

Switzerland and European Union – Tax Treatment of Intra-Group Cross-Border Dividends

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between companies in the EU Member States by granting tax relief for intra-group dividend payments in the case of shareholdings of at least 25%.⁴ The tax relief consists of: (a) an income tax exemption (or a full tax credit) for dividends received, and (b) a withholding tax exemption for dividends paid.

Under Swiss domestic law, the dividends received by Swiss parent companies from their subsidiaries usually qualify for some form of corporation tax relief – e.g. the Swiss participation relief,⁵ which is more generous than the relief provided in the Parent-Subsidiary Directive. The relief under domestic law applies to all Swiss companies that own at least 20% of the registered capital of another company or a participation whose value exceeds CHF 2 million.⁶ Dividends received are not covered by the Swiss-EU Agreement.

In contrast, dividends paid are usually subject to a withholding tax in the source state. Prior to the Swiss-EU Agreement, relief was only possible by applying the provisions of an international tax treaty. In its recent treaty negotiations, Switzerland has favoured a withholding tax exemption for dividends paid, but there is nevertheless an unrecoverable withholding tax in most of Switzerland's tax treaties. It is dividends paid that benefit from the relief provided in the Swiss-EU Agreement.

This article examines the taxation of dividends paid by Swiss subsidiaries to EU parent companies.⁷

1. INTRODUCTION

On 1 July 2005, the agreement between the Swiss Confederation and the European Community on the taxation of savings¹ (Swiss-EU Agreement) entered into force. Its purpose is to eliminate the withholding tax on intra-group cross-border dividend payments between Switzerland and the EU Member States. The Agreement applies to all dividends that fall due after 1 July 2005.

This author wrote an article on the subject in December 2004,² at a time when questions concerning the method of applying the Swiss-EU Agreement remained largely unanswered. Since then, Switzerland has issued various guidelines to facilitate the implementation of the Agreement. The purpose of this article is to provide an update on the developments over the last 12 months.

The Swiss-EU Agreement includes Art. 15, which, inter alia, grants Switzerland measures equivalent to those found in the EC Parent-Subsidiary Directive of 1990.³ By way of background, the Parent-Subsidiary Directive facilitates the free movement of capital

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1. Agreement between the European Community and the Swiss Confederation providing for measures equivalent to those laid down in Council Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments.

2. Hull, H.R., "The EC Parent-Subsidiary Directive in Switzerland – Swiss Outbound Dividends", 59 *Bulletin for International Fiscal Documentation* 2 (2005), at 63.

3. Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, *OJ* No. 225/6 of 20 August 1990. The Directive entered into force on 1 January 1992.

4. The participation threshold is being reduced progressively. See 3.3. and 6.6.

5. Arts. 69 and 70(1)(1) of the Federal Direct Tax Law (DTL), *Loi fédérale du 14 décembre 1990 sur l'impôt fédéral direct*, RS 642.11; Art. 28(1) of the Tax Harmonization Law (THL), *Loi fédérale du 14 décembre 1990 sur l'harmonisation des impôts directs des cantons et des communes*, RS 642.14.

6. See Oberson, X. and H.R. Hull, *Switzerland in International Tax Law* (Amsterdam: IBFD Publications, 2nd ed., 2001), at 58 et seq.

7. Dividends received by Swiss companies are outside the scope of this article, but many of the comments herein may be applied mutatis mutandis.

2. LEGAL BASIS AND ADMINISTRATIVE REGULATIONS

Taxpayers have the choice of applying the comprehensive double taxation treaty between Switzerland and the residence state of the beneficiary or, if the shareholder/beneficiary is a resident of an EU Member State, Art. 15 of the Swiss-EU Agreement.⁸ Arts. 15(1) and (3) of the Agreement provide:

Article 15, para. 1

Without prejudice to the application of domestic or agreement-based provisions for the prevention of fraud or abuse in Switzerland and in the Member States, dividends paid by subsidiary companies to parent companies shall not be subject to taxation in the source state where:

- the parent company has a direct minimum holding of 25% of the capital of such a subsidiary for at least two years; and
- one company is resident (for tax purposes) in a Member State and the other company is resident (for tax purposes) in Switzerland; and
- under any double taxation agreements with any third states neither company is resident (for tax purposes) in that third state; and
- both companies are subject to corporation tax without being exempted and both adopt the form of a limited company.

Article 15, para. 3

Existing double taxation agreements between Switzerland and the Member States which provide for a more favourable taxation treatment of dividends, interest and royalty payments at the time of adoption of this Agreement shall remain unaffected.

