taxanalysts
Respectfully disagreeable since 1970.
tax notes international
Volume 39, Number 6 ■ August 8, 2005

Limitation on Benefits Under Article 22 of the Switzerland-U.S. Tax Treaty

by Markus F. Huber and Matthew S. Blum

Reprinted from *Tax Notes Int'l*, August 8, 2005, p. 547

(C) Tax Analysts 2005. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Special Reports

Limitation on Benefits Under Article 22 of The Switzerland-U.S. Tax Treaty

by Markus F. Huber and Matthew S. Blum

Markus F. Huber is a partner with Ernst & Young in Zurich. Matthew S. Blum is a principal with Ernst & Young in Boston.

The authors are deeply indebted to Kay Hofmann and Andreas Helbing for research and editorial assistance, and Désirée Untersee for preparing the manuscript.

> "When I use a word," Humpty Dumpty said in a rather scornful tone, "it means just what I choose it to mean — neither more nor less."
>
> "The question is," said Alice, "whether you CAN make words mean so many different things."
>
> "The question is," said Humpty Dumpty, "which is to be master — that's all."
>
> — Lewis Carroll, *Through the Looking Glass,* 1875, Chapter 6.

The aim of this article is not to provide a comprehensive commentary on article 22 of the Switzerland-United States income tax treaty signed on October 2, 1996 (Swiss-U.S. treaty 1996), but to facilitate an understanding of the mechanics of the limitation on benefits (LOB) clause, and also to shed light on potential differences between the U.S. and Swiss interpretations. The treaty was signed in both the English and German languages and, following standard treaty practice, it was agreed that both texts have equal authenticity.[1] It is understood that the basic text was drafted in English and was then translated into German.

Switzerland generally drafts treaties in line with the OECD model income tax treaty, which does not contain a rule similar to the LOB clause. Some of the concepts in article 22 of the Swiss-U.S. treaty 1996 have been developed over the past few decades by U.S. treaty policy. Accordingly, the LOB is, to some extent, a new concept in Swiss law. Moreover, some of the expressions used in the English version of the LOB clause lack analogues in the German language. It is therefore quite interesting to note that in some parts of the LOB clause, the wording used in the different languages does not match. The conclusion and interpretation of income tax treaties is governed by public international law, and specifically — at

---

[1]Swiss-U.S. treaty 1996, closing paragraph.

(C) Tax Analysts 2005. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

least insofar as Switzerland is concerned — by the Vienna Convention on the Law of Treaties of May 23, 1969.[2]

According to article 31 of the Vienna Convention, treaties must be interpreted:

- using good faith;
- according to the ordinary meaning of the terms as required by the context; and
- according to the aim and purpose of the treaty.

Based on the second guiding principle, the conclusion has been drawn that if the wording of a treaty is clear, there is no room left for interpretation. Therefore, taking into consideration that the wording in the two different languages may not always match, one may assume that a purely grammatical interpretation of a treaty using the two different versions may lead to different results. That inconsistency is, of course, not in line with the purpose of a treaty, and it may be quite interesting to see how those potential conflicts will be resolved.

The problem of the legal concepts and terms of one country having no counterpart in another country is not unique to the Swiss-U.S. treaty 1996.[3]

I. History

In order to ensure capital import neutrality,[4] many countries — including the United States[5] and Switzerland[6] — introduced withholding taxes on certain items of income sourced in their jurisdiction. However, as a consequence of the introduction of source-country withholding taxes, most investors in cross-border situations suffered double taxation. First, there was taxation at the source of the return on their investment because the source country levied a withholding tax. Second, there was taxation in the recipient's country of residence, where the proceeds generally were subject to local income taxes. Such double taxation was due to a lack of methods to eliminate or mitigate the two levels of cross-border taxation, either by exempting certain items of income from one of the two levels of tax, or by providing for a credit in the second country for the taxes levied in the first country. It became clear that in order to encourage international investment flows, treaties needed to be in place. It was primarily the more developed countries that had a generally levied income tax in place, and hence, the need to have treaties in place arose between the more developed countries. The first parties to those treaties came from a relatively small circle of countries, consisting of the most important states of North America and Europe, contracting with each other in the immediate postwar period.

Before the publication of the first OECD model income tax treaty in 1963 (OECD MTC 1963), the contracting parties generally used the last treaty concluded as the basis for a new treaty. Most likely those treaties were modeled on the League of Nations draft.[7] The draft treaty was then fine-tuned to meet the needs of the contracting parties. The resulting treaty then may have been used as the basis for treaty negotiations with other countries. In other words, the treaties became more complex over time to include more sophisticated rules.

A. Switzerland-United States Treaty 1951

Article VI (2) of the Switzerland-United States income tax treaty of May 24, 1951 (Swiss-U.S. treaty 1951) contained an early form of an LOB clause. According to that clause, an entity resident in one of the contracting states that controlled, directly or indirectly, at least 95 percent of an entity resident in the other state generally would qualify for a reduced 5 percent withholding tax on dividends paid by the subsidiary, unless "the relationship of the two corporations has been arranged or has been maintained primarily with the intention of securing such reduced rate." The inclusion of the "maintained or secured clause" as the criteria to distinguish between proper and abusive use of the treaty was

[2]The Vienna Convention entered into force for Switzerland on June 6, 1990. The situation is different for the United States, which has not ratified the Vienna Convention. However, the U.S. Treasury, in connection with the Swiss-U.S. treaty 1996, has stated that the Vienna Convention reflects customary international law, at least in some instances (Technical Explanation, article 30). Furthermore, U.S. courts and administrative agencies appear to refer to the Vienna Convention as authority.

[3]For example, in line with article 5(2)(a) of the Swiss-U.S. treaty 1996, a "place of management" can create a permanent establishment, but this term is an attempt to translate into English a French term for a concept that has no exact counterpart in U.S. law. Similarly, the provisions in many treaties regarding when an agent creates a PE may reflect a misunderstanding between civil law concepts and the concepts of common law (that is, the system of law in English-speaking countries).

[4]That is, that investors from abroad are not subject to a tax that is significantly lower than the tax applied to domestic taxpayers.

[5]Initially at a rate of 10 percent, but increased several times during the early years of World War II, and eventually set to its current level of 30 percent in 1942.

[6]In 1945.

[7]League of Nations Draft Double Taxation Convention (1927), as updated by the Mexico and London drafts of 1943 and 1946, respectively. It is not known on what model the first Swiss treaties were modeled. The U.S. Treasury reportedly had an undisclosed model treaty for many years before the first U.S. model treaty was published in 1977. It is not known whether that model predated the 1963 OECD model income tax treaty.

(C) Tax Analysts 2005. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

standard practice and can be found in numerous other treaties concluded shortly after World War II.[8]

In addition, to the extent that the subsidiary in the other contracting state derived more than 25 percent of its gross income from interest and dividends other than from its own subsidiary corporations, the net final withholding tax was increased to 15 percent. The purpose of that rule is fairly apparent. A company resident in one of the contracting states that owned, directly or indirectly, 95 percent of an entity resident in the other state, which in turn owned qualifying investments for which it held at least 50 percent of the vote, would be entitled to benefit from the reduced withholding tax of 5 percent. Similarly, real operating companies deriving only small amounts of nonqualifying passive income also would be entitled to benefit from the reduced withholding tax of 5 percent. But portfolio holding companies investing in unrelated companies could remit dividends to their parent in the other contracting state only under a nonrecoverable withholding tax of 15 percent.

Swiss corporate income tax is imposed by both the federal government and the cantons. In the early 20th century, certain Swiss cantons began to introduce tax privileges for domiciliary companies (that is, companies that are resident in Switzerland, but do not carry on commercial or financial activities in Switzerland). Accordingly, the use of those companies was widespread when the treaty was negotiated. It would therefore be quite natural to conclude that the inclusion of such a rule was at the request of the United States, to prevent Swiss-based companies owning portfolio interests in subsidiaries from abusing the treaty by increasing the rate of final withholding tax to 15 percent. However, the same wording may be found in Article VI of the first United Kingdom-United States treaty of 1945, which was used as the template for wording the Swiss-U.S. treaty 1951. Consequently, the inclusion of those clauses formed part of U.S. treaty practice at that time.

B. Swiss Unilateral Anti-Treaty-Shopping Rules of 1962

In the 1960s, offshore financial centers arose in many jurisdictions. Some of them were former colonies and inherited a tax treaty network from their parent countries through an agreement to extend the application of the former parent's treaties to them.[9] Those jurisdictions sometimes then adjusted their internal laws in such a way as to take advantage of the treaties and, at the same time, attract holding companies that could perform a base or conduit function in relation to the United States.

> ***Switzerland is in a difficult position, as it is itself a major center of commerce and industry and, as such, needs to be able to participate in the tax treaty network.***

As a result of numerous factors, Switzerland in the 1950s and 1960s became an attractive location for foreign investors to bundle their investments, either by setting up holding companies or by having companies with a relatively low physical presence hold securities or intellectual property. Those companies generally could invoke treaty protection without any further restriction. Unlike the offshore financial centers, which can dispense with income tax treaties, Switzerland is in a difficult position, as it is itself a major center of commerce and industry and, as such, needs to be able to participate in the tax treaty network. Some of the countries with which Switzerland had concluded treaties were concerned about certain planning opportunities that, in their eyes, could be abusive. In order to decrease the risk that some of the countries would terminate their treaties with Switzerland or introduce unilateral measures against strategies that were viewed as being problematic, Switzerland in 1962 introduced comprehensive unilateral measures (hereinafter BRB 62)[10] to protect the source state from treaty shopping through the use of Swiss companies based on the principle of "*abus de droit,*" or abuse of law.[11]

---

[8]For example, the same wording is found in Article VI of the first United Kingdom-United States income tax treaty of Apr. 16, 1945.

[9]For example, in 1955 the treaty between the United States and the Netherlands was extended to the Netherlands Antilles, and in 1958 the treaty of 1945 between the United States and the United Kingdom was extended to 20 British overseas territories. *See* Picciotto, *International Business Taxation*, 1992, p. 158.

[10]*Bundesratsbeschluss* (BRB, or Federal Decree) of Dec. 14, 1962, on the improper use of tax treaties, including the update of *Kreisschreiben* (KS or Circular letter) of the Swiss Federal Tax Administration of Dec. 17, 1998, (in the revised version of December 2001), the latter referred to as BRB 62/KS 99.

[11]West Germany and France were especially concerned about the growth of holding companies in Switzerland, and put pressure on Switzerland to limit its use for both base and conduit companies, and to negotiate new treaties with anti-avoidance provisions. This development, however, was accompanied by critical comments, one of which denies the contracting states the right to amend the income tax treaty on the grounds that the tax burden in Switzerland is generally lower than abroad.

(C) Tax Analysts 2005. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

C. Milestones Marking the Route to LOB

Many countries agreed in their treaties to lower withholding tax rates for dividend, interest, and royalty payments to those recommended by the OECD in its model tax treaty 1963[12] in order to attract private investments, or to facilitate the setting up of holding companies in their jurisdictions by granting a participation exemption on dividends paid by the holding companies' subsidiaries.

