Swiss Tax Case Report – September 2023

Swiss Supreme Court rules that settlement payments by UAE-based football club are taxable to Swiss resident footballer

In a decision rendered on 23 June 2023 (case number 9C_682/2022 and 9C/683/2023), the Swiss Federal Supreme Court reversed the prior ruling of the Basel-Rural Cantonal Court of 15 September 2021, according to which the provisions of the double taxation treaty between the Unted Arab Emirates and Switzerland would have hindered the Swiss taxation of certain compensation payments made by an Emirates-based football club to its former Swiss player pursuant to a settlement agreement made in connection with an early termination of the footballer's engagement with the club. The case concerned instalment payments received by the footballer after his return to Switzerland. Upon appeals lodged by the Swiss tax authorities, the Supreme Court upheld the tax authorities' position, according to which the tax treaty was not applicable to the payments in question, which could henceforth be fully taxed in Switzerland.

Facts of the case

The Swiss footballer ("Mr. A") had entered into an employment agreement with a certain UAE-based football club (the "FC") on 5 November 2011. The engagement was supposed to run until August 2015. During the term of Mr. A's engagement, he was supposed to take up personal residence in the UAE. Mr. A's engagement was however early terminated with immediate effect by a Settlement Agreement between the parties dated 9 July 2013. The settlement provided for a total compensation for Mr. A of 2.345 million euros, which was payable in five equal instalments of 469'000 euros each over a period of two years, and which was declared to be exempt from taxes in the UAE. A first instalment payment of 469'000 euros occurred in June 2013.Towards the end of 2013, Mr. A. moved back to Switzerland and signed an employment agreement with a Swiss football club. In January 2014, the FC made a further payment of 234,000 Euro to Mr. A, while claiming that any additional claims of Mr. A pursuant to the settlement were prescribed under UAE labor law. Mr. A then filed for arbitration with the Court of Arbitration for Sports ("CAS") to enforce his remaining claims and ultimately prevailed. On 25 April 2017. the CAS ordered the FC to pay an amount equivalent to CHF 1,813,412 to Mr. A, which payments were made in the course of 2017. The Basel-Rural cantonal tax authority added that amount to Mr. A's Swiss taxable income of the year 2017. Objections by Mr. A to the cantonal tax authority and a subsequent appeal to the lower

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cantonal court against this tax assessment remained without success. (It is worth mentioning that Mr. A had omitted to report that claim as an asset in his earlier Swiss tax returns; Mr. A had informed the cantonal tax authority in writing of that failure in January 2018.)

Considerations of the Upper Cantonal Court on further appeal by Mr. A

Upon further appeal by Mr. A, the Basel-Rural Upper Cantonal Court however ruled in favor of Mr. A (judgments of 15 September 2021, cases no. 810 21 47 and 48). In essence, the Upper Cantonal Court concluded that with the signing of the Settlement Agreement in July 2013 (i.e. before Mr. A had again become a Swiss tax resident), Mr. A had already acquired a fixed, enforceable claim to the payments he eventually received from the FC in 2017, hence the income was realized before Mr. A became (again) a Swiss tax resident. The Court first considered how the payments in question had to be characterized for purposes of the UAE-Switzerland double tax treaty (the "UAE Treaty"). The Court referred to art. 15 (1) and art. 17(1) of the UAE Treaty, whereby income of a person resident in one contracting state from independent services or from sportsmen's or artist activities can only be taxed in the recipient's state of tax residence, except the dependent services or sportsman's activities are performed in the other contracting state, in which case that other state has a taxation right for the income. Art. 15 (1) UAE Treaty covers salaries as well as "similar compensation" derived from dependent services. The Court considered that compensation (such as severance) payments arising under an employment agreement my be difficult to characterize for tax treaty application purposes; they may either fall under art. 15 or under art. 21 ("other income" clause) of the UAE Treaty. The Court referred to Swiss legal doctrine and jurisprudence, which requires a close nexus of the severance payment with an actual activity performed in the other contracting state in order for art. 15 (1) to apply (Switzerland would generally apply the exemption method where the employment or sportsman activity may be taxed in the other state where the activity is performed); in the absence of such an immediate nexus, Switzerland would apply the "other income" rule (i.e. exclusive taxation in the country of tax residence) Thus, payments designed to compensate an employee for the early termination of the employment would generally be characterized as "other income". The Court applied that principle to the payments in question.

It remained to be decided by the Cantonal Court at what point in time the revenue should be considered to have been realized, i.e. already by the time the settlement providing for the payments was mutually agreed upon (Mr. A had not yet returned to Switzerland at such point in time), or only upon receipt of the actual payment by Mr. A (which occurred after Mr. A had become a Swiss tax resident again).