On 1 October 2004, the Swiss Federal Council issued its "Message"⁹ to the attention of the Swiss Parliament. The Message includes, inter alia, comments and recommendations concerning the application of Art. 15 of the Swiss-EU Agreement. The Message also states that the rules in Art. 15 are substantively complete and directly applicable.¹⁰ In addition, the Message confirms that the rules are sufficiently precise so that their implementation can be based on the current procedures relating to international tax treaties.¹¹ There have nevertheless been recent changes to Swiss administrative practice to accommodate the Swiss-EU Agreement. See 7. in particular.

The Swiss-EU Agreement is accompanied by a Memorandum of Understanding (MoU). Under the MoU (Para. 2) and the Explanatory Memorandum to the Swiss-EU Agreement, Switzerland and the Member States commit themselves to enter into bilateral negotiations with a view to:

- including, in their respective tax treaty, provisions on the exchange of information on request for cases falling within the concept of "tax fraud or the like" with respect to items of income not subject to the Swiss-EU Agreement but covered by their respective treaty; and
- defining particular categories of cases falling under "the like" in accordance with the tax procedure applied by those countries.

The MoU also covers negotiations for securing equivalent measures with non-EU countries. In addition, the MoU contains a declaration of intent regarding the

implementation of the Swiss-EU Agreement which sets the spirit of the Agreement (see 5.).

On 22 December 2004 and 15 July 2005, the Swiss Federal Tax Administration issued Circulars Nos. 6 and 10,¹² which introduce new procedures allowing Swiss companies to pay the withholding tax on dividends at the net treaty rate(s) rather than having to obtain treaty relief by means of a refund of the 35% Swiss statutory withholding tax.¹³ See 7.

Finally, on 15 July 2005, the Swiss Federal Tax Administration issued a comprehensive circular (Circular) which goes a long way to clarifying many aspects of the Swiss-EU Agreement.¹⁴

3. SCOPE

3.1. Territoriality and the EU accession states

According to Art. 20 of the Swiss-EU Agreement, the Agreement applies to Switzerland and to the territory to which the Treaty establishing the European Communities applies. "Switzerland" refers to the Swiss Confederation. Liechtenstein is not included.

On 27 April 2005, Switzerland and Spain signed a protocol on the exchange of information on request in cases of tax fraud or the like with respect to items of income not subject to the Swiss-EU Agreement but covered by a bilateral treaty or agreement between the two countries. The impetus for the protocol was Art. 18(3) of the Agreement, which provides that, regarding Spain, Art. 15 will apply only from the entry into force of a bilateral agreement between Switzerland and Spain on the exchange of information on request in such cases.¹⁵

The Swiss-EU Agreement applies to cross-border dividend payments between Switzerland and all 25 EU Member States, including the accession states.¹⁶ They include Malta and Cyprus with which Switzerland did

8. Cherry-picking the more favourable provisions of the applicable treaty and the Agreement is not possible.

9. Message relatif à l'approbation des accords bilatéraux entre la Suisse et l'Union européenne, y compris les actes législatifs relatifs à la transposition des accords ("accords bilatéraux II"), RO 04.063 at 5593 et seq.

10. Id., Para. 2.8.5 (at 5840).

11. Id., Para. 5.4.1 (at 5906).

12. Circular No. 6, "Procédure de déclaration pour dividendes de source suisse versés à des sociétés étrangères détenant des participations importantes", Swiss Federal Tax Administration, 22 December 2004.

Circular No. 10, "Procédure de déclaration pour dividendes de source suisse versés à des sociétés étrangères détenant des participations importantes, basée sur l'article 15 paragraphe 1 de l'Accord sur la fiscalité de l'épargne avec la CE (complément à la circulaire no 6 du 22.12.2004)", Swiss Federal Tax Administration, 15 July 2005.

13. See Hull, H.R. and N. Sturzenegger, "The Dividend Withholding Tax and Net Remittance Procedures in Switzerland", 59 *Bulletin for International Fiscal Documentation* 4 (2005), at 152.

14. Directives relatives à la suppression de l'impôt anticipé suisse sur les paiements de dividendes entre sociétés de capitaux associées dans les relations entre la Suisse et les Etats membres de l'Union européenne, Swiss Federal Tax Administration, 15 July 2005.

15. An exception and transitional arrangement also apply with respect to Estonia regarding the dividend withholding tax on payments to Swiss companies until 31 December 2008, but this will possibly apply only to Swiss inbound dividends; Message, supra note 9, Para. 2.8.3.2.2 (at 5836).

16. Id., Para. 2.8.3.2.2 (at 5836). The accession states are Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, the Slovak Republic and Slovenia.

not previously have a comprehensive tax treaty. The Agreement also applies to (Circular, Para. 1):

- Guadeloupe, Guyana, Martinique and Reunion (France);
- Gibraltar (United Kingdom);
- the Madeira Islands and Azores (Portugal); and
- the Canary Islands (Spain).

