

# Tax News

December 2007



Dear Reader

Now that the FTA Circular no. 14 of November 6, 2007, finally brought the long-awaited legal certainty to the indirect partial liquidation issue, the prob-

lems surrounding the double taxation of dividend distributions also seem to be lessening. Under Corporate Tax Reform II, partial taxation of specific dividends is planned at both federal and cantonal level. This represents a significant improvement, in particular for SMEs, where the main shareholder and the owner are often one and the same person, and which are thus the most affected by the practice of double taxation.

Under the new Federal Act on the Improvement of the Tax Framework for Business Activities and Investments, already adopted by the Federal Parliament, a system of privileged taxation of the income on investments in other companies will be introduced if the investor holds at least 10% of the shares of a limited company. If this investment forms part of the taxpayer's private assets, the dividends will in future only be taxed at 60%. Any capital gains on the sale of the investment will continue to be tax-exempt. If the investment is part of the business assets, the dividends will be taxed at 50%, and capital gains on such investments will also only be taxed at 50%. The cantons are given a lot of leeway as regards the method and the amount of relief that is granted, but the condition that the taxpayer must hold at least 10% of the shares of a limited company must be fulfilled. Intragroup dividend income should in future already benefit from tax relief from an investment of 10% (currently: 20%) or CHF 1 million (currently: CHF 2 million) of the market value of the investment, and capital gains relief on investments will apply from an investment of 10% (previously

20%), but the requirement that the shares must have been held for at least one year will remain in place. The referendum to determine whether these rules will actually enter into force will take place on February 24, 2008.

With many cantons having been applying the partial taxation of dividends for some time already, the Canton of Zurich is now also planning to reduce double taxation under the revised tax act in order to become more competitive compared to the other cantons. Specifically, the minimum income tax on investment income of 10% should be reduced by at least 50%, irrespective of whether the investment is held as part of private or business assets. On November 25, 2007, the citizens of the Canton of Zurich approved the revised tax act, which will enter into force on January 1, 2008. On this date, the voters in the Canton of Basel-Land took the same decision.

It can only be hoped that these relief measures for SMEs will soon apply throughout the country, so that Switzerland may remain an attractive business location from a tax point of view too.

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## US Tax Desk: Recent Developments

**In late October 2007, House Ways and Means Committee Chairman Charles Rangel submitted a large tax bill that would have significant impact on both individuals and corporations.**

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The largest benefits to individual taxpayers concerns relief from, or outright repeal of, the alternative minimum tax (AMT) system for individual taxpayers. The AMT system was originally instituted to ensure that certain wealthier taxpayers paid at least some US tax. These individuals were able to avoid regular taxation by earning certain types of tax-exempt income. The AMT system thresholds were never adjusted for inflation and the system is now affecting millions of middle income taxpayers.

To pay for this tax relief individual taxpayers would be subject to a surcharge of 4% to 4.6% on adjusted gross income of over USD 200,000. Other notable tax increases include the taxation of investment management services income received as «carried interest» in an investment fund as ordinary income (instead of as lower-rate capital gains) and the current inclusion into taxable income of deferred compensation for investment services received by hedge fund managers that is kept in offshore tax haven corporations and other structures.

Concerning corporate taxpayers the proposed legislation will reduce the top tax rate from 35% to 30.5%. Offsetting this benefit the section 199 domestic production activities deduction will be repealed. Section 199 had been enacted in 2004, in part, to replace the discredited FSC and ETI export incentive rules (which the EU had contested to the WTO). Also, deductions related to income deferred through controlled foreign corporations will be deferred until the related income is repatriated to the USA. Other significant changes include the repeal of a

current law provision for the allocation of interest expense to foreign assets and repeal of the last-in, first-out method of accounting, clarification of the economic substance doctrine for penalties concerning abusive tax-driven transactions, and disallowance of treaty benefits on deductible payments made to treaty country affiliates of foreign multinationals incorporated in tax haven countries (a similar provision had been previously proposed for which we commented on in our previous edition of CH tax newsletter).

The proposed legislation must go to the Senate and ultimately to the President. Some parts of the bill may be submitted separately to allow for a one-year temporary relief from the AMT while the major tax reforms are further debated. President Bush has already indicated he would veto this legislation in its present form. While it is unlikely the bill will pass in its current form it does provide a starting point for further negotiation. It is likely many of the provisions will survive in one form or another if the Democrats retain control of Congress and/or a Democrat wins the race for the presidency in the 2008 national elections.

**A recent protocol to the 1980 Canada-US tax treaty was signed in September. One of the most important provisions in the protocol was the elimination of withholding tax on cross-border interest payments.**

Previously there had been a long-standing 10% withholding tax on such payments. This may be of particular importance to Switzerland for certain Canadian multinationals with US operations who had financed their US operations using struc-

tures involving Swiss finance branches of Hungarian, Icelandic, or Polish companies to achieve better withholding tax results.

The effective date for elimination of the withholding tax on payments between unrelated parties will be on or after the first day of the second month that begins after the date on which the protocol enters into force. Thus, if ratified this year the earliest date could be March 1, 2008. However, for related party payments the 10% withholding tax will be phased out over a three-year period starting in the first calendar year that ends after entry into force of the protocol. It will lower from 10% to 7% in the first year, then drop to 4% and finally to zero.