Thus, U.S. lawmakers became concerned about treaty shopping. Consequently, the United States refused treaty benefits unilaterally — in some cases through the application of the sham transaction doctrine and, subsequently, through the application of the conduit doctrine. Furthermore, the United States amended its tax law[13] and started to introduce an LOB clause in its income tax treaties.

Article 16 of the U.S. model treaty 1977[14] denies treaty benefits to a company resident in a contracting state if both of the following tests are met: first, if more than 25 percent of the company's capital is owned by nonresident persons; and second, if the dividend, interest, or royalty income of the company is taxed at a substantially lower rate than its regular corporate profits.

Article 16 of the U.S. model treaty 1981 was the start of the modern LOB clause. It provided for alternative threshold tests, including the stock exchange test (article 16(1)(a)), the base erosion test (article 16(1)(b)), the principle purpose test (article 16(2)), and the "lower tax rate on treaty-benefited income" limitation (article 16(3)).

The next major development in U.S. LOB policy was the branch profits tax, enacted in 1986. Historically, the U.S. tax system did not regard a branch as a separate entity for tax purposes. In order to treat foreign-owned U.S. businesses the same way regardless of whether they are organized in the form of a separate U.S. legal entity or a branch of a non-U.S. legal entity, the United States has, since 1986, been levying the branch profits tax on transfers of profits from a U.S. branch of a non-U.S. legal entity to its head office. This tax was enacted at a time when the United States was becoming concerned about perceived misuse of treaties, but many important U.S. treaties (such as the Swiss-U.S. treaty 1951 and the U.K.-U.S. treaty 1945) did not contain an LOB provision. Accordingly, a special provision of U.S. domestic law was enacted to address the issues of what requirements must be met by a resident of a foreign country in order to be in a position to invoke treaty restrictions on the imposition of the branch profits tax in cases where the treaty does not contain a modern LOB provision.[15] The statute and regulations under the branch profits tax contain an ownership and base erosion test, a more refined public trading test, an active trade or business test, and a provision allowing discretionary relief for deserving cases that are not otherwise covered.

Article 22 of the Swiss-U.S. treaty 1996 was, at least to a certain extent, modeled after the U.S. unilateral rules providing for treaty benefits under the branch profits tax. In other words, article 22 of the Swiss-U.S. treaty 1996 is, in some ways, comparable to the U.S. Treasury regulation under the branch profit tax rules.[16] However, the Swiss-U.S treaty 1996 provides for opportunities for treaty benefit eligibility that are not provided for under the branch profits tax regulations.

The Netherlands-U.S. income tax treaty of December 18, 1992, introduced in article 26 the "sufficient nexus" requirement and further refinements in the LOB clause, such as the headquarters test and the active trade or business test. Obviously, the tough negotiations, which lasted more than a decade, did not contribute to tidy documents.[17]

---

[12]In the OECD model tax treaty 1963, the following maximum rates were recommended: 15 percent and 5 percent for "portfolio" and related-party dividends, respectively; 10 percent for interest payments; and zero percent for royalty payments.

[13]For example, the U.S. Tax Reform Act of 1986 contains several provisions designed to prevent treaty shopping.

[14]If 25 percent or more of the capital of a company that is a resident of a contracting state is owned, directly or indirectly, by individuals who are not residents of that state, and if by reason of special measures, the tax imposed by that state on that company with respect to dividends, interest, or royalties arising in the other contracting state is substantially less than the tax generally imposed by the first-mentioned state on corporate business profits, then, notwithstanding the provisions of article 10 (Dividends), 11 (Interest), or 12 (Royalties), that other state may tax such dividends, interest, or royalties.

[15]This imposition of an LOB provision for treaties that do not contain one is, of course, an outright unilateral denial of treaty benefits, but the United States does not shrink from that.

[16]Treas. reg. section 1.884-5. Joint Committee on Taxation Explanation (JCS-16-97, Oct. 6, 1997) made the following statement in that regard: The LOB provisions are "in some ways comparable to the U.S. Treasury regulation under the branch tax definition of a qualified resident."

[17]The Netherlands reportedly was not pleased about renegotiating its income tax treaty with the United States so as to include an LOB clause. However, the United States terminated the extension of the Netherlands-U.S. treaty to the Netherlands Antilles in 1984 (with a limited exception for certain outstanding bond issues), and it was feared that the United States was prepared to terminate the entire Netherlands-U.S. treaty if it was not successfully renegotiated — as, indeed, the United States was later to do with Malta.

(C) Tax Analysts 2005. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

(C) Tax Analysts 2005. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

However, any such LOB provision must take into account not only the tax law of the particular country involved, but also its regulation of foreign exchange, banking, and financial markets in general, and the pattern of investments between the contracting states. Therefore, antiabuse provisions in treaties have become more specific and have been negotiated heavily between the contracting states. Ever since the current version of the Netherlands-U.S. treaty 1992 was drafted, the United States has successfully insisted on including a comprehensive LOB clause in its tax treaties. Historically, LOB provisions have been "one-way" provisions in practice, in that although they applied to residents of both the United States and the treaty partner, treaty partners typically did not bother to enforce them against U.S. residents, with a partial exception for the Netherlands. New procedures implemented by Japan in the summer of 2004 under the new Japan-United States income tax treaty of November 6, 2003, include a rigorous implementation of the LOB provisions in that treaty against U.S. residents. It will be interesting to see how the United States likes having to take a dose of its own medicine.

D. Swiss-U.S. Treaty 1996

The U.S. government initiated negotiations for updating the Swiss-U.S. treaty 1951 around the early 1980s. Switzerland's view as to why the update took so long is as follows: The chief of the section of the U.S. Treasury in charge of international tax policy, the international tax counsel, is one of very few political positions in the U.S. tax administration and, as such, each new U.S. administration can replace the person who may be the key decision-maker negotiating the treaties. Apparently, there were frequent changes on the U.S. side, so discussions frequently stalled until the new team became operational.

In addition, it may be fair to assume that Switzerland did not view renegotiation of the Swiss-U.S. treaty 1951 as a top priority, and Switzerland may not have viewed it as a high priority for the United States either, because the U.S. negotiating team acknowledged that the BRB 62 provided certain effective means against treaty shopping. Furthermore, it is common knowledge that it was difficult to reconcile the Swiss and U.S. views on the appropriate scope of the exchange-of-information clause. And last but not least, the Swiss negotiating team objected to an extensive LOB clause because it felt that the Swiss parliament would never accept it.

However, even given those unresolved issues, it is remarkable that it took close to 17 years to finalize the new treaty. Although negotiations often stalled during the course of those 17 years, toward the end of that period, the negotiations gained considerable momentum and, within a few additional rounds that were scheduled on short notice, a final agreement was reached. In that respect, it should also be noted that during the 1990s the United States renegotiated numerous treaties with European countries. It may therefore be assumed that there was also certain pressure from those countries that had to accept the insertion of an LOB clause in their treaties with the United States to have the treaty with Switzerland finalized, so that Switzerland would not have a competitive advantage. What history makes clear is that the insertion and formulation of the LOB clause in the Swiss-U.S. treaty 1996 was the result of American negotiation power and policy in the 1990s.

The Swiss unilateral treaty shopping rules (BRB 62), as amended by the circular letter of 1999, are overridden in their entirety by the treaty's LOB clause because in Switzerland, the treaty is considered to be a special rule that addresses the topic of abuse of the Swiss-U.S. treaty 1996 in full, leaving no room for the general principles of the Swiss treaty shopping rules.

It will be interesting to see how the United States likes having to take a dose of its own medicine.

Yet, at least some of the spirit of BRB 62 found its way into the Swiss-U.S. treaty 1996, as the "predominant interest" test used in the treaty deviates from the generally used language of U.S. LOB provisions "in order to blend certain principles found in Swiss domestic law with U.S. ownership/base erosion concepts."[18]

II. Purpose of LOB

As mentioned above, the United States took the view that an income tax treaty with benefits that can be claimed by all residents of the other contracting state poses a high risk of misuse by third-country residents (which have no tax treaty with the United States, or have one with less beneficial rates) interposing a conduit company in the contracting state and thus getting access to treaty-benefited income.[19] In particular, to the extent that the former

---

[18]*See* Technical Explanations, article 22, regarding "Predominant Interest Test."

[19]Testimony by the U.S. Treasury Department's international tax counsel before the U.S. Senate Foreign Relations Committee on Oct. 27, 1999, states in part that the "second major objective of our income tax treaty program is to prevent tax avoidance and evasion and to ensure that treaty benefits flow only to the intended recipients."

Netherlands-U.S. treaty, to choose an example at random, would enable residents of all countries to invest in the United States via a treaty-protected holding company, the United States was concerned that other countries had little incentive to agree to beneficial income tax treaties with the United States. It is interesting to note that after the renegotiation of the Netherlands-U.S. treaty, the long-stalled Israel-United States draft income tax treaty finally came into force[20] and the Canada-United States treaty[21] was successfully amended. Thus, the United States believes that its concern that treaty shopping gave other countries no incentive to enter into tax treaties was justified. One measure against treaty shopping is — according to the U.S. view — an increase in certain minimum standards regarding the nexus of a beneficiary with the country of residence/incorporation:[22] If a beneficiary has no close nexus with the country of residence/incorporation, and the base in the contracting state appears to be motivated by the aim to take advantage of the tax treaty, then treaty benefits should be denied. The determination of the taxpayer's intent is not an easy task and hence, a cascade of tests has been elaborated to provide an objective guidance. If one of the tests is successfully passed, one may conclude that a real business purpose or a close nexus between the company and country of residence exists, and treaty benefits may be granted.[23] It must be noted that some of the tests provide for treaty benefits without reservation,[24] while others provide treaty benefits only for certain items of income.[25]

III. Analysis of LOB

Article 4 of the Swiss-U.S. treaty 1996 contains rules for determining the residency of individuals for treaty purposes. Consequently, article 22(1)(a) states that an individual who is resident in one of the contracting states qualifies for treaty benefits. Governmental bodies qualify for treaty benefits according to article 22(1)(b), provided that they are a contracting state or part thereof, or are part of a subdivision as defined in the relevant section. However, as far as corporations, trusts, and estates' entitlement to the treaty benefits is concerned, it may be somewhat more difficult to determine whether they are bona fide residents. Accordingly, a series of tests (described later) is applied to confirm that the potential beneficiary has a close nexus with one of the contracting states or has a real business purpose for the structure it has adopted.[26] Accordingly, if a resident of one of the contracting states meets one of those tests, one may exclude the hypothesis that such residence is primarily motivated by treaty-shopping purposes.

The determination of the taxpayer's intent is not an easy task and hence, a cascade of tests has been elaborated to provide an objective guidance.

From a logical perspective, the tests need to be applied one after the other until the prospective beneficiary meets one of the requirements and thus qualifies for treaty benefits. However, the wording of the treaty does not follow the logical order of the tests. If one follows the schematic below, then the following conclusions may be drawn: The fewer tests one has to pass, the broader the scope of benefits or, alternatively, the more tests one has to pass, the narrower the scope.