The Swiss Federal Tax Administration has clarified that the Agreement may be extended to other states that join the European Union in the future without the need for renegotiation.¹⁷

3.2. "Tax at source" defined

Recent cases before the European Court of Justice (ECJ) have focused on the meaning of "withholding tax" in Art. 5(1) of the Parent-Subsidiary Directive.¹⁸ In the context of outbound dividends, "withholding tax" clearly includes the tax on dividends as provided in the Swiss domestic law on withholding tax.¹⁹

3.3. Developments regarding the Parent-Subsidiary Directive

The Swiss-EU Agreement refers to the Parent-Subsidiary Directive as "Directive 90/435/EWG of 23 July 1990" and does not refer to any amendments to the Directive. The European Union has started to amend the Parent-Subsidiary Directive of 1990. Indeed, on 22 December 2003, the Council adopted Directive 2003/123/EC to broaden the scope and improve the operation of the Directive. Based on a Commission proposal of 8 September 2003, the amended Directive makes three major changes:

(a) it updates the list of companies covered by the Directive;

(b) it relaxes the conditions for exempting dividends from withholding tax by reducing the participation threshold from 25% to 10% in three steps:

- to 20% from 1 January 2005 to 31 December 2006;
- to 15% from 1 January 2007 to 31 December 2008; and
- to 10% as from 1 January 2009; and

(c) it eliminates double taxation for subsidiaries of subsidiary companies.

These new rules do not automatically apply to cross-border dividend payments between Switzerland and the EU Member States because the Swiss-EU negotiations did not cover transitional provisions.

The Swiss-EU Agreement does not resolve the issue of how the Agreement should be interpreted. Should it be interpreted according to the static approach (i.e. the interpretation at the time the Agreement was entered into) or the ambulatory approach (i.e. the interpretation as amended on an ongoing basis)? It would appear, however, that the ambulatory approach is more appropriate since it would allow the Agreement to accommodate changes in interpretation without having to be renegotiated.

4. JURISDICTION

The ECJ does not have jurisdiction to enforce the Swiss-EU Agreement. Cases will arise where a state does not correctly apply the provisions of the Agreement or where the Agreement does not cover a particular situation. In addition, some provisions of the Agreement may require clarification concerning their interpretation or application. According to Art. 12 of the Agreement, if the competent authority of Switzerland and one or more of the other competent authorities referred to in Art. 11 of the Agreement disagree as to its interpretation or application, the competent authorities must endeavour to resolve the disagreement by mutual agreement. The competent authority of Switzerland is the Director of the Swiss Federal Tax Administration²⁰ or his proxy or agent. Art. 12 was based on the mutual agreement procedure currently found in international tax treaties.²¹

Through the mutual agreement procedure, the competent authorities of two states may resolve an issue amicably. The procedure does not replace the ordinary legal appeals that may be possible under domestic law. The mutual agreement procedure is therefore altogether independent from any litigation based on domestic law.

5. INTERPRETATION

For the general points regarding the interpretation of international tax agreements, including the Swiss-EU Agreement, see the earlier article on the Agreement.²²

Interpreting the Swiss-EU Agreement is particularly difficult because there are no international courts that offer legally binding interpretations. Under Art. 13(1) of the Agreement, the contracting parties agree to consult each other at least every three years or at the request of either party with a view to examining and, if the parties deem necessary, improving the technical functioning of the Agreement and assessing international developments.

Regarding the interpretation of the Swiss-EU Agreement, Para. 4 of the MoU includes a declaration of intent. It provides that the parties consider the Agreement and the MoU to provide an acceptable and balanced arrangement that can be considered as safeguarding the interests of the parties. They will therefore implement the agreed measures in good faith and will not act unilaterally to undermine the arrangement without due cause. In this author's view, Para. 4 of the MoU also applies to the measures in Art. 15 of

17. See Message, supra note 9.

18. See Schwarz, J., "European Corporate Group Structures and Financing: The Impact of European Court Decisions and European Legislative Developments", 57 *Bulletin for International Fiscal Documentation* 11 (2003), at 514.

19. Loi fédérale sur l'impôt anticipé du 13 octobre 1965, RS 642.21, and Ordonnance d'exécution de la loi fédérale sur l'impôt anticipé du 19 décembre 1966, RS 642.211. See 6.1.

20. EU-Swiss Agreement, Annex I, Para. A, List of competent authorities; Le Directeur de l'Administration fédérale des contributions/Der Direktor der Eidgenössischen Steuerverwaltung/il direttore dell'Amministrazione federale delle contribuzioni.

21. Message, supra note 9, Para. 2.8.3.2.3 (at 5837).

22. Hull, supra note 2, at 69.

the Swiss-EU Agreement which are equivalent to the Parent-Subsidiary Directive (since Art. 15 is part of the Agreement).

