) and (b) US Treaty (the tie-breaker rule applying to situations of dual tax residence of individuals in both Contracting States), as well as the similar tie-breaker rule of art. 4 (2) (a) and (b) of the OECD Model Tax Treaty; art. 4 (1) US Treaty does not provide the same rule as art. 4 (1) of the OECD Model Tax Treaty, because of the US rule of worldwide taxation not only of its residents, but also of its nationals. Finally, the FSC refers to the weighing of the factual evidence by the FAC, which under the circumstances – i.e. the factual determination that Mr. A overall had stronger ties to the UK compared to the United States – concluded that Mr. A had no permanent home in the United States. Generally, the FSC is bound to the determination of the facts by the lower court, from which it would not deviate except where it is evident that the lower court has established the facts in a totally wrong, arbitrary fashion. Thus, the FSC confirmed the FAC's conclusion that none of the three criteria for US tax residence for purposes of the US Treaty was met by Mr. A, and accordingly he was not entitled to any relief from Swiss withholding tax under that treaty. Consequently, the open partial withholding tax refund claims of Mr. A were rejected, and in addition he was ordered to reimburse the withholding tax refund of CHF 4.55 million he had already received from the FTA on grounds of unjust enrichment.

Comments

In the author's opinion, the decisions of both Swiss court instances feature some questionable elements. The rulings leave the impression that they were in fact led by anti-treaty shopping considerations – however, without stating this clearly. It is rather apparent that neither the FTA nor the Swiss courts were sympathetic to the idea that a foreign resident individual might effectively be able to choose between two different tax treaties concluded by Switzerland to obtain some relief from Swiss dividend withholding tax.

Had Mr. A prevailed with his legal position, he could indeed have made a choice between the UK Treaty and the US Treaty in order to claim a partial refund of the Swiss withholding tax, whichever suited his situation better. It is not apparent why this should be abusive or amount to a problematic "treaty shopping": Mr. A. as a US citizen was undoubtedly subject to US income taxation on a worldwide basis, including in particular for his Swiss dividends. As Mr. A. resided in the UK, he was principally also subject to UK taxation as a resident. However, he elected to be taxed in the UK on a remittance basis, as a means to avoid double taxation between the United States and the UK, at least for his income from non-UK sources not remitted to the UK, such as the Swiss dividends. As a result, Mr. A had to pay tax on the Swiss dividends in the US, but not in the UK. Because of his election, Mr. A, albeit resident in the UK under UK national tax rules, was unable to utilize the UK Treaty to reduce his Swiss withholding tax burden, but he expected to be able to utilize the US Treaty instead to avoid or mitigate double taxation between the United States and Switzerland, as by virtue of his US passport, he had to pay full US taxes on the Swiss dividends.

The special, wider than usual definition of tax residence in the United States of non-Swiss resident US citizens and green card holders for purposes of the US Treaty in its art. 4 (1) (a), 2nd sentence caters for the fact that such "US persons" are subject to US income taxes on a worldwide basis, even if they do not reside in the United States. The definition of US residence, and hence principally access to the tax treaty benefits of such US taxpayers pursuant to the US Treaty only requires some minimum personal nexus with the United States – either a substantial presence, habitual abode or a permanent home in the United States. However, the Swiss administrative and judicial authorities used an overly narrow interpretation of that special residency clause to deny Mr. A the benefits of the US Treaty. In the author's opinion, reading a "tie-breaker" meaning into the relevant special residence clause is not covered by its literal meaning, nor by the purposes of the US Treaty. The FAC effectively refused to acknowledge that Mr. A had a "permanent home" available to him in the United States, because it found that Mr. A had "closer ties" to the UK. Thus, the FAC (and subsequently the FSC) read a "tie-breaker" between the United States and a third country into the special residence definition, which in the author's opinion is not at all supported by the provision's language. The US Treaty in art. 4 (3) indeed includes a typical tie-breaker rule to address situations of dual residence of individuals in Switzerland and in the United States. However, that tie-breaker rule does not have anything to do with the question under what conditions a "US person" not residing in the United States shall be recognized as a US resident for purposes of the US Treaty.

The FSC ruling indicates that the trial had effectively been stayed during a certain period of time, as Mr. A had requested that the residence issue be resolved among the Swiss and US competent authorities (FTA and IRS) through a mutual agreement procedure, pursuant to art. 25 US Treaty. However, the ruling mentions that the mutual agreement procedure eventually had failed. It seems likely that the IRS regarded Mr. A. to be a US resident for purposes of the US Treaty based on the existence of a home in the United States that was permanently available to Mr. A, while the FTA refused to acknowledge the existence of such permanent home due to Mr. A's "closer ties" with the UK. Regrettably the Swiss courts supported that problematic approach of the FTA – which effectively left Mr. A with no double taxation relief at all.