Furthermore, there are three different levels of tests:

- The first level determines whether the beneficiary is a bona fide resident[27] of the country of residence. If the answer is positive, the beneficiary gets treaty coverage on all items of income.
- The second level determines whether the beneficiary has sound business reasons[28] for deriving the income through an enterprise resident in one of the contracting states. If the answer is in the affirmative, the beneficiary may claim treaty benefits on the income derived in connection with, or incidental to, that trade or business.
- The third level examines whether the beneficiaries may achieve lower rates of net final withholding taxes by interposing a company in one of the contracting states. If that is not the case,

[20] Israel-United States income tax treaty of Nov. 20, 1975 (general effective date under article 31: Jan. 1, 1995).

[21] The Canada-United States income tax treaty of Sept. 26, 1980, as amended on Mar. 17, 1995.

[22] *See* Technical Explanations, article 22, regarding "Purpose of Limitation on Benefits Provisions"; another measure to prevent tax avoidance and treaty misuse was the exchange of information between tax authorities.

[23] *Id.*

[24] Article 22(1)(a), (b), (e), (f), or (g) of the Swiss-U.S. treaty 1996.

[25] Article 22(1)(c), (d), and (3) of the Swiss-U.S. treaty 1996.

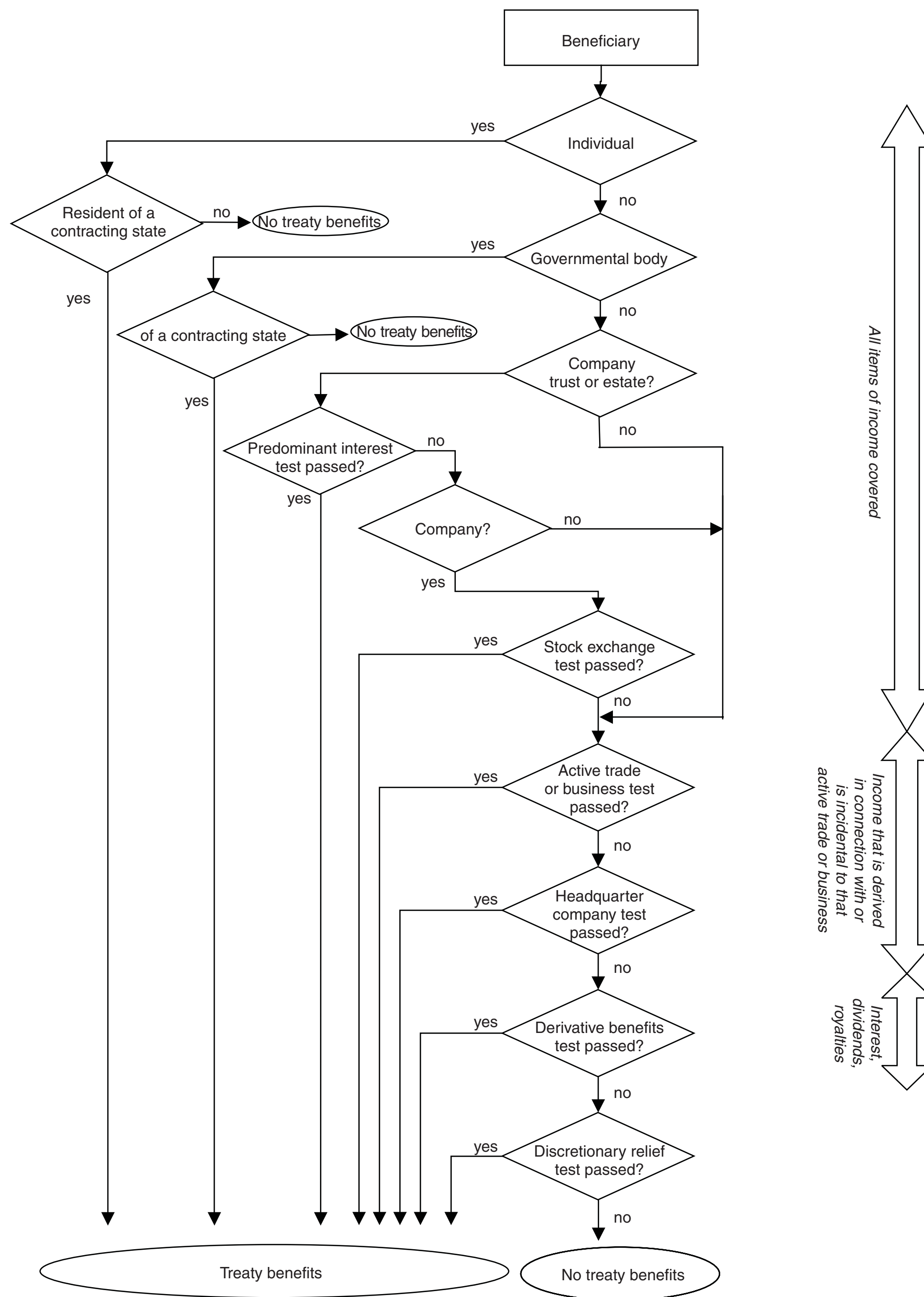
[26] *See supra* note 22.

[27] Article 22(1)(a), (b), (d), (e), (f), or (g), Swiss-U.S. treaty 1996.

[28] Article 22(1)(c), Swiss-U.S. treaty 1996.

(C) Tax Analysts 2005. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Figure 1. Schematic of Article 22 Swiss-U.S. Treaty 1996



then the interposition is not primarily motivated by treaty shopping purposes and the company can claim treaty benefits on interest, dividends, and royalties derived from the other contracting state.

IV. Problems With LOB

On one hand, the Swiss-U.S. treaty 1996 provides residents of the two contracting states with relief regarding potential double taxation, and limits the

(C) Tax Analysts 2005. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

application of domestic tax law. On the other hand, the LOB clause limits the wide class of beneficiaries under article 4 that otherwise could claim treaty benefits. Therefore, being resident in one of the contracting states is no longer sufficient for entitlement to treaty benefits; one also must fulfill the requirements of the LOB clause. Certain commentators have therefore suggested that the LOB clause is "a sophisticated legal contraption that limits the Personal Scope article of a treaty."[29] Indeed, it is true that article 22 denies treaty benefits to certain persons that qualify under article 4 as being resident of one of the contracting states. But discrimination consists of drawing an improper distinction between cases that should be treated alike. The view of the United States is that the case of a Swiss company owned by (for example) residents of Saudi Arabia and not carrying on business in Switzerland is not comparable to the case of a Swiss company owned by American or Swiss residents, carrying on an active business in Switzerland, or otherwise having a substantial nexus with Switzerland. Thus, the aim of article 22 is not to discriminate against certain residents, but to define additional criteria that must be met in order to avoid what is deemed by the contracting states to be an abusive use of the applicable treaty. Therefore, one should view article 22 as a more comprehensive definition of the term "resident of one of the contracting states," completing the process initiated in article 4 of the Swiss-U.S. treaty 1996.

> ***Being resident in one of the contracting states is no longer sufficient for entitlement to treaty benefits; one also must fulfill the requirements of the LOB clause.***

The LOB concept is not found in the OECD model income tax treaty. One may be tempted to view it as a purely American concept, but that may not be entirely true. First, as already indicated, Switzerland developed an early form of anti-treaty-shopping rules in the form of BRB 62, which was, however, a unilateral concept. Second, some of the treaties that Switzerland concluded after the enactment of BRB 62 contained the tests developed by BRB 62.[30] Third, there is some guidance indicating that part of the LOB was modeled to blend certain principles found in U.S. and Swiss practice.[31] Nevertheless, it would be fair to say that the Swiss influence on the LOB clause as it exists in the Swiss-U.S. treaty 1996 is relatively minor, and it may therefore be labeled a one-sided concept developed over a considerable period of time by the United States.

Experience with the early LOB provisions showed that certain issues had not been adequately covered, and as they arose, additional paragraphs were added to later LOB clauses, which do not add to the ease of reading. In that respect, one may note that the ultimate beneficial owner test according to article 22(1)(f) provides for treaty benefits on all items of income. Therefore, from a logical perspective — being basically the analogue test for persons who are neither individuals dealt with in article 22(1)(a) nor governmental bodies dealt with in article 22(1)(b) — the ultimate beneficial owner test should have been included as article 22(1)(c). "As we have pursued our goal of updating our existing treaties to eliminate treaty shopping abuses, however, we have seen an increasing number of other types of transactions that seek to use treaties to achieve inappropriate results."[32]

One fundamental problem in drafting an LOB clause is a difference in points of view. One can imagine at least three possible ways to draft an LOB provision, or indeed, any statute or other legal command:

- Prescribe a general standard of conduct without detailed rules. This may provide very fair results in particular cases, but is open to the objection that the object of the law cannot know with certainty whether he has complied with the law until the judge decides, after the fact.
- Prescribe a coarse-grained set of rules. That gives more certainty, but inevitably is not rich enough to provide the desired answer in all the complex situations that may be encountered. Furthermore, the shrewd will conclude that as long as they can stay within the letter of the law, they will be safe, even if their actions are contrary to the law's spirit.
- Prescribe a fine-grained set of rules. That attempts to provide directions that are rich enough to provide the desired answer in detail in all cases. The problem is that life is richer and more complex than any set of rules. As new situations arise, one is tempted to make the rules more and more complex to address them. Eventually, the excessively baroque edifice will collapse under its own weight.

[29]Limitation on Benefits and the Competent Authority Determination, Bulletin for International Fiscal Documentation, 21 (1996).

[30]Article 22 of the Belgium-Switzerland income tax treaty of Aug. 28, 1978; article 23 of the Germany-Switzerland income tax treaty of Aug. 11, 1971; article 14 of the France-Switzerland income tax treaty of Sept. 9, 1966; and article 23 of the Italy-Switzerland income tax treaty of Mar. 9, 1976.

[31]*See supra* note 18.

[32]*Id.*

(C) Tax Analysts 2005. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

(C) Tax Analysts 2005. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

The first approach — setting forth general standards of conduct — is more consistent with the Swiss civil law tradition. The problem is that it is difficult to define the desired standard of conduct here. The general concept of, for example, car theft is sufficiently well understood that one can draft a rule merely saying that one may not take possession of a car without the owner's consent. It is unnecessary to provide a detailed list of forbidden actions, such as breaking windows, disabling alarms, and using special keys. But the aim of the LOB clause is to provide protection against treaty abuses, which is an abstract goal, and reasonable minds can argue about its scope.

> ***It is highly unlikely that an LOB provision can be perfected that would contain a comprehensive series of tests that cover all prospective situations that may be deemed to be abuse of a treaty.***

The United States prefers a more detailed approach, both because of the ambiguity and because of the risk of judges reading the law woodenly, without thinking about broader implications, and also to narrow the scope of taxpayers taking aggressive positions based on a superficially plausible reading of the law. Admittedly, it is not always safe to underestimate the ability of a U.S. judge to attack an abuse using general principles of the tax law. That said, *abus de droit* is not well developed as a systematic doctrine in U.S. law. It would appear that the United States was able to use its negotiating power to obtain an LOB clause that reflected its preferences.