Generally, pursuant to Swiss tax doctrine, revenues are deemed to be realized for tax purposes upon the earlier of receipt of cash payments or the acquisition of a fixed legal claim to the payments, of which the beneficiary can dispose. The Tax Administration had argued that the termination and settlement agreement between the FC and Mr. A was a contract "*sui generis*" and did not lead to any fixed disposable claim of Mr. A; such fixed claim on the outstanding payments would have arisen only in 2017, when the CAS finally awarded the claim to the outstanding payments to Mr. A. The Tax Administration argued further that the fact that Mr. A had not stated the claims against the FC as assets in his earlier tax returns demonstrated that he did not consider the claims to be final and enforceable. The Court considered that a deviation from the "fixed legal claim" approach in favor of the "cash-in" approach is in taxation practice justified only, where the claim appears to be "particularly uncertain". According to the jurisprudence of the Federal Supreme Court, cash compensation, in particular salary payments, would generally be taxed pursuant to the "cash-in" method. The Cantonal Court held that in the case at hand, Mr. A. had realized the entire severance compensation already upon signing of the termination and settlement agreement with the FC, as Mr. A would have been in a position to assign that claim, which was clearly defined and quantified, against the FC. The Cantonal Court argued that in the light of the first instalment payment by the FC, which occurred in July 2013 in accordance with the Settlement Agreement, Mr. A. could count on the remaining instalments being paid as well, hence the fact that the FC later refused to make any further payments based on an assertion of prescription was irrelevant for the income realization question. The Cantonal Court also considered that the FC had not questioned the existence of the (remaining) claims of Mr. A as such, as the FC only raised an argument of prescription, which was finally rejected by the CAS. With that, the claim was not "particularly uncertain" when it arose, in the opinion of the Cantonal Court, hence a deviation from the "fixed legal claim" approach in favor of the cash-in approach was not justified.

Considerations of the Federal Supreme Court

Upon appeals filed by the Cantonal Tax Administration, the Federal Supreme Court again reversed the decisions of the upper Cantonal Court and concluded that the remaining settlement compensation paid by the FC in 2017 was taxable in Switzerland.

The Supreme Court first considered that in a first step, it had to be analyzed whether the payments in question were realized by the taxpayer in 2017, which would mean that they were subject to Swiss taxes under Swiss domestic tax laws, while in the affirmative, it had to be tested whether the Swiss taxation was barred by virtue of international law, such as the provisions of the UAE Treaty.

Timing of income realization

On the realization (timing) point, the Supreme Court reiterated the general principle established by constant jurisprudence, according to which a claim for monetary compensation is deemed to be realized as soon as the payment claim is quantitatively defined and certain ("fixed") and becomes freely disposable by the creditor. The Supreme Court clarified that generally, the claim must be *due* for being considered realized, as the claim would otherwise not yet be legally enforceable by the creditor. Only exceptionally, a monetary claim could be deemed to be realized before it falls due, especially where the taxpayer could unilaterally determine the due date, or where the parties have delayed the due date merely for tax reasons. The Supreme Court further reiterated its jurisprudence, according to which the "cash-in" approach is applicable to monetary claims where the fulfilment of the claims must be considered "uncertain", in particular, where the debtor is insolvent or unwilling to pay.

The Supreme Court held that, while the Cantonal Court had properly summarized the applicable legal principles in its ruling, it had not properly applied them to the actual fact pattern of Mr. A. The Supreme Court criticized that the lower Court had not considered the fact that the outstanding instalment payments in question were not yet due, and thus not legally enforceable against the FC at the time they were agreed upon in the Settlement Agreement. There was no indication for an agreement of instalment payments over a certain period of time just in the (fiscal) interest of the taxpayer; in addition, either way, the parties both assumed that the severance payments would not be subject to tax in the UAE, meaning that the breakdown of the payments over an extended period of time presumably was not fiscally motivated. According to the Supreme Court, the "hypothetical" assignability of the remaining claims by Mr. A, while the claims were not yet due and enforceable, did not amount to the claims being "fixed" in the meaning of Swiss legal doctrine and constant jurisprudence. The Supreme Court concluded that in principle, Mr. A could only acquire "fixed" payment claims against the FC upon the contractual due dates of each instalment payment. However, as the FC after making the last partial payment in January 2014 took the legal position that all remaining, still outstanding instalments were legally prescribed under UAE labor law, the performance of the remaining instalments on their respective due dates was no longer sufficiently "certain" to justify any taxation pursuant to the "fixed legal claim" method. In the opinion of the Supreme Court, it was not relevant whether the prescription allegation raised by the FC was well founded or rather "frivolous"; rather, this made it apparent that the debtor of the claim was unwilling to pay, which meant that the claims were not sufficiently certain. Overall, the Supreme Court concluded that the

remaining payments were only realized for income tax purposes when they were effectively made by the FC to Mr. A in 2017.