Among other notable provisions in the protocol, this treaty does not provide for elimination of dividend withholding. Several other recent US treaties and protocols have provided for elimination of dividend withholding between parent corporations and 10% owned subsidiaries. The new protocol continues the 5% dividend withholding tax rate for parent-subsidiary dividend flows (similar to the provisions found under the existing Swiss-US treaty). Other significant changes include further tightening of the rules governing treatment of hybrid entities (entities treated as fiscally transparent by one country but treated as a separate entity under the tax rules of the other country), and further extension of the limitation of benefits clause to prevent third-country treaty shopping. ■

## Germany: Current developments

**Germany has recently seen the introduction of some important changes, such as the termination of the double taxation agreement with Austria with regard to inheritance taxes, the non-consideration of profit reductions on investments in foreign companies and the deductibility of professional expenses and operating expenses for taxpayers with a limited tax liability.**

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### **Inheritance tax double taxation agreement with Austria has been terminated**

Germany has terminated the double taxation agreement with Austria regarding inheritance tax (ErbSt-DBA) with effect from the end of the year. This is due to the discontinuation of Austrian inheritance tax with effect from July 31, 2008, which means that double taxation is no longer possible. Germany intends to negotiate with Austria regarding the treatment of inheritances between January 1, 2008, and July 31, 2008, in order to determine whether the provisions of the terminated agreement can still be applied to such cases. As far as inheritance tax is concerned, Austria has to date always had certain advantages over Switzerland in relation to Germany, which can be expected to be lessened by the termination of the ErbSt-DBA.

### **Does the previous practice of non-consideration of profit reductions on investments in foreign companies violate European law?**

In Germany, the Tax Reduction Act of October 23, 2000, which took effect from 2001/2002 implemented a system change and abolished the tax credit method for dividend distributions. With the system change, dividends paid to natural persons are now taxed in accordance with the half-income assessment method, while 95% of the dividends paid to legal entities are free of tax. On the other hand, companies can no longer deduct current-value depreciations of the value of investments in other companies for income tax purposes. The

tax deduction prohibition took effect on different dates: While the deduction prohibition applied to domestic investments from 2002, the new system took effect in 2001 for foreign investments. As a result, a company with foreign investments could be in a worse position in 2001 than a company with domestic investments.

In its decision of April 4, 2007 (Az. I R 57/06, DB 2007, p. 1840), the German Federal Finance Court (BFH) submitted the question of whether the earlier application of the deduction prohibition to investments in foreign countries violates the principle of the free movement of capital to the European Court of Justice (ECJ). The scope of protection would cover not only investments in other EU or EEA countries, but also investments in companies **in third countries**. This means that a current-value depreciation of the value of investment in a Swiss subsidiary by a German parent company would also be affected. In such cases we would recommend keeping the proceedings pending with reference to the above court decision.

### **Deduction of professional expenses and operating expenses for taxpayers with a limited tax liability**

Pursuant to sec. 50a par. 4 of the Income Tax Act (EStG), income tax is levied on certain earnings by way of deducting tax at the source of the income (withholding tax). This applies, for example, to income from art or sports events or from license agreements. The tax is deducted from the gross income without considering the professional or operating expenses. In the

matter of FKP Scorpio Konzertproduktionen GmbH (Rs. C-290/04, DStR 2006, p. 2071), the ECJ decided on October 3, 2006, that the non-consideration of these tax deductions is not compliant with EU law.

The German Federal Ministry of Finance (FMF) reacted to this judgment by letter of April 5, 2007 (IV C 8 - S 2411/07/0002, DStR 2007, p. 763). Until new statutory provisions take effect, operating expenses or professional expenses that are directly related to domestic income in economic terms can in principle be taken into consideration for tax deduction purposes pursuant to sec. 50a par. 4 sentence 1 no. 1 and 2 EStG. However, this is subject to the condition that the operating expenses or professional expenses exceed 50% of the income and that the party to whom payment is due can be identified. A tax deduction of 40% is applied to the difference between the income and expenses (net amount). Independently of this, the taxpayer can claim repayment of the withholding tax if the tax that was withheld exceeds the tax amount as calculated by the «normal assessment method. Contrary to the wording of the law (sec. 50 par. 5 sentence 2 no. 3 EStG), the German tax authorities do not apply the condition that the expenses must exceed 50% of the income as far as the repayment of the withholding tax is concerned. The guidelines of the current letter must be applied to all pending tax returns and tax assessments.

**Please note**

The FMF did not explain its position with regard to sec. 50a par. 4 sentence 1 no. 3 EStG, which applies to licenses, among other things. Subject to sec. 50g and sec. 50h EStG, we believe that the principles of the ECJ judgment could also be applied to tax deductions on this income. ■

**New and ratified double taxation agreements**

**A number of double taxation conventions have recently been revised or ratified. The following is an overview of the most important changes and new rules introduced to Switzerland's network of agreements.**

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**Argentina**

The double taxation agreement between Switzerland and Argentina signed in 1997 could not become effective before as it had not been ratified by the Argentinian parliament. Thanks to the bilaterally agreed temporary applicability from January 1, 2001, the agreement nevertheless had an effect. However, the Argentinian authorities requested a revision of the treatment of license fees under the agreement before the agreement could finally enter into force.

The relevant amending protocol was signed by the representatives of the two countries on August 7, 2006. The most important amendment concerns the cancellation of the zero rate for license fees. When the amending protocol enters into force (presumably during 2008), license payments will be subject to a base tax rate of 3% (rights to use news items), 5% (copyrights), 10% (patents, marks and leasing fees) and 15% (all other cases).

