SWITZERLAND

Revised Swiss Anti-Treaty Shopping Rules

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I. INTRODUCTION

Switzerland has a well-developed network of bilateral double taxation treaties. Hence, Swiss resident individual and corporate taxpayers may often be able to achieve a substantial reduction or elimination of taxes withheld by the foreign source country on dividends, interest, royalties and other types of "passive" income. In addition, Swiss tax laws have traditionally offered favourable tax treatment of dividend income from Swiss and foreign sources, as well as interest, royalty and similar income from foreign sources paid to a Swiss corporation. The combination of these tax features with political stability, a hard currency and a relatively modest tax climate for corporations allowed Switzerland to become a frequently used "base company" location for international businesses, which was ideally suited for "treaty shopping" practices. This was well known not only to international taxpayers, but also to the governments of many foreign high-tax jurisdictions, in particular the United States and Germany.

In 1962, the Swiss Federal Government, in response to the risk of Switzerland being categorized as a tax haven by important industrialized countries, which would have had an adverse impact on the country's ability to conclude favourable double taxation treaties, decided to introduce a Decree (the "Abuse Decree") to prevent the most frequently used "treaty shopping" practices by foreign taxpayers using a Swiss intermediate corporation to derive certain types of foreign income.

II. TREATY SHOPPING UNDER THE SWISS RULES OF 1962

The Abuse Decree and the Circular issued thereunder on 31 December 1962 by the Federal Tax Administration (FTA) describe the following principal treaty-shopping practices:

- *Excessive use of treaty-benefited income* by Swiss corporations for tax-deductible payments to persons who are not entitled to treaty benefits ("flow-through" situations). According to the 1962 Circular, such payments, which also include depreciation of assets acquired from non-residents, are limited to *50 per cent* of the treaty-benefited income. Furthermore, expenses that are related to treaty-benefited income must be covered by such income.
- *Thin capitalization* of foreign-controlled Swiss corporations. According to the 1962 Circular, a foreign-controlled Swiss corporation is deemed to be inadequately capitalized if its interest-bearing debt vis-à-vis foreign persons exceeds *six sevenths* of its total balance sheet. Furthermore, interest paid on debt vis-à-vis affiliated parties must not exceed arm's length interest rates periodically published in the guidelines of the FTA.
- *Excessive accumulation of treaty-benefited income*: A foreign-controlled Swiss corporation is deemed to be excessively accumulating its treaty-benefited income if it does not make regular and reasonable dividend distributions to the shareholders. Under the 1962 Circular, at least *25 per cent* of the treaty-protected income must annually be distributed to the shareholders, such distribution being subject to 35 per cent federal withholding tax.
- *Use of fiduciaries or collecting agents*: A Swiss resident person or legal entity, which receives foreign-source income in a fiduciary capacity or as a collecting agent on behalf of one or more non-resident principals is not regarded to be the beneficial owner of such income and thus cannot claim the treaty benefits.
- *Use of family foundations or partnerships* resident, but not carrying on business, in Switzerland, in which persons not entitled to treaty benefits are substantially interested.

The measures, which the competent authorities may take when they ascertain that a relief from foreign tax is or has been claimed based on a Swiss tax treaty, include:

- the refusal of the certification required on the claim form;
- the refusal to transmit, or the forbidding of the transmission of, the claim form;
- the revocation of a certification already given;
- the recovery of the foreign withholding tax on behalf of the tax authority of the foreign contracting state to the extent that the tax relief has been claimed improperly, and, if it is not possible by other means to remedy the deficiency or to prevent such an improper claim for tax relief in the future;
- the informing of the tax authority of the foreign contracting state that a tax relief has been claimed improperly.

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III. IMPACT OF THE NEW CIRCULAR OF 17 DECEMBER 1998

On 17 December 1998, the FTA issued an additional Circular under the Abuse Decree, which does not replace, but partly amends the Circular of 1962. The new Circular introduces special rules addressed to "active" Swiss companies, stock exchange-listed Swiss companies and holding companies, which are designed to provide a certain relief compared to the previous rules.

A. "Active" Swiss companies

Companies performing an *active business activity in Switzerland* may transfer more than 50 per cent of their treaty-protected income to non-residents, to the extent that such expenses are "commercially justified" and can be proven. In addition, such active companies are exempt from the 25 per cent profit distribution requirement if their distribution policy is "adequate". Active companies are deemed to have adopted an adequate distribution policy, as long as the collection of the withholding tax is not deemed to be jeopardized under the Withholding Tax Act and the regulations thereunder. The withholding tax collection is deemed to be jeopardized, if the following conditions are cumulatively met:

- the capital of the company is at least 80 per cent foreign controlled;
- substantially all of the company's assets are located or invested abroad; and
- the company does not annually distribute at least 6 per cent of its net equity as dividends to its shareholders.

Hence, if the company invests more than a completely insignificant portion of its assets in Switzerland, the collection of withholding tax is not considered to be jeopardized and, therefore, the company is not under any obligation to make regular minimum profit distributions.

B. Listed Swiss companies

Swiss companies the shares of which are *listed on a stock exchange* and *Swiss subsidiaries* of such listed Swiss companies enjoy the same relief as active Swiss companies. The majority of the issued shares of the Swiss company (or its Swiss parent) in terms of nominal value and voting power must be listed on at least one stock exchange and be regularly traded. Recognized stock exchanges include the Swiss Exchange and foreign stock exchanges, the listing rules of which provide for similar requirements as those of the Swiss Exchange.

C. "Pure" holding companies

"Pure" Swiss holding companies, which can prove that their principal or exclusive activity and function is the administration and/or financing of corporate participations, also enjoy the same relief as active Swiss companies and listed Swiss companies.

D. "Mixed" holding companies

"Mixed" Swiss holding companies, which in addition to the mere holding company function perform other ancillary activities such as administration/exploitation of intellectual property, reinvoicing etc. continue to be subject to the 50 per cent limitation in respect of expenses paid to non-residents. However, the profit distribution requirements (if any) are the same as those applying to "pure" holding companies, active companies and listed companies (i.e. only if withholding tax collection is deemed to be jeopardized).

E. Thin capitalization standard tightened to conform with federal tax rules

The previous debt-to-equity rule of six to one has been amended under the new Circular to the effect that now the thin capitalization rules set forth in the FTA's Circular of 1997 on "hidden equity" are applicable also for the purposes of the Abuse Decree. These rules in particular require an equity financing (including non-interest-bearing loans) of participations of at least 30 per cent.

IV. FINAL REMARKS

The special anti-abuse rules integrated in some of the Swiss income tax treaties (such as the treaties with Germany, Belgium, Italy and France), as well as the extensive "limitation of benefits" provision included in the Swiss income tax treaty with the United States have priority over the Abuse Decree and continue to be applicable. Whereas the anti-abuse rules in the treaties with Germany, France, Belgium and Italy basically follow the model of the 1962 Decree and Circular and provide for additional "subject to ordinary cantonal tax" requirements for treaty relief of interest and royalties, the Abuse Decree as such is no longer applied in relation to the United States.

The revised Circular under the Abuse Decree may be seen as a first step in the direction of a complete abolition of Switzerland's unilateral treaty shopping provisions, which have been increasingly replaced by more differentiated provisions that are integrated in the tax treaties themselves. Moreover, the liberalization introduced by the new Circular constitutes a further step in the continuing process of improvement of the tax climate in Switzerland for international holding companies and other business operations.

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