Thus, U.S. LOB provisions contain tests that attempt to define certain situations that may be deemed to be abusive. The advantage of those tests is that they are objective. However, experience indicates that in reality, new plans are always being developed in order to achieve certain goals. It is therefore highly unlikely that an LOB provision can be perfected that would contain a comprehensive series of tests that cover all prospective situations that may be deemed to be abuse of a treaty. Therefore, one may conclude that the LOB is still in the process of being refined in the course of new treaty negotiations by the United States. It also may be fair to assume that the complexity of the LOB will grow substantially in the future.

V. Beneficiary

There are basically three different classes of beneficial owners:

- individuals;
- public establishments; and
- others, meaning those that do not fall into either of the other two categories.

A. Individuals

1. Resident

An individual resident in one contracting state may claim the benefits provided for in the treaty.[33] The term "resident of a contracting state" is defined in article 4 of the Swiss-U.S. treaty 1996.[34] In general, a person is resident of a contracting state if he is subject to tax based on his essential connection with the state (for example, his domicile, residence, nationality, place of management, or place of incorporation). There is no specific requirement that a person be subject to tax on his worldwide income in that state in order to be a resident.[35]

This is not specific to the Swiss-U.S. treaty 1996. For example, article 4(1) of the France-United States income tax treaty of August 31, 1994, like article 4(2) of the Swiss-U.S. treaty 1996, provides that a person is not a resident of France for treaty purposes if he is subject to French tax only on income from sources in France. France taxes French corporations on the territoriality principle, but no one suggests that French corporations cannot qualify for benefits as residents of France under the France-U.S. treaty because they are not subject to French tax on their worldwide income. Article 4(2) of the Swiss-U.S. treaty 1996 must be read to mean that a person is a resident of Switzerland if Switzerland *could* justly subject him to Swiss tax on his worldwide income on account of his Swiss domicile, residence, nationality, place of management, or place of incorporation — in other words, that Switzerland could justly say "he is one of us," regardless of whether Switzerland actually subjects him to Swiss tax on his worldwide income.[36]

2. U.S. Concept

According to U.S. tax laws, U.S. citizens, non-U.S. citizens with the right of permanent residence in the United States (green card holders), and certain non-U.S. citizens who meet a test of substantial presence in the United States are subject to U.S. income tax on their worldwide income, regardless of their place of residence. Accordingly, U.S. citizens

---

[33]Article 22(1)(a), Swiss-U.S. treaty 1996.

[34]The Swiss-U.S. treaty 1951 did not have such a comprehensive definition.

[35]Article 4(1)(a), Swiss-U.S. treaty 1996.

[36]Indeed, the United States has issued regulations specifically providing that a charitable entity can be a resident of a treaty country and derive income for purposes of the treaty even if, under that country's laws, the entity is tax-exempt. Treas. reg. section 1.894-1(d)(6), example 11.

and green card holders qualify for treaty benefits unless another rule in the treaty itself excludes them from those benefits.

Under the Swiss-U.S. treaty 1996, such persons are not considered resident in the United States for treaty purposes unless they have a substantial presence, permanent home, or habitual abode there. In other words, if U.S. citizens or green card holders are resident in a third country, they will be excluded from the benefits of the treaty.[37] According to article 22(1)(a) of the Swiss-U.S. treaty 1996, an individual who is resident in one of the contracting states may claim treaty benefits without any further restriction.

Given the fact that U.S. citizens and green card holders are considered to be subject to tax in the United States regardless of their place of residence, U.S. treaties include special rules regarding the personal scope. U.S. treaties therefore generally include a clause providing that, regardless of the treaty, the United States may treat U.S. citizens under its own laws as if the treaty had not come into effect (article 1(2), Swiss-U.S. treaty 1996). That clause generally is referred to as a "savings clause,"[38] because without it, the United States would be prohibited under the treaty from enforcing its internal rules against residents of the other state. Under article 4(3) and (4) of the Swiss-U.S. treaty 1996, if green card holders are considered to be resident in Switzerland, their unlimited U.S. tax liability will cease because of the wording of the savings clause.[39] In other words, the treaty overrides U.S. internal law for those green card holders.

3. Swiss Concept

According to Swiss tax law, individuals are subject to unlimited income tax liability if they are tax residents of Switzerland. An individual is considered to be a tax resident of Switzerland if he or she is domiciled in Switzerland[40] or stays in the country for a certain period of time.

An individual is domiciled in Switzerland if he or she resides in Switzerland with the intent of staying on a long-term basis (domicile by intent) or if Swiss federal tax law specifically assigns him or her a Swiss domicile.[41] An individual may also become resident for tax purposes in Switzerland if he or she stays in Switzerland for at least 30 days with gainful employment, or for at least 90 days without gainful employment, regardless of temporary interruptions, if any.[42]

4. Lump-Sum Tax Arrangements

Another feature in connection with being resident in Switzerland has been introduced in article 4(5) of the Swiss-U.S. treaty 1996 by way of a condition that the individual must be subject to ordinary Swiss income tax. That provision disqualifies individuals who are taxed under a lump-sum agreement from the benefit of the treaty. The U.S. view is that "a person who would otherwise be treated as a resident of Switzerland will not be considered a resident of Switzerland for purposes of the Convention if the person makes an election under Swiss law not to be subject to the income tax on residents."[43] However, the wording of article 4(5) of the Swiss-U.S. treaty 1996 does not support that view in all cases. According to the general principle that if the wording of a provision is clear, there is no room left for interpretation, it remains to be seen how the United States could defend its position. Admittedly, given the fact that the regime of lump-sum taxation is not recognized under U.S. tax law, it is not entirely certain that the United States has considered the following scenario.

Suppose a resident of Switzerland agrees, as is possible, to be subject to tax either on a lump sum or on his income from U.S. sources, whichever is greater. The Swiss view is that such an individual could qualify for treaty benefits, as he would pay no less Swiss tax than he would if he had been subject to the generally imposed Swiss income taxes on his income from sources in the United States. Furthermore, as noted above, it is clear that one can be a resident of a country for treaty purposes without being subject to its taxes on worldwide income. Contrary to the U.S. view, the Swiss view follows the strict wording of the paragraph and allows an individual to benefit from the treaty if all items of income from the United States are subject to taxation in Switzerland. The view that an individual who is taxed on a lump-sum basis and is subject to ordinary taxes on all items of income from the other states should be considered to be a resident of the

[37]Article 4(1)(a), Swiss-U.S. treaty 1996. This is a very curious provision, as under U.S. law, U.S. citizens are always subject to U.S. tax on their worldwide income, regardless of their residence, and the United States is never willing to concede that point in its tax treaties. It would seem that Switzerland took the view that a U.S. citizen who is a resident of, say, Japan for Japanese tax purposes and derives income from Switzerland should fall under the Japan-Switzerland treaty, not the Swiss-U.S. treaty.

[38]Technical Explanations regarding paragraph 2, article 1(1)(8).

[39]Article 4(1), Swiss-U.S. treaty 1996.

[40]Article 3(1), Federal Direct Tax Law (DTL) of Dec. 14, 1990, and article 3(1), Federal Tax Harmonization Law (THL) of Dec. 14, 1990.

[41]Article 3(2), DTL, and article 3(2), THL.

[42]Article 3(3), DTL, and article 3(1), THL.

[43]Technical Explanations regarding paragraph 5.

(C) Tax Analysts 2005. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

first state is embedded in most of the treaties concluded by Switzerland and represents standard Swiss treaty policy. That is in line with the general practice applied by Swiss tax authorities and supported by their internal guidelines.[44]

B. Public Establishments

The government of a contracting state, a political subdivision or local authority thereof, or any agency or instrumentality of any such government, subdivision, or authority is a resident of the contracting state and thus qualifies for the benefits provided for in the treaty without any further tests.[45] The Memorandum of Understanding (MOU) provides a definition of government that includes, among other things, a corporation (other than a corporation engaged in commercial activities) that is wholly owned, directly or indirectly, by a contracting state.[46]

According to article 22(1)(b), a public establishment that is resident in one of the contracting states in line with the above may claim treaty benefits without any further restriction.

C. Others

This category comprises all classes of beneficial owners that do not fall into the above-mentioned groups (primarily companies, trusts, estates, foundations, associations, and so on). In order to establish whether the beneficiary is a bona fide resident of one of the contracting states, the concept of predominant interest in an entity has been developed. Furthermore, an additional series of tests has been developed to establish that a taxpayer that satisfies the requirements of any test probably has a real nontax purpose for the structure it has adopted, or has a sufficiently strong nexus with the other contracting state.[47] That nexus or business purpose outweighs any treaty shopping purpose.

VI. Tests

A. Ultimate Beneficial Owner Per Article 22(1)(f)

1. Legislative History

According to the U.S. model income tax convention 1996 and most income tax treaties concluded by the United States, there is no abuse of the treaty by a resident person (other than an individual) of a contracting state if: at least 50 percent of the resident person's capital is owned by persons who are themselves entitled to treaty benefits (beneficial ownership test); and no more than 50 percent of the resident person's gross income is used, directly or indirectly, for payments to persons who are themselves not entitled to treaty benefits (base erosion test).

Interestingly, the Swiss-U.S. treaty 1996 did not set those two tests out as distinct tests that both must be met,[48] but instead combined them in the requirement of *predominant interest* as outlined in article 22(1)(f):[49] Persons, not being entitled to treaty benefits themselves, may not be in the aggregate the ultimate[50] beneficial owners of a predominant interest in the form of a participation or otherwise in a company, trust, or estate. That is, to a certain extent, a new concept that attempts to blend certain principles found in Swiss domestic law with U.S. ownership/base erosion concepts.[51]

2. Differences in Wording

The English version of article 22(1)(f) of the Swiss-U.S. treaty 1996 provides that treaty benefits are available to an entity "unless one or more persons who are not entitled to the benefits of this Convention under subparagraphs a), b), d), e) or g) are, in the aggregate, the ultimate beneficial owners of a predominant interest in the form of participation or otherwise, in such company, trust or estate."

The version in the German language reads (in a translation into English) as follows: treaty benefits are available to an entity "unless one or more persons who are not entitled to the benefits of this Convention under subparagraphs (a), (b), (d), (e) or (g) do have an aggregate predominant interest in the form of participation or otherwise, in such company, trust or estate."

Accordingly, in the German version, the words "ultimate beneficial owners" are missing. From a linguistic perspective, an analogue to that term in the German language could easily have been found, as articles 10(2), 11(1), and 12(1) use similar language by referring to "beneficially owned" by a

[44]Circular letter no. 9 of the Swiss Federal Tax Administration, Dec. 3, 1993.

[45]Article 4(1)(b) and article 22(1)(b), Swiss-U.S. treaty 1996.

[46]MOU, "1. In reference to paragraph 1(b) of Art. 4 (Resident)."

[47]*See supra* note 22.

[48]With the exception of a family foundation resident in Switzerland for which the beneficial ownership and base erosion tests apply. (*See* article 22(1)(g), Swiss-U.S. treaty 1996.)

[49]For the sake of completeness, article 22(1)(e)(ii), Swiss-U.S. treaty 1996, also refers to the ultimate beneficial owners in the context of the stock exchange test.

[50]It is understood that the test will look through one or more entities to the ultimate beneficial owner when necessary.

[51]*See supra* note 18.