The Swiss-EU Agreement does not have a rule similar to Art. 3(2) of the OECD Model Tax Convention, which provides that undefined terms in a treaty have the meaning that they have under the domestic law of the state applying the treaty unless the context requires otherwise. There is, however, a general consensus that international tax treaties must be interpreted in Switzerland in accordance with the rules of public international law. Those rules are in Arts. 31 to 33 of the Vienna Convention on the Law of Treaties, which entered into force in Switzerland on 6 June 1990.²³ Based on a decision of the Swiss Supreme Court, it can be argued that the principles of the Vienna Convention apply to the interpretation of tax treaties in Switzerland, including the Swiss-EU Agreement.

The decisions of the ECJ will almost certainly influence the Swiss courts in interpreting the Swiss-EU Agreement. For example, in its Circular of 15 July 2005, the Swiss Federal Tax Administration referred to the ECJ's decision in *Denkavit* (see 6.7.). Since Switzerland and the European Union based their negotiations on the Parent-Subsidiary Directive, it can be presumed that they will refer to the ECJ's decisions in interpreting the Agreement, even though the decisions are not binding on Switzerland. Indeed, compatibility with EC law has been on the agenda, if not applied, for almost all the changes to Swiss legislation over the past ten years. Thus, consistency with the ECJ's decisions appears to be in the spirit of the Swiss-EU Agreement.

6. QUALIFYING DIVIDENDS

As with the Parent-Subsidiary Directive, the qualifying conditions and principles of the Swiss-EU Agreement represent the minimum common requirements.

6.1. Dividends defined

As per the Federal Tax Administration, the term "dividends paid" is to be interpreted in light of Art. 10 of the OECD Model, which defines dividends as payments that are characterized as dividends under the domestic legislation of the company distributing the dividends. There has been some debate as to the justification of the reference to the OECD Model. Nevertheless, for Switzerland, the term "dividends paid" certainly encompasses all dividends subject to the Swiss withholding tax under Swiss domestic law.²⁴ The term includes hidden dividend distributions as well as dividends on the liquidation of a company (Circular, Para. 3). The term does not include capital gains and interest payments.²⁵

6.2. Legal form

Art. 15(1) of the Swiss-EU Agreement requires that both the parent and subsidiary "adopt the form of a limited company". For purposes of Swiss company law, this means that the only companies that qualify are

companies having the form of a Swiss corporation, limited liability company or corporation with unlimited partners.²⁶ Other forms of company and cooperatives do not qualify even though they may be subject to withholding tax.

Regarding European companies, the Swiss Federal Tax Administration has confirmed that the reference should be to the Parent-Subsidiary Directive as applied after the ten accession states joined the EU (Circular, Para. 9b). The Parent-Subsidiary Directive requires that a company have one of the forms listed in the Annex, and the withholding tax is abolished only if the company has one of those forms. The proposed new rules in the Parent-Subsidiary Directive extend the applicability to a larger number of legal persons and entities, including companies formed under the European Company Statute (known by their Latin name *Societas Europaea* or SE).

6.3. Fiscal residence

According to Art. 15(1) of the Swiss-EU Agreement, one company must be resident (for tax purposes) in a Member State and the other company must be resident (for tax purposes) in Switzerland and, under any double taxation treaty with a third state, neither company may be resident (for tax purposes) in that third state.

Under Swiss domestic law, a company is considered to be resident, and thus subject to full taxation, if it is incorporated in Switzerland or if its place of effective management is located in Switzerland.²⁷ In interpreting this provision, however, reference should be made to Art. 4 of the OECD Model (Circular, Para. 6). Hence, if two or more jurisdictions claim that a company is a resident of their state by application of domestic law, the place of effective management takes precedence.

It would appear that the Swiss Federal Tax Administration will disqualify a company from taking advantage of the Swiss-EU Agreement if it is incorporated under the law of a Member State, and therefore fully subject to tax in that Member State (incorporation system), while having its place of effective management in a non-EU country that does not have a tax treaty with the first state. Therefore, dual resident companies with their fiscal residence outside the EU may not qualify for the Swiss-EU Agreement.

6.4. Direct shareholding

Art. 15(1) of the Swiss-EU Agreement requires that the parent company have a direct holding and that dividends be paid by a subsidiary company to a parent company. "Subsidiary" means a company whose capital is included in the 25% holding requirement (see

23. RS 0.111 = RO 1990 1112.

24. Danon, R. and P.-M. Glauser, "Cross-border Dividends from the Perspective of Switzerland as the Source-State - Selected Issues under Article 15 of the Swiss-EU Savings Agreement", 33 *Intertax* 11 (2005), at 508.

25. Art. 7 of the Swiss-EU Agreement limits the characterization of dividends negatively by defining the term "interest payment".

26. *Société de capitaux*; Message, supra note 9, Para. 2.8.3.2.2 (at 5836).