UAE Tax Treaty Aspects

The Supreme Court then moved on to analyze whether Switzerland had to exempt the payments in question from Swiss taxes (with progression) pursuant to art. 22 (1) (a) UAE Treaty. This would be the case, if the UAE Treaty conferred a taxation right to the UAE for the payments by the FC.

According to the Supreme Court, the potentially relevant provisions of the UAE Treaty are art. 17 (artists and sportsmen), art. 15 (dependent services) and art. 21 (other income). After stating that the UAE Treaty is generally applicable to persons residing in at least one of the contracting states, the Court considered that the UAE have a taxation right for the payments in question, if Mr. A derived the payments as a sportsman from an activity/performance personally exercised in the UAE (art. 17(1) UAE Treaty). If that prerequisite is not fulfilled, The UAE could have a taxation right if the compensation in question constitutes salary or a similar remuneration derived from dependent services, which he carried out in the UAE, without the parameters of art. 15 (2) UAE Treaty being met. To make that determination, the treaty provisions must be interpreted.

Treaty Interpretation Principles; Role of OECD Commentary

For the interpretation of the UAE Treaty, the Supreme Court primarily refers to the Vienna Convention of 23 May 1969 on the Law of Treaties. As far as relevant for the case at hand, the principles of the Vienna Convention constitute codified international customary law. As such they are relevant for the interpretation of the UAE Treaty, even though the UAE is not a party to the Vienna Convention. Thus, the Supreme Court points to arts. 31 and 32 of the Vienna Convention. Furthermore, according to standing practice of the Supreme Court, the Court takes the OECD Model Tax Treaty and the Commentary to that treaty into account for the interpretation of Swiss tax treaties, if such treaties have adopted those standards. While there are some uncertainties about the details of the practice, there is a general understanding that the OECD Commentary provides an important tool for the tax treaty interpretation in accordance with the Vienna Convention, even though the Commentary is not directly binding.

The Supreme Court referred to art. 17(1) of the UAE Treaty, which requires the receipt of the income in question by a sportsperson from a personal activity performed in the territory of the source state as a condition precedent for such source state's taxation right. That provision is found to be in line with the corresponding regulation under the

OECD Model Treaty in its version that prevailed when the UAE Treaty was concluded (version of 29 April 2000). The OECD Commentary provides a source of interpretation notwithstanding the fact that the UAE are not an OEC member state. The OECD Commentary requires a close nexus between the income and the personal activity performed in the state in question. The Federal Supreme Court follows a similar approach, it requires an immediate nexus with a personal performance of the sportsperson in the state in question. Thus, payments indemnifying for performances that could not take place are excluded from the application of art. 17(1).

Even though the settlement agreement between Mr. A and the FC was not very specific in terms of describing for exactly what Mr. A was to receive payments, the agreement made clear that Mr. A had to renounce any further claims against the FC. The stipulation of instalment payments was strongly indicative for a compensation for the lack of future salaries for Mr. A. The Supreme Court concluded that the payments constituted an indemnification for salaries that would have arisen in the future for further personal performances of Mr. A. This type of compensation did not fall under art. 17 (1) UAE Treaty.

The Supreme Court tested further whether the payments would have constituted salaries in the meaning of art. 15(1) UAE Treaty. Neither the UAE Treaty nor the OECD Model Treaty define the notion of "salaries" and similar payments. In an earlier case decided by the Federal Supreme Court, which concerned severance payments made in the year 2012 to a Swiss resident manager of a French company, the Court had ruled that the corresponding art. 15 of the Switzerland-France double tax treaty was not applicable, as the payment had not been made in exchange for a personal performance of work in France. In arriving at such conclusion, the Court had mentioned the OECD Commentary, but had not taken it into consideration specifically (which had been criticized in legal doctrine). The Supreme Court now held that, even though the UAE are not an OECD member state, the OECD Commentary may principally be utilized as a source of interpretation of art. 15(1) UAE Treaty. Detailed comments on severance and similar payments occurring upon or after the end of an employment relationship were added to the OECD Commentary in 2014, i.e. about there years after the UAE Treaty was concluded. The Supreme Court had thus to consider how to deal with later additions to the OECD Commentary in terms of interpreting a Swiss tax treaty that had been concluded before the OECD Commentary was amended. The previous approach of the Supreme Court to that question was not always consistent. Referring to a majority of Swiss and international scholars, the federal and cantonal tax authorities had represented that comments added to the OECD Commentary after conclusion of the tax treaty in question should not be taken into account as a source of interpretation of the tax treaty in question. On the other hand, the OECD itself has taken the opposite approach, at least where

the updated versions of the Model Convention and the Commentary do not "substantially deviate" from the relevant tax treaty provisions. This has found the approval of some international scholars.