On November 14, 2007, the Federal Council approved its dispatch to the amending protocol of August 7, 2006, and requested the Federal Assembly to ratify this agreement. The agreement of 1997 and the amending protocol of 2006 will enter into force without any restrictions as soon as the parliaments of both countries have ratified the amending protocol.

**France**

New forms for claiming relief from French withholding tax on dividends, interest and license fees («avoir fiscal») were introduced on January 1, 2007. These forms must also be used for applications under the double taxation agreement between Switzerland and France with immediate effect. The R-F

forms are being replaced by the new form 5000 (confirmation of domicile), which must be supplemented either by form 5001 (dividends), 5002 (interest) or 5003 (license fees), depending on the type of income.

Given the special features of the CH-F double taxation agreement, the French authorities will allow the use of the old forms for a transition period. However, applicants are advised to start using the new forms immediately, also for income that fell due before January 1, 2007, and for which the application deadline has not yet expired.

As these forms are very general, they do not take account of all the special features of the CH-F double taxation agreement. Special attention must be paid to the fact that the simplified procedure («procédure simplifiée») for dividends in relation to Switzerland can only be used by natural persons for the time being. The French authorities are currently investigating whether the simplified procedure could in future also be used by legal entities domiciled in Switzerland and collective investment vehicles established under Swiss law.

**Columbia**

Columbia is Switzerland's third most important trading partner in Latin America after Brazil and Mexico. On October 26, 2007, the representatives of Switzerland and Columbia signed a bilateral agreement to avoid the double taxation of income and assets. The agreement mostly follows the OECD model convention and is in line with Switzerland's agreement policy. The text of the agreement and the dispatch will soon be submitted to the National Council and the Council of States.

### The Netherlands

The negotiations between Switzerland and the Netherlands concerning the revision of the double taxation agreement between Switzerland and the Netherlands dating from 1951 have been finalized and the new provisions are currently going through a consultation process.

As part of the revision, the existing agreement and additional protocol of 1966 should be replaced. The complex structure of the agreement dating from 1951/1966 no longer met modern requirements and needed to be adapted to the OECD model convention.

It can be assumed that both the structure and the contents of the revised agreement will be in line with the OECD model convention and Switzerland's agreement policy. The previous agreement also applied to wealth tax, but as this tax was abolished in the Netherlands in 2001, there is no longer any double taxation risk in this regard.

Concerning the territorial validity, the new agreement will presumably be valid for all Dutch territories in Europe as well as those territories outside of Europe where the Netherlands have territorial rights and jurisdiction under international law. On the other hand, the revised agreement will probably not apply to those parts of the Kingdom of the Netherlands outside of Europe.

In practical terms it can be expected that, under the revised agreement in conjunction with the OECD model convention, any conflict between the country where a legal entity has its statutory domicile and another country from where the legal entity is actually managed will be solved in favor of the country in which the management is located. Under the current double taxation agreement, such a conflict will be solved in favor of the country of domicile.

It is also expected that the investment threshold for applying the zero rate to dividends will be reduced from 25% to 10%. In line with Art. 10 par. 2 (a) of the OECD model convention and the taxation of savings income agreement, the investment

threshold will probably have to be met with a direct investment.

The current agreement's anti-abuse clause regarding the application of the zero rate on dividends from important investments in subsidiaries and associated companies (Art. 9 par. 2 [a]) is expected to remain valid. As far as interest and license fees are concerned, the revised agreement in conformity with Switzerland's agreement policy will assign the exclusive right to tax these payments to the country of domicile (previously, a base tax of 5% on interest payments was charged). As with the double taxation agreements with Germany, Austria, Finland, Norway, Spain and Great Britain (not yet ratified), the revised double taxation agreement between Switzerland and the Netherlands will also contain an expanded provision on official assistance. ■

## Introduction of the Authorized Economic Operator in the EU and consequences for Swiss businesses

**Since September 11, 2001, and essentially driven from the other side of the Atlantic, customs security (international supply chain security) has gained in importance. The old continent is not to be outdone.**

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These days, the AEO (Authorized Economic Operator) is subject of much debate. The press regularly reports on the progress of negotiations in this field. Seminars on the subject are even organized in this country. Swiss businesses may ask themselves whether they need to obtain this accreditation.

### AEO status

The creation of the AEO status constitutes one of the principal elements of the EU program relating to customs security. The AEO program is due to come into effect on January 1, 2008.

AEO certification is intended for economic operators wishing to benefit from customs control facilities in the context of security and safety, applied to the entry and exit of goods to and from the Community's customs territory.

AEO status can be granted to any business established on the Community's customs territory subject to some very strict criteria, particularly concerning security.

The advantages of this accreditation for the certified operator are currently unclear and, to a certain extent, uncertain. There has been talk of a reduction in the number of customs controls, priority customs clearance and reduction in the volume of data to be submitted in clearing customs.

All the same, the consequences of not having accreditation, or worse, where the process of accreditation has been blocked, are still relatively obscure. Inconvenience, not to say a certain general degree of suspicion on the part of customs authorities, should not be ruled out. The main reason for an accreditation demand will, however, be

pressure from customers anxious to have AEO-accredited suppliers in order to satisfy their own customers down the line.

### Consequences for Swiss businesses

Swiss businesses by definition cannot benefit from this status, as it is reserved for businesses domiciled in the EU. Swiss businesses therefore risk having to face a competitive disadvantage, to the extent that their customers prefer to deal with AEO-accredited suppliers.