27. Art. 50 DTL and Art. 20(1) THL.

6.6.). There is therefore no relief for dividends or deemed dividends paid between related parties that are not in a parent-subsidiary relationship. Switzerland will nevertheless look through certain partnerships and other structures deemed to be transparent for applying this condition (Circular, Para. 4).

6.5. Subject to tax

According to Art. 15(1) of the Swiss-EU Agreement, both the parent and subsidiary must be subject to corporation tax without being exempted. Art. 2(c) of the Parent-Subsidiary Directive contains a similar requirement: relief is granted if a company "is subject to ... taxes, without the possibility of an option or of being exempt". Although the wording is very similar, under the Swiss-EU Agreement, the issue of whether the entity has actually made an election to be exempt from tax does not arise.

The Swiss-EU Agreement has not established the meaning of being "subject to corporation tax", and the meaning is far from clear within the EU itself. Is it sufficient for a company to be regarded as a taxable person under domestic law, or is it necessary for the company to actually pay tax? Can a company that is within the scope of tax legislation qualify for relief even if it does not actually pay the corporation tax? Is a minimum tax rate required?

The EU Member States have their own answers to these questions. Switzerland will introduce procedures to determine which EU companies qualify. The typical example of a non-qualifying company is a Luxembourg holding company which falls under the Law of 31 July 1929 and is therefore fully exempt from corporation tax.²⁸

Art. 49 of the Federal Direct Tax Law lists the companies that are subject to the Swiss federal corporation tax, which include qualifying limited companies as defined above. The term "subject to tax" as used in Swiss domestic law²⁹ is almost exactly the same as the term "subject to tax" in the Swiss-EU Agreement.³⁰ There is therefore no reason why Switzerland would not interpret the Swiss-EU Agreement in the same manner as its domestic legislation. Although all commercial companies are subject to corporation tax in Switzerland, the question has nevertheless been raised as to whether the actual payment of tax is required.

In this context, the argument was that exempt companies do not qualify because there is no reason to compel a contracting state to prevent double taxation if, because of the exemption, no double taxation arises.³¹ Indeed, if it is not necessary that tax actually be paid, it would appear that the Swiss-EU Agreement is irrelevant in this regard because an exemption from withholding tax would be granted even if there was no double taxation.

This is no longer a conclusive argument. There are many situations in which a company does not actually pay tax, e.g. if the company has current losses or loss carry-forwards. In addition, many countries, including Switzerland, are familiar with the avoidance of virtual double taxation in their international treaty network. Adding to this, such a position would be inconsistent

with Switzerland's current tax treaties which, even though they provide full withholding tax relief, do not include a subject-to-tax clause with respect to the Swiss distributing company. Finally, this position does not consider that the text of the Swiss-EU Agreement does not appear to contain a requirement that tax be paid.³² The Agreement refers to companies being "subject to tax", not to any items of income being "subject to tax". Since the payment of tax is not required, Switzerland accepts the possibility that a company is "subject to tax" but does not actually pay tax.

As a result of this reasoning, Switzerland recently clarified its position regarding Swiss companies in the context of outbound dividends³³ by confirming that all Swiss entities qualify unless they are fully (or almost fully) tax exempt by virtue of a tax holiday granted for Swiss federal, cantonal and communal purposes or unless they are not subject to tax.

Under the tax holiday regime in Swiss domestic law,³⁴ a company can be granted full relief from the federal corporation tax for a limited period of time (usually five to ten years). Such a company is disqualified (Circular, Para. 8a(VI)). The situation of companies taking advantage of only a partial tax holiday is to be determined on a case-by-case basis.

This unilateral anti-abuse rule is limited in scope since Switzerland offers very little tax relief from its federal corporation tax.³⁵ Other forms of relief do not jeopardize the application of the Swiss-EU Agreement. Indeed, as mentioned above, the Agreement (Art. 15) refers to companies being "subject to tax", not to any items of income (dividends) being "subject to tax". Hence, any relief specific to dividends, such as the participation exemption, would not jeopardize the application of Art. 15. The same is true regarding (a) companies that may qualify for partial relief from the federal corporation tax by virtue of a profit allocation to a foreign permanent establishment, (b) holding companies and (c) auxiliary companies.

Art. 56 of the Federal Direct Tax Law³⁶ lists the entities and institutions which are not subject to the Swiss federal corporation tax and which, in principle, do not

28. Such companies are also outside the scope of the Switzerland-Luxembourg tax treaty (Art. 28).

29. French: "sont assujetties à l'impôt sur les sociétés"; German: "der Körperschaftsteuer unterliegen".

30. The French and English versions of the Swiss-EU Agreement use the same terminology as Swiss domestic law. The German version differs in terminology ("Steuerpflichtig sein" in Swiss domestic law), but not in substance. Although the term "subject to tax" is also used in Art. 15 of the Agreement in the context of abolishing the withholding tax ("shall not be subject to taxation in the source states", emphasis added), the German and French versions use different terminology, hence clearly distinguishing between objective and subjective exemptions.