(C) Tax Analysts 2005. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

resident of a contracting state. The corresponding part of the German version uses the same language (that is, it also refers to the "beneficial owner"),[52] which is an even more literal translation than is usually found in most treaties concluded by Switzerland. Following a grammatical interpretation, one could assume that the text in German covers a broader scope of persons that are excluded, as one of the additional restrictions is not reflected. It will be interesting to research whether the differences in wording result in different interpretations in the contracting states.

3. U.S. Concept of Predominant Interest

A predominant interest is a direct or indirect interest of more than 50 percent.[53] According to the Technical Explanations, the predominant interest test performs the same function as the ownership/base erosion test, but "the predominant interest test was used in this context in order to blend certain principles found in Swiss domestic law with U.S. ownership/base erosion concepts."[54]

> ***From a Swiss perspective, it is quite clear that the reference in the Technical Explanations to Swiss principles found in domestic law refers to the Swiss unilateral anti-treaty-shopping rules.***

The Technical Explanations talk about a twofold predominant interest test. On one hand, the ultimate beneficial ownership of the predominant *equity* interest in the entity in the aggregate is examined (the ownership test), and on the other hand, the ultimate beneficial ownership of the predominant interest in the entity, whether equity, debt, or contractual,[55] is examined (the combined test).

It is the U.S. view that before the combined test is applied, the ownership test must be met. For example, if more than 50 percent of the shares in a company are owned by qualifying persons, it will next be determined whether access to the treaty benefits by the company is denied because a predominant interest in the company is held by persons that are not entitled to treaty benefits. Having said that, if the majority of the shares of the company are owned by nonqualifying persons, the predominant interest test stops and the company is not entitled to the treaty benefits, unless it qualifies under one of the other tests as described below.[56] The examples provided by the MOU regarding article 22(1)(f) appear to support the view taken by the United States. In all cases, the ownership test is applied first, and then one checks whether or not, due to contractual agreements, one person may have a predominant interest. However, that may be primarily the result of the fact that the examples may have been provided by the U.S. negotiating team and may have been used in the context of other treaties that were recently negotiated by the United States.

4. Swiss Concept of Predominant Interest

The Swiss do not share the U.S. view and allow, for example, a company to benefit from the treaty even if the qualifying persons own less than 50 percent of its shares but have, in the aggregate, a predominant interest in the company, taking into account contractual arrangements, and so on. From a Swiss perspective, it is quite clear that the reference in the Technical Explanations to Swiss principles found in domestic law refers to the Swiss unilateral anti-treaty-shopping rules.[57] Indeed, those rules do not focus just on the equity ownership of a person not entitled to treaty benefits in a company resident in Switzerland, but rather, on a direct or indirect participation or other form of interest in that company to a considerable (predominant) extent.[58] The existence of a simple contract may suffice to establish an interest,[59] and the interest becomes predominant if those persons have, individually or together, the legal or factual possibility to obtain the treaty-favored income.[60] Given the fact that the LOB is considered to be more comprehensive, the BRB 62 and its accompanying circular letters do not apply to the Swiss-U.S. treaty 1996. Nevertheless, given the fact that article

---

[52]Article 10(2), Swiss-U.S. treaty 1996.

[53]*See supra* note 18.

[54]*Id.*

[55]The protocol to the Swiss-U.S. treaty 1996 states in "8. With reference to paragraph 1(f) of Art. 22 (Limitation on Benefits)" that in addition to equity interests that such persons may hold in the company, trust, or estate, other contractual interests that the persons may have in the company, trust, or estate and the payments that such persons directly or indirectly receive (or have the right to receive) from that company, estate, or trust, that reduce the amount of the taxable income of the company, trust, or estate (for example, interest or royalty payments) shall be taken into account to assess the predominant interest of such persons. However, payments at arm's length for the purchase or use of tangible property in the ordinary course of business or remuneration at arm's length for services rendered must not be considered for this purpose.

(Footnote continued in next column.)

[56]*See supra* note 18.

[57]BRB 62/KS 1999.

[58]*See* article 2(2)(b) of BRB 62.

[59]So-called silent participation (*Stille Beteiligung*), that is, legal and beneficial ownership is not required.

[60]*See* KS 1962 II 2.

(C) Tax Analysts 2005. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

22(1)(f) was drafted to blend certain principles found in Swiss domestic law with U.S. ownership/base erosion concepts, it may be concluded that the principles of BRB 62 had an influence on the wording of the treaty.

5. Differences in Interpretation

In short, the German version of the language does not support the two-step approach used by the United States. However, the U.S. Technical Explanations seem to underline that the United States does not want to use a substantially different approach from that used in other recently negotiated treaties. In other words, following the U.S. view, one would come to the conclusion that the reference to the "blend of certain principles" would imply that each country should continue to use its well-established practice. However, that could lead to differing results.

Consider the case of a Swiss entity that is owned 49 percent by Swiss residents having, through contracts, a predominant interest in the Swiss entity, with the remainder owned by residents of a third country. From a U.S. perspective, the Swiss entity would not pass the ownership test and, accordingly, one would not apply the combined test. From a Swiss perspective, one would note that the majority of the stock in the Swiss entity is owned by residents of a third country and would nevertheless investigate whether or not the Swiss resident shareholders may have a predominant interest in the Swiss entity. If that predominant interest were found to exist, the Swiss entity would qualify for treaty benefits under article 22(1)(f) of the Swiss-U.S. treaty 1996. Given those material differences, the use of the differing well-established practices as identified above would lead to entirely unsatisfactory results, or even to the possibility of double taxation, which would defeat the underlying purpose of the treaty (namely the avoidance of double taxation).

That inconsistency should be solved through a competent authority agreement in accordance with article 25(3) of the Swiss-U.S. treaty 1996. Because the United States agreed to different wording than in its usual model, and acknowledged in the Technical Explanations that this was because Swiss concepts are of some relevance, it can be assumed that there must be some place for introducing Swiss concepts when construing the treaty, even from a U.S. point of view. Interestingly, the protocol to the Germany-United States income tax treaty (1989) provides for a tax credit mechanism in cases of double taxation following the placement of income or capital under differing provisions of the treaty, or attribution to different persons.[61] In that context, it is noteworthy that the treaty provides for the possibility that a deadlock situation following a competent authority procedure might be submitted for arbitration in accordance with article 25(6) of the Swiss-U.S. treaty 1996. However, the arbitration procedure can be instituted only after an exchange of notes between the contracting states to bring the arbitration procedure into operation, and the relevant notes have not yet been exchanged.

The predominant interest test is worded negatively in the treaty.

It is important to note that the predominant interest test is worded negatively in the treaty. In other words, an entity resident in one contracting state that derives income from the other contracting state can be disqualified from treaty benefits only if persons not entitled to the Swiss-U.S. treaty 1996 in the aggregate have a predominant interest in the receiving entity. Apparently, in the U.S. practice, the words "predominant interest" should be interpreted to imply that the persons have a common interest.[62] In other words, if persons that are not entitled to treaty benefits do not have such a common interest, the criterion of predominant interest is not met and, accordingly, the entity should qualify for treaty benefits under article 22(1)(f). The latter may be true if the shares of an entity are widely held by unrelated persons.[63]

The language used does not imply that there must be a common interest between the persons exerting an influence on the entity; rather, it should be sufficient if the persons that are not entitled to the treaty benefits have a majority interest in the form of an equity interest or otherwise in the entity. That conclusion may be drawn from the English, as well as the German-language, version. However, if one uses as a starting point that the treaty is to be interpreted in accordance with its goal (the purpose of the LOB is to deter treaty shopping), then one may come to a different conclusion. In other words, if no person has a predominant interest in an entity, that entity obviously is not being used as an instrument for treaty shopping purposes. As mentioned above, the text itself does not imply that interpretation; however, the treaty also does not provide for

[61]Paragraph 21 to article 23 (Relief From Double Taxation) and article 25 (Mutual Agreement Procedure). From this mechanism, one may conclude that the contracting states understood that antiavoidance provisions might be applied by one state and not by the other.

[62]*See supra* note 18.

[63]*Id.*

(C) Tax Analysts 2005. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

the contrary. Therefore, in line with generally accepted interpretation methods, one may conclude that if no person has a predominant interest in an entity, the entity should qualify under article 22(1)(f) of the Swiss-U.S. treaty 1996 regardless of the residence of the shareholders.

Admittedly, such a case might not arise very frequently in practice. Suppose a Swiss company is owned in equal shares by four unrelated individuals resident in four countries. If they set up the company jointly as an investment vehicle, they might well be viewed as having a common interest, thereby failing the predominant interest test. As a commercial matter, one is frequently reluctant to invest in a privately held company owned by strangers — it has been said that such an investment is akin to a call option on a lawsuit. Perhaps a company that is publicly traded on a secondary market that is not one of the qualifying exchanges, so that it does not qualify under the publicly traded test but is clearly widely held by unrelated people who are not acting jointly, is an example of a company that could benefit from that interpretation.

We note that the BRB 62 denies treaty benefits if an entity is foreign-controlled, in the sense of being an instrument of persons that do not, themselves, qualify under the relevant treaty as residents, regardless of whether that foreign control provides a common predominant interest. However, because the LOB (which is considered to be more comprehensive) explicitly overrides the BRB 62, and the U.S. view seems to be supported by the purpose of the LOB clause, one may conclude that the U.S. view is correct.

Thus, it may be concluded that an entity is entitled to the treaty benefits if qualifying persons have a predominant interest in it, as well as if no person (or group of persons) has a predominant interest in the entity at all.[64]

B. The Stock Exchange Test

This test was introduced in the U.S. model tax treaty of 1981 and has been used by U.S. treaty negotiators ever since.[65] It also found its way into the Swiss-U.S. treaty 1996, namely in article 22(1)(e). There are two ways in which a company can pass the stock exchange test: if its principal class of shares is primarily and regularly traded on a recognized stock exchange, or if one or more companies fulfilling that requirement are the owners of a predominant interest in the company.

The English version of article 22(1)(e)(ii) refers again to "the beneficial owners of a predominant interest in such company."

The German version (in a translation into English) refers to companies "which are controlled by one or more entities fulfilling the requirements of subparagraph (i)." Accordingly, in the German version, the words "the beneficial owners of a predominant interest" are missing and have been replaced by the single word "controlled." It is also quite remarkable that, regardless of the fact that article 22(1)(f) and (e)(ii) use the same language in the English version, the expressions used in German are different. Following a grammatical interpretation, the text in German covers a broader scope of persons, since one of the additional restrictions is not reflected.

1. Shares of the Beneficiary Are Publicly Traded (Direct Stock Exchange Test)

The fact that the shares of a company are publicly traded and that there is a certain float is a clear indication that the company was not formed and interposed solely to get treaty benefits. However, to avoid providing treaty benefits to entities that are just pro forma listed on a stock exchange, the treaty requires that there be a certain float of the shares, and that those shares give access to vote and value.

a. Principal Class of Shares

The U.S. view is that "principal class of shares" means the class of shares that represents the majority of the voting power and value of the company. In most cases, that class will be the ordinary or common shares of the company.[66]

b. Primarily

Interestingly, this term differs from the term "substantially," which generally is used in U.S. treaties for the avoidance of double taxation.[67] However, there is no further description of the term in the Technical Explanations, and the Swiss view, following the text of the treaty, acknowledges that the trading of the shares on a recognized stock exchange must be greater than all trading on unrecognized stock exchanges.[68]

[64]*Id.*

[65]*See, for example*, the Germany-United States income tax treaty of Aug. 29, 1989; the Luxembourg-United States income tax treaty of Apr. 3, 1996; and the Netherlands-United States treaty 1992.