The only means of mitigating these drawbacks is by introducing a similar status into Swiss legislation, in conjunction with the conclusion of mutual recognition agreements with the EU, the USA and other trading partners.

The Swiss customs authorities are currently working on this «Swiss AEO» project on the basis of certified receiver and certified sender of goods. Negotiations are also currently taking place with the EU with a view to recognition of the project. The EU has itself commenced talks with the USA.

### Conclusions

Even if it is questionable how effective accreditations such as the AEO status may be in the fight against terrorism, they form part of the global economic landscape. Even if no immediate action needs to be taken, it would be wise to keep a close eye on the situation. This newsletter intends to do just that. ■

## EU tax controversy

**Switzerland rejected the EU Commission's arguments regarding the cantonal tax privileges put forward in justification of its decision as being unfounded from the outset, and refused to negotiate, although it indicated its willingness to discuss the issue.**

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According to the decision of the EU Commission of February 13, 2007, the EU regards some cantonal tax privileges such as the administrative and holding privilege as state aid as defined by Art. 23 (1) of the free trade agreement between Switzerland and the European Community of 1972, which distorts competition and hampers the trade in goods in a manner that is not compatible with the free trade agreement.

On request of the Council of States Committee for Economic Affairs and Taxation (postulate 07.3003), the Federal Council approved the report «State aid to companies: company taxation and tax competition – developments in the European Union» on November 7, 2007. The report concludes that the EU follows an approach of restricted tax competition which is supported by a well-established policy of state aid. In contrast, Switzerland takes a positive view of tax competition and takes account of this aspect in its legislation. At the same time Switzerland, as opposed to the EU, is very restrained when providing direct state aid.

On November 12, 2007, representatives of Switzerland and the EU Commission met and discussed the technical aspects of the EU's assessment of certain cantonal tax practices regarding companies. The meeting was characterized by an atmosphere of openness, and the opposing viewpoints were discussed frankly. The discussion focused on whether the cantonal tax regime is subject to the free trade agreement, and whether it can hamper the trade of goods between Switzerland and the EU and thereby interfere with the free play of market forces or distort competition.

The differences in the taxation of income from domestic and foreign sources were also discussed. In this regard the Swiss delegation made it clear that holding companies' income from domestic and foreign sources are taxed in the same manner, and emphasized that the holding privilege is available to the same extent to domestic and foreign-controlled companies. The Swiss delegation explained the Federal Council's standpoint as follows:

- The tax regime criticized by the EU is not subject to the free trade agreement, as the latter only governs trade with specific goods. The types of companies in question may exercise no or at the least only subordinate activities in Switzerland and may not exercise any trading activities, and the subordinate business activities or trading activities are taxed in the normal way in Switzerland.
- As Switzerland is not a member of the EU and also not part of the single EU market, neither the competition rules of the EC agreement nor the code of conduct regarding the taxation of companies of the EU member states applies to Switzerland.
- The criticized tax provisions cannot be interpreted as state aid, as they do not favor specific producing industries. The criticized tax privileges can also be claimed by all economic players who meet the applicable criteria, independent of the sector and whether they are controlled by domestic or foreign shareholders.

For these reasons Switzerland refuses to enter into substantive negotiations with the

EU on this issue. However, the representatives of both parties emphasized their willingness to continue the technical dialog in spite of their differing viewpoints. Another meeting will take place at the beginning of 2008. ■

## New federal act on regional policy

**Last October, the Swiss Council of States and National Council approved the new Federal Act on Regional Policy (NRPG). The referendum period expired on January 25, 2007, and the new act will enter into force completely on January 1, 2008.**

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The new legislation replaces the Lex Bonny and its ordinances. While state guarantees are abolished and industry-wide financial aid is now integrated in the multi-year programs of the cantons, Art. 12 NRPG still gives the Confederation the power to grant tax relief to companies that make an important contribution to the national economy. The details are set out in a new ordinance by the Federal Council. The draft was discussed in parliament this past autumn, but no significant amendments to the existing practice were proposed. The new ordinance is based on the ordinance of June 10, 1996, on aid to the areas of economic renewal, and its most important points were accepted without any changes. This means that the current practice can mostly be continued without any changes.

At the same time the Federal Department of Economic Affairs submitted the draft of a new ordinance on the identification of the areas of economic renewal to parliament. As far as the new area perimeters are concerned, the draft proposes a reduction in development areas.

### Tax relief under the new law

Under Art. 12 NRPG, the Confederation can continue to grant tax relief as regards direct federal tax, provided that the canton in question also grants tax relief on direct taxes pursuant to Art. 23 par. 3 of the Federal Act on the Harmonization of Direct Cantonal and Municipality Tax (StHG). As before, the tax relief granted by the Confederation may not exceed the relief granted to companies by the canton in terms of type, duration and scope.

Art. 12 par. 2 NRPG sets out the general criteria for the granting of tax relief. The

cumulative criteria for industrial companies and production-related service enterprises are that they create new jobs or preserve existing jobs and that projects meet the requirements of regional economies under the NRPG.

These criteria should be given concrete form in ordinances. According to Art. 3 of the draft of the new ordinance on tax relief in favor of companies in the areas of economic renewal, projects that are highly innovative, create a great deal of added value and target a market across the borders of the area of economic renewal qualify for tax relief. The projects must also have special importance for the regional economy and help the company itself or its suppliers and partners

- a) to create new jobs, or
- b) to adapt existing jobs to changing circumstances in a manner that ensures that the jobs will be retained in the long term.