The Supreme Court referred to its own jurisprudence, as well as jurisprudence of the International Court of Justice (in particular, the ICJ judgment of 13 July 2009 "*Différend relatif à des droits de navigation et des droits connexes*" in a matter of Costa Rica vs. Nicaragua, ICJ Recueil 2009, page 242, § 63) and predominant legal doctrine, according to which in principle, international treaties are to be interpreted statically, rather than dynamically. Therefore, relevant is the meaning of notions and provisions used in an international treaty at the time such treaty was concluded. A dynamic interpretation would be conceivable only where an international treaty, which was concluded for a very long or indefinite term, has utilized open notions, the meaning of which would be subject to change over time, and this would be recognizable by the parties. Only under such limited circumstances, the jurisprudence of the International Court of Justice would establish an assumption that the contracting parties wanted to give those notions a meaning that would change over time. According to the Supreme Court, later versions of the OECD Commentary could "theoretically" also be considered, if they reflect an amended practice of the contracting states in terms of interpretation of the tax treaty, which evidences the agreement of the contracting states on the interpretation. However, such agreement cannot be deduced in the case at hand, as one contracting state (the UAE) is not an OECD member and is not represented in the Fiscal Committee of the OECD. In addition, the Supreme Court expressed general doubts as to whether the OECD Commentary meets the requirements of art 31(3)(b) of the Vienna Convention, given that the Commentary by itself does not represent any common treaty application practice, as the tax treaty application is the responsibility of the tax and judicial authorities of the contracting states, rather than their delegates on the Fiscal Committee (the Swiss Federal Supreme Court thus concurs with the view of the Austrian Constitutional Court and dismisses the opposite opinion expressed in the 2021 ruling of the Supreme Court of Canada on the Alta Energy Luxembourg case). Overall, the Swiss Federal Supreme Court gives later versions of the OECD Commentary rather limited weight in the interpretation of tax treaties.

The Federal Supreme Court considered that, while the tax treaty notions of "salaries" and in particular "similar compensation" would in principle be open to a dynamic interpretation, they must be construed by reference to the national law of the contracting state that has to apply the tax treaty, so as to ensure that all taxable revenues from employment are effectively taxed. The more recent explanations in the OECD Commentary are not designed to define those notions; they are rather aimed at identifying the

actual reason for a given compensation, in order to determine whether the compensation was made in exchange for the performance of services in the relevant state. The Supreme Court does not see here any open notions, the interpretation of which could be subject to change over time.

According to the Federal Supreme Court, all language versions of art.15(1), 2nd sentence of the UAE Treaty require a nexus between the income and the effective performance of work in the state in which the work is performed. No such nexus is given where the payment, although grounded in the employment relation, does not compensate for actual work performed in the state of activity. This is in line with the previous version of the OECD Commentary, which prevailed when the UAE Treaty was concluded. The Supreme Court sees no reason to grant the state of activity any taxation right under art. 15(1) UAE Treaty, even if the compensation payment has its reason in the prior employment relationship, where the compensation is not made in exchange for actual work performed in that state. The decisive point from the perspective of the state of residence is that art. 15 UAE Treaty does not grant any taxation right the to the *former* state of activity for the compensation payment; accordingly, Switzerland as the state of residence does not have to grant any double taxation relief pursuant to art. 22 UAE Treaty. Switzerland can thus apply its national tax laws, under which the payments in question are subject to income taxes. The payments are comparable to continued salary payments after termination of the employment, or a compensation for damages resulting from the loss of salaries. The UAE Treaty does not limit Switzerland's taxation right for these payments.

Summary Comment

A "dynamic" interpretation of the UAE Treaty in accordance with the July 2014 update of the OECD Commentary could have led to a different outcome of the case, insofar as the updated version of the Commentary suggests the existence of a sufficient nexus between a compensation payment and former services performed in the state of activity, where an employee was terminated and released from the duty to provide any further services, if the compensation covers the loss of salaries during the contractual termination notice period. According to the opinion of the Fiscal Committee of the OECD, severance payments made by an employer upon termination of the employment based on applicable labor law or employment contract should in cases of doubt be considered as compensation for the past twelve months of employment, and hence fall under art. 15(1) OECD Model Tax Treaty; the same should be true for compensation for damages resulting from a termination that was found to be unlawful or in breach of the employment agreement. However, the Federal Supreme Court has rejected such an "dynamic"

interpretation of the UAE Treaty in line with the update of the OECD Commentary that was released three years after the UAE Treaty had been concluded.