[66]*See* Technical Explanations regarding "Publicly Traded Entities." In the Netherlands-U.S. treaty 1992, the term generally is defined as the class of shares that represent more than 50 percent of the voting power and value of all shares.

[67]*See* article 24(2)(d), Luxembourg-U.S. treaty 1996; article 26(1)(c)(i), Netherlands-U.S. treaty 1992; and article 28(1)(d), Germany-U.S. treaty 1989.

[68]By reference to article 3(2) of the treaty; *see also* Technical Explanations regarding "Publicly Traded Entities."

(C) Tax Analysts 2005. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

c. Regularly Traded

The U.S. Treasury applies its internal law to interpret this term:[69] A share is considered "regularly traded" if the company's shares are traded on at least 60 days during a tax year and the trades concern at least 10 percent of the average number of shares outstanding during the year.[70]

The Swiss view appears to be different, to the extent that it is questionable whether or not U.S. internal law may be used to interpret that term. It is true that a similar term may be used and defined in other treaties concluded by the United States. However, in those treaties, it is required that there be a substantial and regular trading of such shares.[71] The requirement of a certain minimum turnover indicates that there is a certain level of trade, or in the wording of the other treaties, a certain "substantiality" of trade. In other words, the amount of turnover measures the *substantiality* of trading, but does not prove that trading is *regular*. Suppose there is a very substantial turnover in trading, but the trading consists of a small number of large block trades. The Swiss view is that because the treaty requires regular trading, but (unlike certain other U.S. treaties) does not require substantial trading, the U.S. view that there must be a minimum turnover does not seem to be supported by the language of the treaty.

d. Recognized Stock Exchange

Article 22(7)(a) of the Swiss-U.S. treaty 1996 lists the stock exchanges that are recognized by the contracting states. However, the competent authorities may also agree on any other stock exchange by mutual agreement. One should be aware that in many cases, U.S. depository receipts of non-U.S. companies (including Nestlé SA) are traded on an unofficial U.S. market known as the "Pink Sheets," which is not one of the recognized stock exchanges. Of course, if the majority of the shares are traded on a recognized exchange, the fact that some shares may be traded on an unrecognized exchange such as the Pink Sheets should not affect treaty benefits.

2. Subsidiary of a Publicly Traded Company (Indirect Stock Exchange Test)

Following article 22(1)(e)(ii), a company may also qualify for treaty benefits if it is ultimately owned by one or more companies fulfilling the abovementioned requirement. In the Swiss view, the question of ownership therefore presents the same issue as under the predominant interest test, as described above (that is, not only equity ownership is taken into consideration, but also contractual agreements and the like). The United States supports that view, as the Technical Explanations require that "50 percent of the aggregate interests, not merely the class or classes accounting for more than 50 percent of a company's vote and value" must be held by publicly traded entities. Furthermore, it is emphasized that not only the ownership, but also "debt and contractual interests," must be considered.[72]

That supports the German language used in article 22(1)(e)(ii) by referring to control. However, the U.S. explanations emphasize that the "predominant interest test should be interpreted consistently with the predominant interest test that applies to Art. 22(1)(f)."[73] Thus, it appears that from a U.S. perspective, one needs first to check the ownership, and only if that test is met can one apply the combined test. However, again, the language of the treaty does not support the two-phase test.

Shortly after the treaty was negotiated, the team representing Switzerland in the negotiations stated that in its view, entities held indirectly by entities incorporated in a third country but otherwise fulfilling the requirements of the stock exchange test should be eligible for treaty benefits. That view appeared to be supported by the fact that article 22(7)(a) enumerates various stock exchanges outside of the borders of the contracting states on which the shares could be listed without jeopardizing the benefits of article 22(e)(ii).

The United States was always of the view that such a company would need to be incorporated in one of the contracting states[74] (that is, that the reference to article 22(e)(i) also encompasses the fact that the entity must be resident in one of the contracting states).

Thus, one may conclude that for purposes of article 22(1)(e)(ii), one or more entities controlling the entity that claims treaty benefits must be resident in one of the contracting states. However, the entities in between may be resident in third countries. Hence, the view expressed by certain commentaries that all the entities interposed in between must be residents of either of the contracting states does not appear to be supported by the language of

[69]As no definition is provided for in the treaty; therefore, article 3(2) is applied accordingly.

[70]*See* Technical Explanations regarding "Publicly Traded Entities" by reference to the branch tax provisions.

[71]For example, article 28(1)(d), Germany-U.S. treaty 1984; article 30(1)(c)(i), France-U.S. treaty 1994; article 16(1)(e), Austria-United States income tax treaty of May 30, 1996; and article 17(1)(e), Sweden-U.S. income tax treaty of Sept. 1, 1994.

[72]*See* Technical Explanations regarding "Subsidiaries Publicly-Traded Corporations."

[73]*Id.*

[74]*Id.*

(C) Tax Analysts 2005. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

the treaty.[75] However, the documents exchanged when the MOU was revised apparently support the view that not just the beneficiary and the ultimate beneficial owner must be resident in a contracting state, but also all the entities interposed in between. In the interim, the revised MOU addresses those concerns reflecting the U.S. view.

Following the rationale behind the LOB, one needs to interpret the list of recognized stock exchanges according to article 22(7) of the Swiss-U.S. treaty 1996 as an additional measure to safeguard that the shares are listed on one of the major stock exchanges. In other words, the aim is to prevent shares from being listed on a pro forma basis on a smaller stock exchange that may provide only limited access to potential traders, in order to be in a position to invoke the stock exchange test.

If a company qualifies under the stock exchange test (under article 22(1)(e)(i) or (ii) of the Swiss-U.S. treaty 1996), then it qualifies for treaty benefits for all items of income.

C. Active Trade or Business (Activity Test)

Article 22(1)(c) of the Swiss-U.S. treaty 1996 provides that a person — persons qualifying under the activity test are not restricted in any way — may receive treaty benefits for income related to the active conduct of a trade or business. The rationale behind the test is that a person engaged in an active trade or business in one of the contracting states should get access to treaty benefits for items of income that are connected with the active trade or business. In other words, the fact that an active trade or business is performed in one of the contracting states establishes a nexus with that state and provides a bona fide reason for the choice of location. In order to prevent the use of such a place of business to channel additional items of income, only income having a close nexus with, or that is incidental to, the trade or business qualifies for treaty benefits.

Having said that, the activity test entails three elements that must be satisfied cumulatively:

- the person must be engaged in the active conduct of a trade or business in the resident state;
- the income derived from the other contracting state must be derived in connection with, or be incidental to, that trade or business; and
- the trade or business must be substantial if the income arises from a transaction with a related person.

1. Active Conduct of Trade or Business

The question of whether a person is engaged in an active trade or business that qualifies for treaty benefits is inherently difficult to answer. In the treaty text itself, there is a clarification in article 22(1)(c) that states that the making, managing, or holding of investments for the person's own account — unless those activities are banking, insurance, or securities activities performed by a bank, insurance company, or registered securities dealer — are not considered to constitute an active trade or business. The protocol to the treaty and the MOU provide further explanation in that regard. The explanation is generally consistent with the definition of an active trade or business under U.S. domestic law.[76]

However, if a holding company owns an entity that conducts an active trade or business in the same contracting state, the activity is attributed to the holding company. Accordingly, if a holding company in the first state receives income from a subsidiary in the second state that is engaged in the same active trade or business as an operating subsidiary in the first state of the holding company, then the holding company qualifies for treaty benefits for those items of income.[77] The delegation of certain activities to independent third parties does not affect the person's entitlement to treaty benefits.[78]

2. Income Derived in Connection With or Incidental to the Trade or Business

According to the MOU, "Income is considered to be derived 'in connection' with an active trade or business in a Contracting State if the income-generating activity in the other Contracting State is a line of business which *forms a part of*, or is

---

[75] *See* Technical Explanations regarding "Subsidiaries Publicly-Traded Corporations" that refer to a direct or indirect interest.

[76] The protocol describes in "7. With reference to paragraph 1(c) of Art. 22 (Limitation on Benefits)," when a person actively conducts a trade or business; MOU, "4. In reference to subparagraph 1(c) of Art. 22 (Limitation on Benefits)."

[77] MOU, "4. In reference to subparagraph 1(c) of Art. 22 (Limitation on Benefits)": Example I.

[78] Protocol, "7. With reference to paragraph 1(c) of Art. 22 (Limitation on Benefits): In this regard, one or more of such activities may be carried out by independent contractors under the direct control of the resident. However, in determining whether the corporation actively conducts a trade or business, the activities of independent contractors shall be disregarded." For an example of the United States' application of this principle under domestic law, see IRS Rev. Rul. 73-237, 1973-1 C.B. 184, in which a building contractor was held to be engaged in an active trade or business even though all of the actual construction work was done by unrelated subcontractors, due to the building contractor's activities, through its own employees, of arranging for contracts, obtaining materials and supplies, and selecting and overseeing the subcontractors.

(C) Tax Analysts 2005. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

complementary to, the trade or business conducted in the first-mentioned State."[79]

The words "form part of" is further explained as meaning that the two activities involve the design, manufacture, or sale of the same products or types of products, or the provision of similar services, and the word "complementary" as meaning that the activities need not relate to the same types of products or services, but should be part of the same overall industry and be related in the sense that the success or failure of one activity will tend to result in the success or failure of the other.[80]

Examples include the provision of inputs to a manufacturing process that occurs in the other state, the sale of the output of the manufacturer resident in the other state, or the sale of the same sort of products in the first contracting state that are being sold by the trade or business carried on in the second contracting state. Another way of expressing this is that the activities performed in one of the contracting states should be "upstream" from, "downstream" from, or "parallel" to the activities in the other contracting state.[81]

Finally, income can qualify if it is incidental to the trade or business in the other contracting state (that is, if its production facilitates the conduct of the trade or business in the other contracting state.) The example given in the MOU is the interest income earned from the short-term investment of the person's working capital in securities issued in the other contracting state. Another possible example might be an airline in one state that temporarily leased airplanes that were idle due to seasonal factors to an airline in the other state.

Each item of income received by the person from the other contracting state must be considered separately under those rules. As a consequence, it is conceivable that only some items of income may benefit from the treaty, while others do not.

3. Substantiality

Most of the treaties concluded by the United States in the past few years contain a certain materiality requirement (namely, that the activities in the recipient state must not be immaterial in relation to the activities in the source state). Typically, "materiality" is measured by reference to asset values, income, and payroll expenses, which are fixed at a certain percentage of the total revenue in some of the treaties.[82] As far as Switzerland is concerned, a payment between related parties (in which the recipient of the income owns, directly or indirectly, 10 percent or more of the shares or other comparable rights in the payor) is treated as derived in connection with a trade or business only if the trade or business is *substantial* in the state of residence.[83] However, given the different size of the countries, it was assumed that a fixed ratio may be arbitrary and, accordingly, the parties agreed that one should decide whether the income is substantial based on different criteria that take into consideration the relative size of the U.S. and Swiss economies.[84] No safe harbor rules exist in that respect.