31. Terra, B.J.M. and P.J. Wattel, *European Tax Law* (Boston: Kluwer Law and Taxation Publishers, 1993), at 178.

32. Maisto, G., "Shaping EU Company Tax Policy: Amending the Tax Directives", 42 *European Taxation* 8 (2002), at 287, 288 (by analogy).

33. The interpretation of this condition for inbound dividends will differ depending on the source state of the dividends.

34. Arrêté fédéral en faveur des zones économiques en redéploiement du 6 octobre 1995, RO 1996, 1918.

35. See Oberson and Hull, supra note 6, at 58 et seq. Most relief is granted to companies for cantonal and communal tax purposes rather than for Swiss federal tax purposes.

36. Art. 23 of the Tax Harmonization Law is a similar provision applicable for cantonal and communal tax purposes.

qualify for relief under Art. 15 of the Swiss-EU Agreement. They include: (a) the federal government, the cantons, and their agencies; (b) the municipalities, churches and other regional cantonal corporations, and their agencies; (c) certain licensed transport enterprises; (d) certain employment pension or provident funds of enterprises that have a presence in Switzerland and of closely-related enterprises if their assets are permanently and exclusively devoted to social security for personnel; (e) certain domestic social insurance and compensation funds; (f) certain legal entities that pursue public welfare or charitable objectives or that pursue religious objectives on a nationwide basis; and (g) certain foreign countries that own domestic real property used exclusively by diplomatic and consular representatives, subject to reciprocal rights. For details, see the earlier article on the Agreement.³⁷

The Swiss Federal Tax Administration has confirmed that, in principle, it will not grant relief to these entities and institutions under the Swiss-EU Agreement.

6.6. Participation threshold

The requirement in Art. 15(1) of the Swiss-EU Agreement – that the parent company have a minimum holding of 25% of the capital of a subsidiary – is in line with the 25% criterion in Art. 10 of the OECD Model. It is also consistent with the Parent-Subsidiary Directive, which requires a minimum holding of 25% of the capital of a company of another Member State. As mentioned above, the European Union has amended the Parent-Subsidiary Directive, and the changes include reducing the participation threshold from 25% to 10% over four years (see 3.3.). These changes will not be immediately applicable in the Swiss-EU relations.

Different types of equity investments are added together in order to determine whether the participation threshold is met. In addition, any debt financing that is recharacterized as equity for Swiss tax purposes may be taken into account.

6.7. Minimum holding period

Under Art. 15(1) of the Swiss-EU Agreement, the parent company must have a direct minimum holding of 25% of the capital of a subsidiary company for at least two years. This is an anti-abuse provision designed to prevent dividend stripping by way of a short-term concentration of small non-qualifying holdings in one hand in order to temporarily pass the 25% threshold.³⁸ The provision is similar to Art. 3(2) of the Parent-Subsidiary Directive, which permits each Member State to unilaterally deny the parent-subsidiary status to companies that do not hold shares (or whose shares are not held) for an uninterrupted period of at least two years. The two-year requirement is not consistently applied. Germany, for example, requires only one year, and the Netherlands has no such requirement.

Switzerland has confirmed that the holding period is grandfathered. In other words, if a dividend is distributed by a Swiss company immediately after the entry into force of the Swiss-EU Agreement, it can qualify

for relief if the otherwise qualifying shares have been held for at least two years at the time of the dividend distribution.

It has also been clarified that the dividend distribution may occur at any time during the two-year period as long as the participation is retained for two years. In other words, the participation need not necessarily have been held for two years before the dividend distribution.³⁹ Interestingly, the Swiss Federal Tax Administration has referred to the ECJ's decision in *Denkavit* to justify its position.⁴⁰ Indeed, in the combined cases referred to as *Denkavit*,⁴¹ the ECJ concluded that the Member States may not make the withholding tax exemption subject to the condition of an uninterrupted holding period until the actual distribution of profits; rather, the exemption should apply if the company submits reasonable guarantees that the holding period will be satisfied, even though the holding period has not been satisfied at the time the dividends are paid.

As a result of *Denkavit*, the Member States remain free to determine how to ensure that the holding period is observed where dividends are paid before the minimum holding period has expired.⁴² Switzerland has taken the position that dividends paid by Swiss companies before the expiration of the two-year period are subject to withholding tax under Swiss domestic law or a more favourable comprehensive tax treaty. If the participations on which the dividends were paid are still held at the end of the two-year period, the beneficiary may claim a refund from the Swiss Federal Tax Administration (Circular, Para. 5b). See 7.