A project's importance for the regional economy is measured against the following criteria in particular:

- a) The number of new jobs within the area of economic renewal;
- b) The investments planned within the area of economic renewal;
- c) The purchases and orders or services required from suppliers or companies within the area of economic renewal;
- d) Collaboration with research institutions and training colleges directly related to the project.

In contrast to the Lex Bonny, Art. 12 par. 2 (c) of the NRPG contains the additional requirement that the canton must demand

repayment of any tax relief wrongfully claimed. Under the previous rules the Confederation already implemented measures to combat misuse several years ago. The decisions of the Confederation on the granting of tax relief under the Lex Bonny also usually contained a general clause that allowed its intervention in the event of misuse.

This provision complied with parliament's desire to combat misuse more effectively. In specific terms this means that relief from direct federal tax can only be granted if the canton in its decision to grant tax relief adds an explicit provision under which any tax relief wrongfully claimed must be repaid. The purpose of this provision is to settle cases where a company that enjoys tax relief takes a conscious decision not to implement a project as set out in the business plan or where the company intentionally gives up its business activities during the phase in which it enjoys tax relief.

As a result of the tightening of the provisions on misuse, the rules regarding the monitoring of state aid by the State Secretariat for Economic Affairs (SECO) will also be expanded.

While the new regulations will not change the procedural rules in any way, Art. 8 of the draft ordinance includes the explicit right to revoke decisions by the Confederation to grant tax relief if the underlying cantonal decision is revoked.

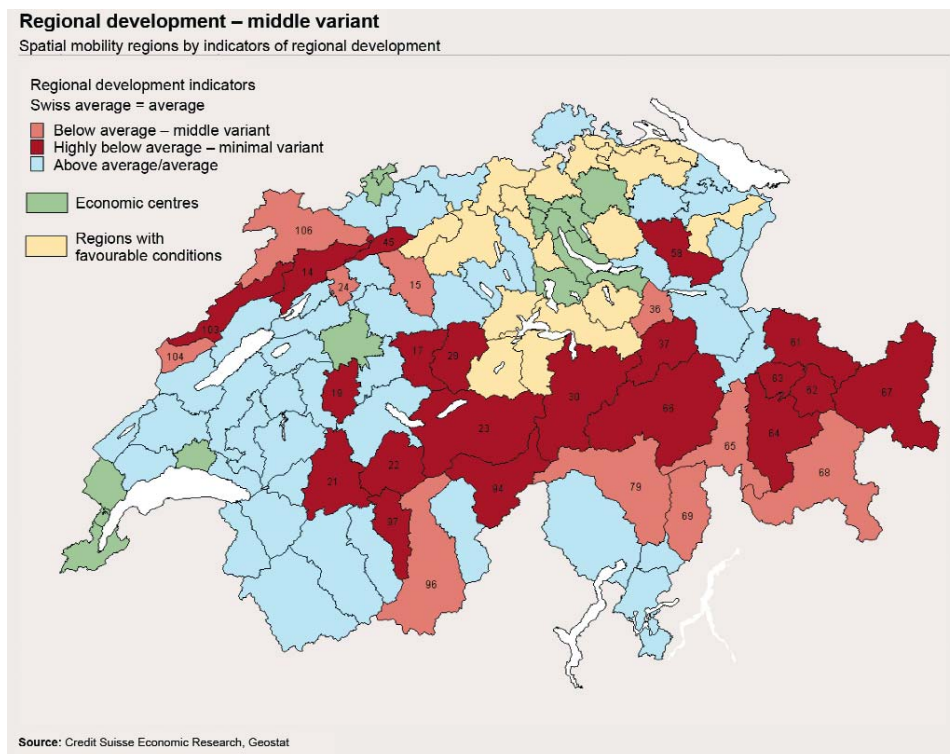
Special attention should be paid to Art. 9 of the draft ordinance, which contains the transitional provisions applying to tax relief granted under the current act. The wording of Art. 9 of the draft ordinance raises the question whether tax relief granted under the current act will automatically expire on

December 31, 2008. An informal query sent to SECO brought to light that, contrary to the strict interpretation of the law, tax relief granted under the current act will not be questioned and will remain valid without any changes until the end of the original term (even if this should be later than December 31, 2008), unless the conditions under which tax relief was granted should change. It is therefore advisable to find out if any changes to the situation under which tax relief was granted under the old law (e.g. a change in domicile) would have legal consequences under Art. 9 before such changes are implemented.

### New area perimeters

With the replacement of the Lex Bonny by the new Federal Act on Regional Policy, the ordinance on the identification of the areas of economic renewal will also be revised. According to the draft of the revised ordinance, the areas of economic renewal will be reduced. From 2008, tax relief at federal level can only be granted to companies in the economically weakest areas (cf. map).

The reduction of the development areas earned criticism from the cantons and regions that will be affected. It is true that it does not seem to make much sense to grant tax relief only to companies in the economically weakest regions. It is questionable whether international companies carrying out a business location appraisal will consider areas that are far from airports or large train stations and/or cannot be reached by public transport. ■



## Social insurance tax trap

**This specific case concerned the obligation to contribute to the AHV of a stay-at-home wife whose husband works abroad and pays contributions to the foreign social security scheme. In its decision of May 9, 2007, the Federal Supreme Court ruled that partial international double taxation in the area of social insurance is permissible.**

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A married couple, the wife Swiss and the husband German, have been living in the Canton of Thurgau for a long time. She worked in Switzerland until 1999, when she stopped working. He works for a German company, receives his salary in Germany and also pays social security contributions in Germany. The AHV compensation fund is now claiming AHV contributions from the wife as someone who is not gainfully employed.