> ***The reason behind the substantiality requirement is the prevention of treaty shopping abuse.***

The reason behind the substantiality requirement is the prevention of treaty shopping abuse, whereby a company attempts to qualify for benefits by engaging in de minimis connected business activities that have little economic cost or effect regarding the company's business as a whole.[85]

It should be noted that the activity test provides for limited treaty benefits, as only the income that is derived in connection with, or is incidental to, the active trade or business qualifies.

D. Headquarters Test

A company resident in one contracting state that receives income from the other contracting state may qualify for treaty benefits if it is a recognized headquarters company for a multinational corporate group.[86] That test was included for the first time in

[79]*See* MOU, "4. In reference to subparagraph 1(c) of Art. 22 (Limitation on Benefits)." (The same explanation had been included in article 26(b) of the Netherlands-U.S. treaty 1992.)

[80]*See* Technical Explanations regarding "Derived in Connection With Requirement."

[81]Joint Committee on Taxation Explanation (JCS-16-97, Oct. 6, 1997).

[82]For example, article 26(2)(c), Netherlands-U.S. treaty 1992, and article 24(3)(c), Luxembourg-U.S. treaty 1996.

[83]*See* Protocol, "7. (b) With reference to paragraph 1(c) of Art. 22 (Limitation on Benefits)." An amusing example is given in the commentary to the Netherlands-U.S. tax treaty by referring to a hot dog stand in Switzerland that does not qualify as a holding company to receive dividends from a large U.S. sausage-making business.

[84]*See* Technical Explanations regarding "Active Trade or Business Test — Subparagraph 1(c)." U.S. data suggests that as of 2002, the Swiss economy was 2.3 percent the size of the U.S. economy.

[85]*See* MOU, "4. In reference to subparagraph 1 (c) of Art. 22 (Limitation on Benefits)."

[86]Article 22(1)(d), Swiss-U.S. treaty 1996. This test is not included in the U.S. model tax treaty 1996 or in many other treaties concluded by the United States in the past decade.

(C) Tax Analysts 2005. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

the Netherlands-U.S. treaty 1992, given the fact that the Netherlands hosts a substantial amount of European headquarters that have been established without the intention of treaty shopping.[87] The test functions as an objective (safe harbor) test and is used as a surrogate for identifying the actual intent. As there are numerous requirements that a headquarters company must fulfill to demonstrate that its incorporation is motivated by sound business reasons, one may assume that the scope of entities covered by the test is not very broad, and that it is possible that a taxpayer will not pass the test even though it is not engaged in treaty shopping.

Furthermore, experience indicates that most headquarters are used to group entities in a certain area. Usually, U.S. entities are not held by the European headquarters, so from a practical approach, the test is of limited interest for dividends. The requirements to be recognized as a headquarters company are set forth in article 22(7)(b). All of the requirements must be met collectively. However, given the limited scope of entities that may qualify under the headquarters test, we do not comment further on those requirements. It should be noted that, like the active trade or business test, the headquarters company test provides for only limited treaty benefits.

E. Family Foundation

A Swiss-resident family foundation qualifies for treaty benefits unless the founder or the majority of the beneficiaries are individuals not resident in one of the contracting states, or if more than 50 percent of the income earned by the foundation *could* benefit persons who are not resident in one of the contracting states.[88]

F. Limited Derivative Benefits Test

If a company has failed all of the above-mentioned tests, it might still be eligible for treaty benefits under article 22(3). The scope of the benefits is limited to dividend, interest, or royalty income.

The rationale behind this additional entitlement is that the company's beneficial owners (shareholders) not resident in one of the contracting states but satisfying the requirements in accordance with this paragraph would be able to benefit from similar relief on the respective items of income provided for in treaties concluded between their resident states and one of the contracting states. Accordingly, the argument that the structure was set up for purposes of treaty shopping no longer prevails.

Although not provided for in the U.S. model treaty 1996, the limited derivative benefits clause basically follows the standard model used by the U.S. treaty negotiators.[89]

The derivative benefit test consists of three separate tests that must be met by the company cumulatively — namely, the ownership test, the base reduction test, and the derivative benefits test.[90] For a better understanding, the limited derivative benefit clause is explained following the attached schematic:

1. 30 Percent Ownership by Residents of Country of Incorporation

The (ultimate) beneficial owners[91] of more than 30 percent of the aggregate vote and value of all the company's shares are resident in the contracting state receiving the dividend, interest, or royalty income from the other contracting state and are entitled to treaty benefits according to article 22 (1)(a), (b), (d), (e), (f), or (g).

Again, it is interesting to note that there is a deviation between the English and German versions of the treaty. The German version refers to the requirement that more than 30 percent of the aggregate vote and value of all of the company's shares must be held by qualifying residents of that contracting state. Accordingly, the German version implies a direct ownership. The English version follows the concept of the ultimate beneficial owner (implying that if those persons qualify, any intermediary holding should not jeopardize treaty benefits). However, that view is not supported by the Technical Explanations, which refer only to the fact that the ownership must be direct. Even if not supported by the English version, it appears that the parties reached consensus that the 30 percent stake must be held directly by residents of that contracting state.

However, after the negotiations were finalized, it was discovered that the 30 percent ownership test imposes a relatively high hurdle for intermediary Swiss holding companies (owned by foreign shareholders that want to profit from the Swiss-U.S. treaty 1996 benefits regarding income payments by

[87]*See* article 26(3), Netherlands-U.S. treaty 1992; in fact, article 22(1)(d) of the Swiss-U.S. treaty 1996 follows the wording in the Netherlands-U.S. treaty 1992.

[88]Article 22(g). If the income of a foundation could be distributed on a discretionary basis to a number of persons, and there were no restrictions that prevented nonqualifying individuals from receiving the income, the family foundation would not qualify under this provision. *See* Technical Explanations regarding "Family Foundation Test."

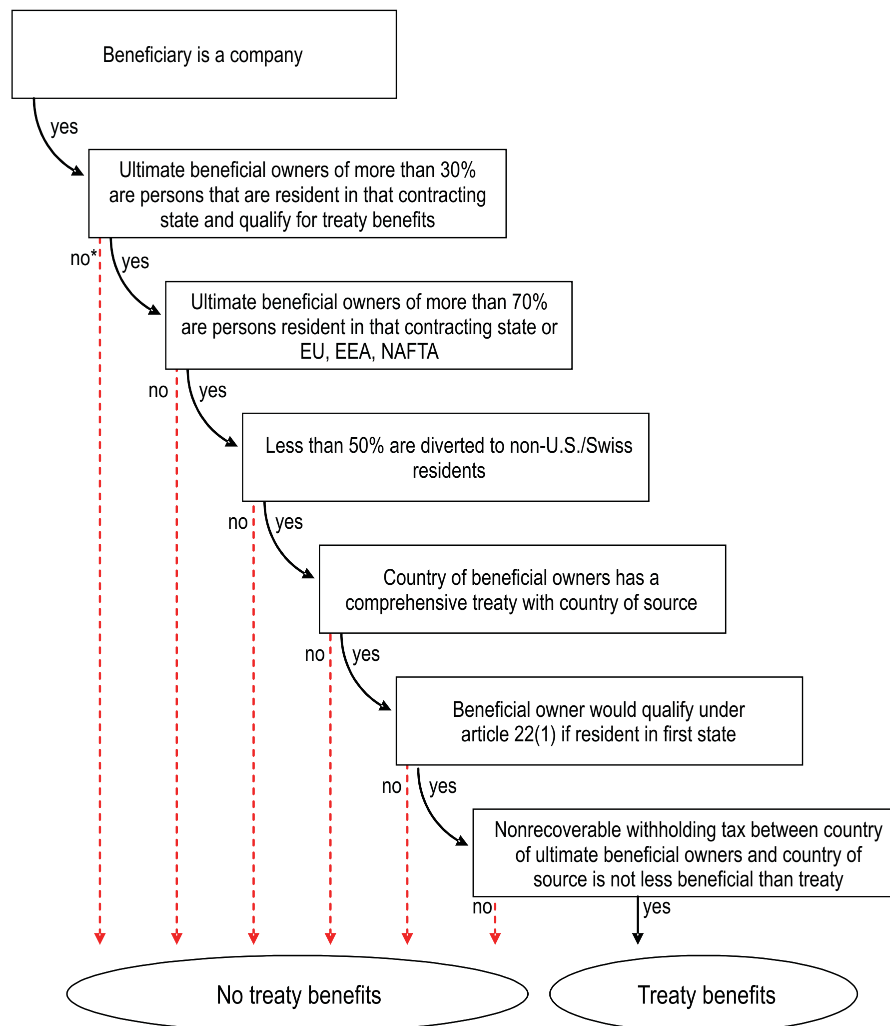
[89]Similar provisions can be found in article 26(4), Netherlands-U.S. treaty 1994, and article 24(4), Luxembourg-U.S. treaty 1996.

[90]*See* Technical Explanations regarding para. 3.

[91]Interestingly, in Technical Explanations regarding para. 3, it is referred to as a direct ownership.

(C) Tax Analysts 2005. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Figure 2. Derivative Benefits Clause According to Article 22 (Para. 3)



See MOU May 23, 1997, "7. In reference to paragraph 6 of article 22 (Limitation on Benefits)"

its U.S. subsidiaries), and that there are other solutions under more recent treaties concluded by the United States that would be more beneficial.[92] Accordingly, the MOU, as amended on May 23, 1997, provides additional benefits (which will be discussed under the section on discretionary relief).

[92]*See, for example*, article 24(4) in connection with (6) of the Luxembourg-U.S. treaty 1996.

2. 70 Percent Ownership by Residents of Country of Incorporation or Members of EU, EEA, or NAFTA

The ultimate beneficial owners of more than 70 percent of the aggregate vote and value of all the company's shares are either residents of the contracting state receiving the dividend, interest, or royalty income from the other contracting state (and entitled to treaty benefits), or are residents of states that are members of the European Union or the European Economic Area (EEA), or are parties to

(C) Tax Analysts 2005. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

the North American Free Trade Agreement. In other words — following the strict letter of the wording — if a U.S. company is held by Swiss shareholders, it would not meet the 70 percent test because Switzerland is not a party to the mentioned agreements. However, it appears that there is a consensus, as it is held that article 22(3)(a)(ii) of the Swiss-U.S. treaty 1996 provides that more than 70 percent must be owned by any number of residents of a contracting state[93] entitled to benefits under paragraph 1 *or* persons that are residents of member states of the European Union, the EEA, or NAFTA.

As mentioned above, there is a deviation regarding the German and English versions of the treaty.