6.8. Anti-abuse regulations

The provision in Art. 15(1) of the Swiss-EU Agreement – “[w]ithout prejudice to the application of domestic or agreement-based provisions for the prevention of fraud or abuse in Switzerland and in the Member States” – is not an autonomous anti-abuse clause. It does not introduce a supranational concept of abuse, but refers to the application of “existing” domestic or agreement-based provisions, i.e. “existing” at the time of the dividend distribution.

Switzerland has not introduced any new anti-abuse provisions to accommodate this requirement. In the Circular of 15 July 2005, however, the Swiss Federal Tax Administration confirmed the general principle that a shareholder of a Swiss company must be the actual beneficiary of dividends in order to qualify for relief. The Administration also indicated that “tax fraud and tax evasion” and “abuse of law” can be con-

37. Hull, *supra* note 2, at 72.

38. Terra and Wattel, *supra* note 31, at 179.

39. This is also the case when the Swiss-EU Agreement is applied to dividends between Switzerland and Luxembourg even though Art. 10 of the Switzerland-Luxembourg tax treaty requires that the two-year holding period be completed before the dividend distribution.

40. Circular, Para. 5b (despite the fact that the ECJ has no jurisdiction over the Swiss-EU Agreement).

41. *Denkavit International BV, VITIC Amsterdam BV and Voormeer BV v. Bundesamt für Finanzen* (Joined Cases C-283/94, C-291/94 and C-292/94).

42. Schwarz, J.S., “Current Issues under European Community Law on Cross-Border Dividends”, 55 *Bulletin for International Fiscal Documentation* 2 (2001), at 46.

sidered as "provisions for the prevention of fraud or abuse".

Based on these general principles, the Swiss Federal Tax Administration may deny or reduce the amount of treaty relief granted if the relationship between the Swiss subsidiary and the EU parent company is arranged or maintained primarily with the intention of securing treaty relief.⁴³ In order to correctly apply such anti-abuse provisions, Switzerland has introduced strict rules of application in its international tax treaties.⁴⁴ Indeed, the Swiss Federal Tax Administration requires that the shareholder be economically justifiable (valid business purpose) in order to avoid all doubt as to the reason for setting up the parent company. If there is any doubt as to the economic justification for the relationship between the Swiss distributing company and the shareholder, the 0% treaty rate will be denied.

In addition to the general principles of abuse of law, Switzerland has introduced provisions on the improper use of tax treaties, contained in the 1962 Abuse Decree and the 1962 Circular.⁴⁵ These provisions concern only inbound dividends and are therefore beyond the scope of this article, which is limited to outbound dividends. The anti-abuse rules in the 1962 Abuse Decree have nevertheless been largely incorporated into Switzerland's tax treaties with Belgium (Art. 22), France (Art. 14) and Italy (Art. 23), and they must in principle continue to be adhered to,⁴⁶ although we can query whether the subject-to-tax rules should remain applicable when the subject-to-tax rules in Swiss-EU Agreement are more lenient.

After it is determined that a company qualifies for treaty relief, the Swiss competent authority does not systematically apply the treaty rate to all the dividends distributed. If, for example, the shares of a Swiss company are transferred to EU residents after having been held by non-EU residents for a certain length of time, the reduced treaty rate will often be denied with respect to any open reserves existing at the time of the share transfer. This is the "old reserve theory", which is a Swiss unilateral measure aimed at limiting international tax evasion in the form of treaty shopping. Although highly contested, the theory is justified by the presumption that the open reserves existing before the share transfer should normally have been distributed to the previous non-EU shareholders. If the distribution had been made before the transfer of shares to the EU shareholders, the treaty between Switzerland and the residence state of the previous shareholders would have applied. It goes without saying that if, for some reason, the previous shareholders did not qualify for treaty relief on the dividend distributions, no relief from the Swiss withholding tax would be possible.

The Swiss Federal Tax Administration has clarified that the "old reserve theory" will not apply if a parent company finds itself in a more favourable position after the entry into force of the Swiss-EU Agreement (Circular, Para. 3). In other words, if a UK parent of a Swiss subsidiary, which would currently suffer a 5% withholding tax, no longer suffers a withholding tax under the Swiss-EU Agreement, the Swiss Federal Tax Administration will not claim the 5% withholding tax on the undistributed reserves existing in the Swiss sub-

siary at the time of the entry into force of the Swiss-EU Agreement.

6.9. Treaty provisions

According to Art. 15(3) of the Swiss-EU Agreement, the existing tax treaties between Switzerland and the EU Member States which provide a more favourable tax treatment for dividends, interest and royalty payments at the time the Agreement is adopted will remain unaffected. Art. 15 does not affect the existing bilateral treaties with other (third) countries which may be more favourable than the Agreement. Switzerland and the EU Member States also maintain their competence to conclude bilateral agreements.