The AHV act does in fact say that natural persons resident in Switzerland must pay compulsory AHV contributions, irrespective of whether they are gainfully employed or not. If someone is also subject to foreign social security contributions, he/she can ask to be released from the obligation to pay Swiss contributions. Persons who are not gainfully employed must pay AHV contributions from the age of 20 until 64/65. Depending on their social circumstances, the annual contribution is between CHF 353 and CHF 8,400. The contribution of a married person is calculated on the basis of half of the married couple's assets and pension income.

If a couple is married and the spouse pays AHV contributions amounting to at least twice the minimum contribution, the stay-at-home spouse's contributions are regarded as having been paid. In the present case, however, the Federal Supreme Court refused to take the spouse's social security contributions into account as these contributions are paid in another country and not in Switzerland. The court ruled that the rules of the country of residence (Switzerland) can be applied under the bilateral social security agreement between Germany and Switzer-

land, a fact which is also not changed by EU Ordinance 1408/71, as the country-of-employment principle applied under this ordinance only applies to the gainfully employed spouse and not to his wife who is not employed.

The unhappy outcome of this decision is that the stay-at-home wife must pay AHV contributions in Switzerland, although her husband's entire income from gainful employment is subject to German social security. As mentioned above, the contributions are based on half of the couple's assets and income, which means that half of the income already taxed in Germany is taxed again.

These arguments of the Federal Supreme Court can also be applied to another case which occurs much more often, i.e. the countless numbers of employees who are sent to work in Switzerland. Such employees usually remain subject to the social security of their country of origin while working in Switzerland. If the spouse should also temporarily take up residence in Switzerland, the situation would be similar as in the above ruling by the Federal Supreme Court.

Whether the authorities will in fact oblige the non-working spouse to pay Swiss AHV contributions, thereby introducing a system of partial double taxation, remains to be seen. ■

## Decision of the Swiss Federal Administrative Court of June 5, 2007: Refund of withholding tax by a «holding branch»

**A recent decision of the Swiss Federal Administrative Court<sup>1</sup> centered on whether a so-called «holding branch» (Swiss branch of a foreign company) should be entitled to claim refund of withholding tax.**

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### Facts

Z is the Swiss branch of the Netherland Antilles-based company X. The branch was set up in 1989 and holds a participation in the Swiss company R. The latter was bought by X's parent company in 1988, which is also based in the Netherland Antilles, and was immediately sold to subsidiary X, which was still based in the Netherlands at that time. X transferred its statutory domicile to the Netherland Antilles in 2003. The participation in R was transferred to the branch Z in 1996. R distributed a dividend to Z in 2002, after which Z applied for refund of withholding tax (WHT).

Z was denied entitlement to reclaim withholding tax by the Swiss Federal Administrative Court (SFAC).

### Considerations

The SFAC examined Z's entitlement to reclaim WHT under several provisions of the Federal Withholding Tax Act (WHTA) and refused it for the following reasons:

According to Art. 24 par. 2 WHTA, legal entities may reclaim WHT if they are headquartered in Switzerland when the taxable performance becomes due. The SFAC considered X – which was based in the Netherlands when the dividend was paid out – and not the branch Z to be the beneficial owner of the dividend income. As a result, reimbursement of WHT according to Art. 24 par. 2 WHTA was refused (no headquarters in Switzerland).

Furthermore, the SFAC examined the claim for refund under Art. 24 par. 3 WHTA, according to which foreign companies are entitled to refund if they are liable to pay cantonal or communal taxes for the income

deriving from a Swiss branch or for the business assets of the Swiss branch. The SFAC considered the criteria of a foreign headquarter, operations carried out by a Swiss branch and Z's Swiss tax liability to be met. However, WHT can only be refunded if the relevant income can be allocated to the branch's assets and if the said business assets serve directly and exclusively the activities of the Swiss branch. The SFAC considered that a branch may not hold participations, and that the holding of participations was not in line with the statutory purpose of Z. Furthermore, the court noted that the participation, and therefore the dividend, would have to be allocated to X, and that the participation did not exclusively or predominantly serve the activities of Z. As a result, the entitlement to a refund was denied under Art. 24 par. 3 WHTA.

Finally, the SFAC examined whether tax avoidance had occurred (Art. 21 par. 2 WHTA). Under the said article, refunding of WHT is refused if an unusual structuring is chosen for the purposes of saving taxes and if this actually results in significant tax savings. In the present case, the SFAC took the view that Z was solely established for reclaiming WHT respectively to repatriate the income out of R up to the ultimate group company (offshore company) in a tax-neutral way, and that there were no commercial or business reasons for the present structuring. As a result, the SFAC considered the tax avoidance scheme to be fulfilled.

In our view, the final result of the decision turned out correctly, particularly in the light of a tax avoidance scheme. However, the view of the SFAC according to which branches should not be able to hold partici-

pations is questionable. The prevailing doctrine foresees that branches may definitely hold participations and are – through their foreign head office – entitled to reclaim WHT under Art. 24 par. 3 WHTA if the participation represents part of the essential business assets. ■

<sup>1</sup> Decision by the Swiss Federal Administrative Court of June 5, 2007: A-1521/2006.

## Tax treatment of the home ownership promotion scheme («WEF»)

### The new circular on the tax treatment of home ownership promotion through occupational pension plans represents an alignment with the amendment to social insurance legislation that entered into effect on January 1, 2006.

