

Tax Alert

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Switzerland Reacts to EU State Aid Decision

Markus F. Huber, Dr. iur., Partner International Tax Services; markus-frank.huber@ch.ey.com
Lionel Noguera, LL.M., Manager International Tax Services; lionel.noguera@ch.ey.com

Executive Summary

On February 13, 2007, the European Commission and Switzerland issued statements regarding the sustainability of certain Swiss cantonal tax regimes. Although the final text of the European Union position paper has not been publicly released, the press releases and previous statements provide sufficient information to allow us to summarize the situation.

It is worth mentioning that the news of February 13, 2007, merely reflects a formal and unilateral decision taken by the European Commission as part of a process that began eighteen months ago. This is only another step in a long process, which is bound to last a number of years. Regardless of the outcome, the Swiss tax authorities firmly maintain that “Switzerland’s appeal as a location for Swiss and foreign companies will remain intact or may even be improved upon.”

Taxpayers looking at or already taking advantage of the beneficial treatment offered by Swiss holding companies, auxiliary companies, and mixed companies are well advised not to take any immediate action with respect to the decision of the EU Commission. Nevertheless, during the coming years, it may be wise to monitor closely further EC/Swiss developments.

1. Swiss Cantonal Tax Regimes under Scrutiny
 Although the OECD gave all Swiss tax

regimes a clean bill of health in September 2006, the European Commission is maintaining that cantonal tax relief afforded to “holding companies”, “auxiliary companies”, and “mixed companies” are tantamount to state aid. For the moment, no other forms of Swiss corporate tax relief are being targeted.

Qualifying holding companies take advantage of a full tax exemption from cantonal corporate income tax in order to avoid multiple levels of taxation of dividend flows. Auxiliary and mixed companies, on the other hand, perform predominantly administrative or ancillary activities in Switzerland. Whereas auxiliary companies may not be engaged in any commercial activities in Switzerland, mixed companies are primarily engaged in commercial activities abroad. Although their Swiss source income is subject to full taxation, they are taxed at significantly reduced rates on their foreign source income.

2. EU Concerns

The European Commission is claiming that holding, mixed, and auxiliary companies are incompatible with the *1972 Swiss-EC Free Trade Agreement*. This Agreement has wording (Article 23) that is similar to the state aid disposition within the EC Treaty of Rome as amended (Article 87). Further, the European Commission notes that similar tax regimes would not

be allowed inside the EU under the mentioned state aid provisions of the EC Treaty and that the Commission has taken action against member states in similar circumstances.

3. Swiss Response

The Swiss Federal Government has issued a clear rejection of the European Commission’s claims, based primarily on the following arguments:

- There is no contractual rule in place between the EU and Switzerland that would oblige Switzerland to align the taxation of legal entities with the rules of the EU member states. Therefore, the Swiss tax regimes under scrutiny may not infringe any agreement.
- Regarding the scope of the *1972 Free Trade Agreement*, the Swiss authorities maintain that the agreement is not applicable in the present context since it only covers certain designated goods.
- Switzerland is not a member state of the EU. Accordingly, neither EU state aid provisions nor the EU Code of Conduct on Business Taxation is applicable to Switzerland, and Switzerland is accordingly not bound by the Commission’s “decision.”
- The regimes being scrutinized may not be classified as being discriminatory against Swiss based multinationals, and favoring foreign based multinationals having a presence in Switzerland since

those regimes are available to all groups acting on an international level.

- Those regimes do not impact trading between the EU and Switzerland, since neither under the holding nor under the auxiliary regime are any trading activities on the Swiss market permissible. Under the mixed company regime, a limited involvement may be possible; however, the resulting income is generally subject to tax at full federal, cantonal, and communal rates without any form of relief.
- In addition, since holding and auxiliary companies have been in existence for well over 50 years, and since the EU has only been making claims against these regimes for the past 18 months, the Swiss authorities have strongly reacted against any form of creeping application of EU internal state aid rules to the *1972 Free Trade Agreement*.

4. Next Steps

In the near future, the European Commission's decision is expected to be made public. It is already certain that the EU will use this decision to start negotiations with Switzerland.

Given the apparent strength of the technical arguments already provided by the Swiss authorities, the EU will probably have to use more political arguments during the negotiations to defend its position. On the Swiss side, preparations are already being made to substantiate the fact that similar tax privileges may exist within the legislative framework of EU Member States.

5. Analysis

It appears that based on technical analysis, the *1972 Free Trade Agreement* does not provide a sound legal basis for the EU to scrutinize the mentioned regimes unilaterally. Therefore, one may expect that the EU will need to solve these issues on a bilateral basis. In that respect it should be noted that the rules in question are gov-

erned by 26 cantonal laws. The Swiss constitution explicitly confers the autonomy to levy taxes and to legislate to the cantons. In other words, the federal government has no mandate to negotiate on behalf of the cantons. There is a kind of framework tax law (tax harmonization law) stipulating certain minimum standards to which the cantonal tax laws have to adhere. Article 28 of the tax harmonization law explicitly mentions the tax regimes under scrutiny. Suffice it to say that changing the Article may be a time consuming process since it would require parliamentary discussions and is subject to a referendum.

In addition, it should be noted that one of the cornerstones of Swiss law is the principle of mutual trust. In other words:

- Changes in tax law need to be announced well in advance;
- Changes in tax law are subject to referendum;
- "Old regimes" generally are grandfathered for a certain period of time.

Therefore, one may assume that even if changes in the tax laws were forced through by political pressure from the EU, the legislative implementation of such changes would take quite a few years, after which the current regimes would still be grandfathered for another number of years. In addition, should changes be required, one may take it for granted that new regimes offering similar benefits may replace the current regimes under scrutiny.

As mentioned above, the decision of the EU Commission seems to lack legal basis. Taxpayers looking at or already taking advantage of the beneficial treatment offered by Swiss holding companies, auxiliary companies, and mixed companies should not take any immediate action with respect to the decision of the EU Commission. Nevertheless, it may be wise to monitor closely further developments. It should be reiterated that regardless of the

outcome of the current discussion, it is already clear that Switzerland will undertake all measures necessary in order to maintain its position as a fiscally attractive location for foreign investment. ■

Ernst & Young, Zurich
Philip Robinson
Managing Partner
Tel: +41 58 286 31 97
philip.robinson@ch.ey.com

Markus F. Huber
International Tax Services
Tel: +41 58 286 31 89
markus-frank.huber@ch.ey.com

Ernst & Young, Geneva
Howard R. Hull
International Tax Services
Tel: +41 58 286 55 17
howard.hull@ch.ey.com

Ernst & Young, Berne
René Schreiber
International Tax Services
Tel: +41 58 286 63 52
rene.schreiber@ch.ey.com

Ernst & Young, New York
Alfred Preisig
Swiss Tax Desk,
Tel: +1 212 773 6475
alfred.preisig@ey.com

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