As a rule, under the OECD Model, the tax rate in the source state of dividends is limited to 15% of their gross amount. If, however, the recipient shareholder is a company (other than a partnership) which holds directly at least 25% of the capital of the company paying the dividends, the tax rate in the source state is limited to 5% (Art. 10(2) of the OECD Model).

Comprehensive tax treaties may have more favourable rules than the Agreement:

- the participation threshold may be less than 25%;
- there may not be a minimum holding period;
- there may be a different residence requirement or subject-to-tax requirement; and
- the scope of qualifying legal forms may be greater.

Switzerland's recent tax treaties generally tend to reduce the withholding tax on dividend distributions to qualifying shareholders. Presently, Switzerland has a 0% rate on dividend distributions to qualifying shareholders in its tax treaties with Denmark (Art. 10(1)), Luxembourg (Art. 10(1)), the Netherlands (Art. 9(2)), Sweden (Art. 1, protocol of March 1992), France (Art. 11(2)(b), protocol of August 1997), Austria (Art. I, protocol of 20 July 2000) and Germany (Art. 3, Ordinance of 30 April 2003). This rate applies to the dividends distributed by Swiss subsidiaries to residents of the treaty state.

The conditions of the above-mentioned full relief are more favourable than those in the Swiss-EU Agreement. Indeed, although the 25% participation requirement is the norm (20% in the treaties with Germany and Austria and 10% in the treaty with France), the other qualifying conditions are significantly different. In particular, for the most part, they do not have a subject-to-tax requirement or a minimum holding period.

43. This would be a general application of the anti-abuse rules in Switzerland's tax treaties with the United Kingdom (Art. 10(3)(d)) and the Netherlands (Art. 9(2)(a)(i)).

44. Supreme Court judgement of 9 November 1984, ATF 110 Ib 287 = RDAF 1986, 142; Federal Tax Administration decision of 25 April 1979, RDAF 1979, 142.

45. Federal Decree on Measures Against the Improper Use of Tax Treaties concluded by the Swiss Confederation, adopted on 14 December 1962, RO 1962 1680 = RS 672.202.

46. Danon and Glauser, *supra* note 24, at 519.

7. PROCEDURES

7.1. Net remittance procedures

On 22 December 2004, the Swiss federal government adopted the Net Remittance Ordinance which covers the method of applying for the Swiss withholding tax relief on substantial participations held by foreign companies.⁴⁷ The Net Remittance Ordinance stipulates that, as of 1 January 2005, Swiss companies distributing qualifying dividends may directly apply the treaty withholding rate(s) prospectively without having to make the full 35% prepayment.

The new rules apply to dividends distributed on "substantial participations",⁴⁸ i.e. participations that qualify for an additional reduction or a full exemption from the Swiss withholding tax under a comprehensive income tax treaty or other international treaty (such as the Swiss-EU Agreement). Switzerland nevertheless retains the right to deny the application of the new rules if reciprocity is not granted by the residence state of the beneficiary.

Swiss companies intending to distribute dividends under the new net remittance procedures are required to obtain a ruling from the Swiss Federal Tax Administration before distributing any dividends. This is done by means of Form 823C. Certain information may be certified by the tax administration of the beneficiary's state. The Swiss authorities will verify whether the shareholder qualifies for treaty relief and then grant a written authorization. Thereafter, dividends paid must be declared on Form 108 (along with the other usual forms) within 30 days after the due date of the dividends.

Such a ruling is valid for three years, but it is subject to the requirement that any changes in the facts and cir-

cumstances be reported immediately by the dividend-paying company. The company retains the right to levy the full 35% withholding tax if it is in doubt as to whether the shareholder qualifies for treaty relief.

7.2. Minimum holding period procedures

On 15 July 2005, the Swiss Federal Tax Administration issued Circular No. 10,⁴⁹ which clarifies the procedures where a Swiss company pays a dividend on capital that was held by a qualifying company in an EU Member State for less than two years.

As mentioned above, although the Swiss-EU Agreement requires that shares in a Swiss company be held by a company in an EU Member State for a minimum period of two years to qualify for relief, a dividend may be distributed at any time during the two-year period as long as the participation is retained for two years. In other words, it is not necessary that the participation have been held for two years before the dividend distribution. This being established, the dividends are nevertheless initially subject to the Swiss withholding tax at the domestic tax rate of 35% or the more favourable treaty rate. It is only after the two-year period has lapsed that the shareholder of the Swiss company may claim a full refund under the Swiss-EU Agreement. This is done by filing Form 70.

47. Ordonnance sur le dégrèvement des dividendes suisses payés dans les cas de participations importantes détenues par des sociétés étrangères, dated 22 December 2004; supplemented by Circular No. 6 (see note 12, *supra*).

48. See Hull and Sturzenegger, *supra* note 13.

49. See note 12, *supra*.