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The amendments to the laws relating to the occupational pension plans that entered into effect on January 1, 2006, and that were implemented for tax purposes in the new circular<sup>1</sup> mainly restrict tax planning options with making early withdrawals for the purpose of the promotion of home ownership.

Basically, under certain conditions, an early withdrawal from the occupational pension plans recognized under the BVG<sup>2</sup> may be paid out or repaid to purchase owner-occupied homes, cooperative housing association shares or to repay a mortgage. It is important to note in this regard that from now on, when buying additional years of contribution, the benefits accruing as a result cannot be withdrawn in the form of capital in the three following years (e.g. for the purpose of the home ownership promotion scheme).<sup>3</sup>

Ever since the option of an early withdrawal became possible, its payout has been taxed at a special rate, separate from other income.<sup>4</sup> In addition, the cost incurred by taking out additional insurance to reduce the gap in pension coverage is not tax deductible.

When real estate or cooperative housing association shares are sold, the amount received must be paid back to the occupational pension plan or paid into a vested benefits account for a maximum of two years, and reinvested under the home ownership promotion scheme. When reinvested within two years, an early withdrawal to promote home ownership will only be assumed to the extent of the interest accrued on this amount (which, if it exceeds an amount of CHF 5,000, must be reported). If not reinvested within the two years, the early withdrawal must be trans-

ferred back to the occupational pension plan. Any interest accrued in the interim will be transferred to the occupational pension plan and be tax-exempt.

If an early withdrawal is paid back, the tax originally paid on the relevant amount may, as a rule, be reclaimed. On the other side, no deduction for tax purposes is available when making the repayment into the occupational pension plan. This means that the lower tax paid on an early withdrawal is returned, but no deduction may be made on any regular and presumably higher income tax. In addition, no interest is remunerated for the period between payment of the tax and its repayment.

For the sake of completeness, it should be mentioned that there are no tax consequences when pension plan claims are pledged as collateral, provided that this does not result in realization of the pledged collateral. The tax consequences of realization of pledged collateral are the same as for an early withdrawal.

Whereas previously any early withdrawals for home ownership could remain outstanding and it was possible to buy additional years of contribution, this has not been possible since January 1, 2006.<sup>5</sup> Since early withdrawals are taxed at a preferential rate and the purchase of additional years of contribution may be tax deductible, this combination used to provide some leeway for tax planning. The new provision has eliminated this option on January 1, 2006.

It is still possible to optimize tax liability through the structuring of pension solutions, through properly timed staggering of any purchases where there is a gap in contribution, or through an integrated consideration of the home ownership promotion

scheme as part of total wealth planning. However, as a result of the circular at hand, which primarily implements the new social insurance provisions as of January 1, 2006, there is less flexibility with regard to tax planning and more demands are made on tax advisors to find creative solutions. ■

<sup>1</sup> Circular no. 17 from the Federal Tax Administration dated October 3, 2007.

<sup>2</sup> Swiss Federal Law on Occupational Retirement, Survivors' and Disability Pension Plans, SR 831.40.

<sup>3</sup> Art. 79b par. 3 BVG. Prior to this, however, a payment of capital into a pension plan and a payout within a short period of time thereafter was not just simply accepted, but was reviewed in terms of tax evasion.

<sup>4</sup> Circular no. 1, dated November 22, 1989, circular no. 23, dated May 5, 1995, and circular no. 17, dated October 3, 2007; Art. 83a par. 1 BVG.

<sup>5</sup> Art. 79b par. 3 BVG; exception: if no additional buy-in is possible pursuant to Art. 66b of the Ordinance on Occupational Retirement, Survivors' and Disability Pension Plans («BVV2») or on repurchase following a divorce / court-ordered dissolution of a partnership pursuant to Art. 79b par. 4 in conjunction with Art. 22c of the Swiss Federal Law on Vesting in Pension Plans («FZG»).

## Abolishing the Dumont ruling – position of the Federal Council

**The Federal Council and Parliament wish to provide tax relief to buyers of real estate in need of renovation: in future, taxpayers shall no longer be denied the option of deducting the cost of repairs for run-down real estate they have purchased (Dumont ruling).**

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Contrary to the bill prepared by the National Council Committee for Economic Affairs and Taxation, the Federal Council intends to abolish the Dumont ruling not only at the federal level, but at the cantonal level as well.

With the so-called Dumont ruling of June 15, 1973, the Swiss Federal Court switched from its former technical maintenance stance to an economic stance. Any renovation costs incurred immediately after the purchase of real estate are thus defined as expenditures incurred close to the time of acquisition and are, as a rule, not deductible from taxable income. «Immediately» was defined by the Supreme Court as a period of five years from the date of acquisition of the property; this period of time is still in effect today.

In 1997, following several decisions confirming the original ruling, the Swiss Federal Court limited the previous ruling. Now, it must be differentiated between properties in a neglected and properties in a well-maintained state. Accordingly, only in the latter case are any renovation costs incurred immediately after a purchase deductible from taxable income.

The criticism of the Dumont ruling did not fall silent even after this alignment. This fact was the reason for the parliamentary initiative submitted in 2004. The initiative caused the National Council Committee for Economic Affairs and Taxation to prepare a bill.