In their agreement of August 20, 2003, the competent authorities of the United States and Switzerland established that a U.S. resident will be treated as a resident of a country that is a party to NAFTA for purposes of article 22(3)(b) of the Swiss-U.S. treaty 1996 if the person is an individual resident in the United States[94] or is a U.S. company.[95, 96]

3. Not More Than 50 Percent of the Income May Be Diverted to Nonqualifying Persons

The base reduction test under article 22(a)(iii) of the Swiss-U.S. treaty 1996 prevents a company from stripping out its profits to debt holders who are not qualifying persons as defined under the ownership tests, thereby escaping full taxation in the resident state of the company and/or its beneficial owners by eroding the tax base with deductible payments. Less than 50 percent of the company's gross income for its preceding fiscal period may be transferred to nonqualifying persons in the form of payments that are deductible as expenses from the gross income (which usually includes interest and royalty payments). In addition, due to the different wording of the clause, it appears to include — contrary to article 22(1)(f) — proceeds from the sale or rental of tangible property or reimbursements for services rendered at arm's length in the ordinary course of business.[97] In addition, based on the wording, it appears that the base erosion test under article 22(3)(a)(iii) is more restrictive than the one under the MOU of May 23, 1997, as under the latter, payments to persons that are residents of countries that are part of the European Union, EEA, or NAFTA are not considered to be tainted. According to article 22(3)(a)(iii), only payments to residents of one of the contracting states may escape the 50 percent threshold.

4. Comprehensive Income Tax Convention

The shareholders included in the 70 percent threshold must be resident in a country with which the other contracting state (the state paying the dividend, interest, or royalty income) has a comprehensive income tax treaty, and the shareholders must be entitled to all the benefits provided by that treaty. Those rules do not include limited agreements governing transportation income or the Bermuda-United States treaty 1986,[98] which governs only insurance income, but should not exclude the (small) number of old U.S. treaties that do not have an LOB clause. The term "comprehensive income tax treaty" also appears in U.S. domestic law, section 1(h)(11)(C)(i)(II). The U.S. Treasury has concluded that under a special provision of that statute governing treaties that are not "satisfactory," several treaties that do not have an LOB clause, such as the Greece-United States treaty of February 20, 1950, are "satisfactory" for this purpose.[99] Thus, it would seem that a "comprehensive" income tax treaty does not need to include an LOB clause.[100]

5. Entitlement According to Article 22(1)

If the respective shareholders are assumed to be resident in one of the contracting states, then they also must qualify for the benefits of the Swiss-U.S. treaty 1996.

6. Withholding Tax Rate

The country of residence of the shareholder must not provide for a treaty rate that is less beneficial than the one under the Swiss-U.S. treaty 1996, which clearly indicates that if the treaty rate is not more beneficial under the Swiss-U.S. treaty 1996, then the interposition of a company that is resident either in the United States or Switzerland may not be motivated solely by treaty shopping incentives.[101] That can be problematic for shareholders in certain

[93]*See supra* note 90.

[94]Or a political subdivision of the United States, an instrumentality of the United States, or a political subdivision thereof.

[95]Whose principal class of shares is primarily and regularly traded on a recognized stock exchange within the meaning of article 22(1)(e)(i).

[96]In order to address and clarify the issue that while the United States is a party to NAFTA, it does not have a comprehensive income tax treaty with itself.

[97]*See supra* note 90.

[98]Treaty of July 11, 1986, between the government of the United States and the government of the United Kingdom (on behalf of the government of Bermuda) related to the taxation of insurance enterprises and mutual assistance in tax matters.

[99]IRS Notice 2003-69.

[100]*See also* IRS Private Letter Ruling 200201025 (Oct. 5, 2001).

[101]Each item of income must be assessed separately (that is, on one hand, the derivative entitlement to treaty benefits may be granted for royalty income, but on the other hand, it may be denied for interest income.

(C) Tax Analysts 2005. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

countries, because certain U.S. treaties (for example, the Canada-U.S. treaty 1980) provide less favorable treatment for interest than the Swiss-U.S. treaty 1996.

G. Triangular Cases

The treaty includes a special rule designed to prevent the full reduction of withholding tax on income derived in the United States that is attributed to a PE in a third country of an enterprise resident in Switzerland.[102] That rule was included because the foreign income of a foreign PE of a Swiss entity is exempt from Swiss tax.[103] Under the special triangular rule, a 15 percent withholding tax on dividends, interest, and royalty payments must be applied if the combined Swiss and third-state tax is less than 60 percent of the tax that would be imposed if the Swiss entity earned the income in Switzerland. It seems that the United States considers this a treaty misuse and is therefore not willing to give up its source-based withholding tax. In addition, under the special rule, the United States is permitted to tax other types of income without regard to the income tax treaty.

The special rule does not apply to royalties received as compensation for the use of, or the right to use, intangible property produced or developed by the third-country PE. Nor does the special rule apply if the U.S.-source income is derived in connection with, or is incidental to, the active conduct of a trade or business carried on by the PE in the third country.[104]

The rationale behind this rule is that if a legal entity registers a branch in a low-tax country and the income received by the branch originates from the other contracting state, a certain minimum level of taxation may be established by not granting the full benefits that the treaty would otherwise provide. Again, this applies only to certain items of income.

H. Discretionary Relief

Finally, article 22(6) allows the competent authorities of the source state, after due consultation with the competent authorities of the resident state, to grant an entity the benefits under the Swiss-U.S. treaty 1996 even if the entity has failed all preceding tests, provided that it is nevertheless considered as not being a vehicle to misuse the convention. However, experience to date and the time-consuming consultation process involved suggest that only a small number of enterprises will find that route to treaty benefits to be viable.

> ***The treaty includes a special rule designed to prevent the full reduction of withholding tax on income derived in the United States that is attributed to a PE in a third country of an enterprise resident in Switzerland.***

In 1997, the MOU was supplemented by a special provision taking into consideration the fact that the clause dealing with the limited derivative benefits requires a 30 percent ownership by residents of that contracting state, which would disqualify, for example, Swiss foreign controlled holding companies from the benefits of that clause. The more relaxed version of the derivative benefits clause[105] grants treaty benefits on dividend, interest, and royalties, provided that certain requirements are met. (See Figure 3.)

VII. Final Remarks

Both contracting states share the concern that treaties are vulnerable to misuse by third-country residents. The concepts to ban treaty misuse that are generally used by the contracting states are, however, quite different, and to a large extent are the result of different legal systems (common law versus civil law). The inclusion of the LOB is the result of the negotiating power of the United States. However, it is interesting to note that the clause deviates in certain aspects from the standard clauses generally used by the U.S. treaty negotiating team at the time the treaty was negotiated. Therefore, it comes as no surprise that there are differences in the U.S. and Swiss interpretations of certain clauses. To a certain extent, one may deem that to be the result of the fact that while the English version repeatedly uses standard expressions, the same term may be translated differently each time it is used in the German version. However, we are inclined to assume that those differences are

[102]Article 22(4), Swiss-U.S. treaty 1996. Although the rule is formulated bilaterally, it does not apply to a U.S. corporation that has a PE in a third country, as those PEs are subject to U.S. tax that is at least as high as required by this article. A similar rule first emerged in the protocol 1993 amending the Netherlands-U.S. treaty 1992 (see articles 1 and 2). A similar rule also can be found in article 30(5) of the France-U.S. treaty 1994.

[103]Article 52(1), Federal Direct Tax Law of Dec. 14, 1990.

[104]Article 22(4)(a) and (b), Swiss-U.S. treaty 1996.

[105]Based on this paragraph, Swiss holding companies with foreign shareholders are eligible for treaty benefits, provided that certain additional conditions are met.

(C) Tax Analysts 2005. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

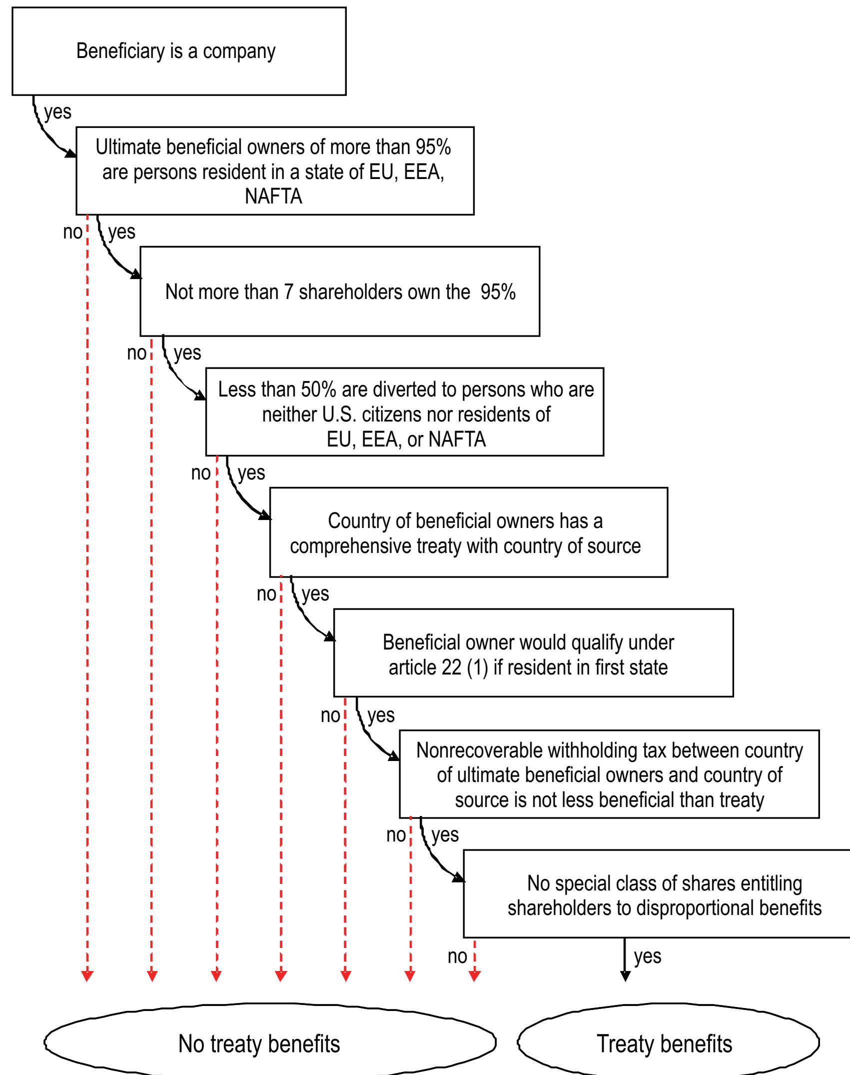


Figure 3.
Discretionary Benefits Clause According to MOU* May 23, 1997

**MOU May 23, 1997, "7. In reference to paragraph 6 of article 22 (Limitation on Benefits)"*

a result of the different concepts used by the contracting states, rather than inefficiencies in translation.

Regarding the future development of the LOB, if one takes into consideration the concept of the LOB, it is highly unlikely that an LOB provision will be perfected that contains a comprehensive series of tests that covers all prospective situations that may be deemed to be treaty abuse. Therefore, one may conclude that the LOB is still in the process of being refined in the course of new treaty negotiations by the United States. Furthermore, it may be fair to assume that any potential refinement may add to the complexity of the LOB clause. It remains to be seen whether a balance may be found between the two entirely different approaches used by the contracting states to keep the complexity of the LOB on a manageable level. ◆

(C) Tax Analysts 2005. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.