### Abolition at the federal level

The report, adopted by a slight majority of the National Council Committee, supports the abolition of the Dumont ruling at the

federal level, as does the opinion of the Swiss Federal Council of November 7, 2007. Besides discussions about the impacts on the construction industry and on the home ownership promotion scheme, there are controversial debates regarding the restriction of the principle of equal treatment. The members of the Committee who rejected an abolition of the ruling, use the same arguments as the Swiss Federal Court did in 1973: without the Dumont ruling, any buyers of run-down properties who pay a lower purchase price than buyers of well-maintained buildings could deduct renovation costs from their taxes, too. This unequal treatment cannot be reconciled with the constitutional principle of taxation based on financial strength. The members of the National Council Committee in favor, on the other hand, accept this differential treatment of buyers: the deduction to be allowed represents compensation for any additional risk involved in buying property in a neglected state. One of the main arguments for abolishing the Dumont ruling is, in the end, also one of unequal treatment, namely between owners of old and owners of new property: the costs of renovating neglected property may currently only be deducted in the case of the former.

### Abolition at the cantonal level

An advance survey conducted in the cantons by the Swiss Tax Conference on how the Dumont ruling is being applied shows an astonishingly inconsistent interpretation of the ruling. The data from the 24 participating cantons show that only 11 of them comply with the ruling of the Swiss Feder-

al Court. The other cantons either use a different definition of the term «neglected» or do not apply the Dumont ruling to cantonal income tax at all (cantons of Basel-Land, Schaffhausen and Thurgau).

In contrast to the communiqué published by the Federal Council, the majority of the National Council Committee members rate protection of cantonal tax sovereignty and promotion of competition in the area of taxation higher than the constitutional mandate of harmonizing taxation. It therefore recommends in its report to refrain from rejecting the current practice at the cantonal level and to allow the cantons to have a corresponding option respectively. For reasons of taxation consistency, the Federal Council clearly argues, in contrast, for a harmonization in the areas of taxation of income and capital gains from real estate. With the unified rule, it wishes to offer additional incentives to buyers of real estate to quickly renovate newly acquired properties and thus provide additional support to the construction industry.

### Outlook

The differences between the National Council Committee report and the recently published opinion of the Federal Council indicate that especially the decision as to whether the abolition must be accepted at the cantonal level or not, will give reason to further discussions. The matter will be submitted to the National Council, as the first level of government, for consultation in the 2007/2008 winter session. Provided that both councils come to an agreement quickly, it is expected that the new provision in the Swiss Federal Direct Tax-

ation Act will enter into effect as of January 1, 2009. If the ruling were also to be abolished at the cantonal level, transitional rules would have to be worked out, which would mean that any new provision in the Swiss Federal Tax Harmonization Act

could not be expected before the year 2011. According to the Swiss Federal Tax Administration, it is not assumed that the new legislative provisions will be applied retroactively. ■

## Immediate measures in the field of spousal taxation in Switzerland

**«Get married? No, thanks! It's too expensive for us!» As of the new year, the tax burden should no longer be an obstacle to marriage.**

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Although the cantons already counteract the so-called «marriage penalty» with a more favorable tax rate for married couples or with a special spousal and joint-income deduction, the factor addition and the progressive tax rate at the federal level continue to result in a significant additional tax burden for spouses with two incomes compared with unmarried couples in the same situation. Already 20 years ago, the Swiss Supreme Court criticized this additional burden as being unconstitutional, and after the Swiss people rejected the partial splitting for married couples together with the tax package in the spring of 2004, the Swiss Federal Council, in September 2005, submitted for consultation a bill to alleviate the marriage penalty. The marriage penalty under the direct federal tax shall now be alleviated as of January 1, 2008, with implementation of immediate measures in the field of spousal taxation. This will result in the tax authorities incurring losses of CHF 650 million annually. The reduction will be implemented through an increased and reformed joint-income deduction and a new spousal deduction.

Although the goal of this bill from the Federal Council – to remove inequalities between spouses and unmarried couples in the same financial situation – was welcomed by a great majority, the measures proposed by the Federal Council to increase

tax rates for singles and the fact that no consideration was given to retired spouses were not so welcome. An agreement was therefore reached on efficient and easy-to-implement immediate measures in the form of a compromise.

With this «combination solution», the Federal Council found a compromise between the bill and the criticism from the cantons and the parties affected. The joint-income deduction that may be made from the taxable income of a married couple is now 50% of the lower of the two salaries of the couple, up to a maximum of CHF 12,500. The currently effective joint-income deduction of CHF 7,600 will be retained as a minimum rate. In addition, spouses who are legally married and live together may now claim a spousal deduction in the form of a social deduction of CHF 2,500. Retired spouses, spouses with only one income, registered partnerships and spouses that have income from sources other than earned income are also entitled to a deduction.

For 160,000 of the 240,000 joint-income spouses, the immediate measures will bring about an abolition of the disadvantage compared to unmarried couples in the same situation, while the remaining 80,000 will find themselves in a significantly better position.

To summarize, the combination solution takes into account the well-known legal

injustice in that it removes or at least reduces the unconstitutional additional burden on joint-income couples and keeps the difference in tax burden between single-income and joint-income couples within reasonable bounds. Although the immediate measures will only soften the tax burden for one third of all joint-income couples, the combination solution is certainly a welcome step in the direction of a tax reform of spousal taxation at the federal level. ■

### Imprint

#### Tax News

Electronic publication in German, French and English

#### Designed and produced by

Ernst & Young Ltd  
Tax and Corporate Communications & Marketing  
P.O. Box, 8022 Zurich

#### Subscriptions/address changes

[www.ey.com/ch/newsletter](http://www.ey.com/ch/newsletter)