'THE SWITZERLAND-EC SAVINGS TAX AGREEMENT: A POSITIVE RESULT?'

Gianluca Nessi[1]

Introduction

The European Union (hereinafter: 'EU') is a supranational and intergovernmental union of 27 Member States[2], as well as the largest political and economic entity by area and population covering the European continent[3]. Accession negotiations are currently underway with several states to reinforce the process of enlargement[4].

Switzerland remains however an exception. Its political and neutral independence, as well as its federal structure and its tax autonomy have played an important role in its long and proud history of 'going it alone'[5]. All of these arrangements have served its interests (and those of its people) well. Yet, such arrangements do not signify total isolation. In 1992, when the European Community (hereinafter: 'EC') constituted the internal market and guaranteed the 'four freedoms', with the aim of securing the free movements of people, goods, services and capital throughout its

---

1 Gianluca works at Icofin SA, Ascona (Switzerland) and can be contacted at gianluca@icofin.org. This article is based on his LLM dissertation King's College, University of London.

2 On 1 May 2004 the following countries joined the EU: Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia. In addition, on 1 January 2007, Bulgaria and Romania joined as well.

3 Its overall population now amounts to a staggering 494 million people and its combined nominal Gross Domestic Product ('GDP') amounts to Eur 11.5 ($14.2) trillion in 2006 <http://en.wikipedia.org/wiki/European_Union#_note-EU_GDP.2C_World_Monetary_Fund> (26 April 2007).

4 Candidate countries are: Croatia, Turkey and the former Yugoslav Republic of Macedonia. While potential candidate countries are: Albania, Montenegro, Bosnia and Herzegovina and Serbia.

5 B Beck, 'Switzerland and the European Union' <http://www.swissnetwork.com/?page=ViewArticle&id=15&category=> (26 April 2007).

area[6], Switzerland actually concluded an agreement with the European Economic Area (hereinafter: 'EEA')[7]. Nevertheless, on 6 December 1992 a slight majority of the Swiss voters (50.3 per cent) and 16 out of 23 Swiss cantons rejected its ratification[8]. As a result of these referenda, the Swiss government was prevented from joining the EEA and the possibility of full EU membership disappeared.

However, being Switzerland such a small country, open markets for exports and imports as well as a well functioning legal system including trade and investment agreements are essential requirements[9]. Switzerland's main trading partners are the EU Member States[10] and despite the fact that the Swiss citizens have voted to remain outside the EU, a good relationship with the EU Member States is vital for the whole Swiss economy[11]. As a consequence, pragmatic Swiss politicians decided that bilateral negotiations with the EU were the way to follow for the best interests of the country[12]. To reconcile the wish and need of Switzerland to integrate into the European market with the reluctance of the Swiss people to join the EU, the bilateral agreements seem at least for the time being to satisfy Switzerland's need in its relationship with the EU[13]. As a result, in 1994 the Swiss government opened bilateral negotiations, which ended with the signature of 'Bilateral I' on 21 June 1999 which comprises seven agreements between Switzerland on the one part and

6 Art 3(c) EC Treaty.

7 As per art 1, the agreement - which was signed in Oporto on 2 May 1992 – aimed "[t]o promote a continuous and balanced strengthening of trade and economic relations between the Contracting Parties with equal conditions of competition, … with a view to creating a homogeneous European Economic Area …" <http://secretariat.efta.int/Web/EuropeanEconomicArea/EEAAgreement/EEAAgreement> (26 April 2007).

8 BS Frey and I Bohnet, 'Democracy by Competition: Referenda and Federalism in Switzerland' [1993] The journal of Federalism 71, 73.

9 'Competition Policy in Small Economies – Switzerland' (2003) OECD Global Forum on Competition <http://www.oecd.org/dataoecd/58/22/2486055.pdf> (26 April 2007).

10 In 2005 the Swiss biggest partner was Germany, followed in descending order by Italy, France, Austria and the United Kingdom. In 2005, 62.3% of the export went to EU countries and 80% of the imports came from EU Member States <http://www.swissworld.org/eng/economy/Trade.html?siteSect=302&sid=4004809&cKey=1171380391000&rubricId=11020> (26 April 2007).

11 Ibid.

12 Beck (n 4).

13 'Bilateral Trade Relations – Switzerland' <http://ec.europa.eu/trade/issues/bilateral/countries/switzerland/index_en.htm> (26 April 2007).

the EU and its Member States on the other[14].

After signing 'Bilateral I', the EU was hesitant about beginning new negotiations, but soon realised that there was an urgent need to talks with Switzerland on two important issues: taxation of savings and the fight against tax fraud[15]. Switzerland agreed to hold talks, but requested to include in the negotiations its participation in the Schengen/Dublin cooperation agreement on internal security and asylum[16], as well as other dossiers that the two sides had declared their intention to negotiate when they signed 'Bilateral I'[17]. Furthermore, Switzerland set the precondition that all the dossiers were to be negotiated and signed simultaneously[18]. As a consequence, bilateral negotiations were re-opened and a second set of agreements ('Bilateral II') was signed on 26 October 2004, including nine new agreements[19]. As part of Bilateral II, Switzerland[20] and the European Community concluded an agreement on the taxation of savings, which entered into force on 1 July 2005[21]. The Savings Tax Agreement (hereinafter: 'STA') - which is accompanied by a Memorandum of Understanding (hereinafter: 'MoU') - represents the implementation of 'equivalent measures'[22] to those found in the EU Savings Tax Directive (hereinafter: 'ESTD')[23].

14 The seven agreements concluded were on the following subjects: Free movement of persons, Technical barriers to trade, Public procurement markets, Agriculture, Civil aviation, Overland transport and Research.

15 'Bilateral Agreement II' Integration Office DFA/DEA Information (2004) <http://www.europa.admin.ch> (26 April 2007).

16 Council Directive 2001/51/EC of 28 June 2001 supplementing the provisions of art 26 of the Convention implementing the Schengen Agreement of 14 June 1985 [2001] OJ L 187/45. This directive abolished controls of persons at the internal frontiers of the EU, thus permitting the free movement of persons between EU member states.

17 'Bilateral Agreement II' (n 14).

18 Ibid.

19 The nine agreements concluded were on the following subjects: Cooperation in the fields of justice, police, asylum and migration (Schengen/Dublin), Taxation of savings, Fight against fraud, Processed agricultural products, Environment, Statistics, Media, Education, occupational training youth and Pensions.

20 According to art 20 STA, the agreement applies to Switzerland and to the territory to which the Treaty establishing the European Communities applies. 'Switzerland' refers to the Swiss Confederation, therefore the 'Principality of Liechtenstein' is not included.

21 Art 17(2) STA.

22 Para 1 MoU.

23 Council Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments [2003] OJ L 157/38.

The Savings Tax Agreement is fundamentally composed of three pillars:

1. The implementation of a retention ('withholding tax')[24] on interest from Swiss paying agents to an individual resident of a EU Member State[25];

2. The introduction of an exchange of information in case of 'tax fraud[26] and the like[27]' on elements covered by the Agreement[28]; and

3. The extension to Switzerland of rules comparable to the EU Parent-Subsidiary[29] and EU Interest and Royalty Directives[30,31].

---

24 It is interesting to note that the STA uses the word 'retention' instead of 'withholding tax', which confirms the fact that from a Swiss standpoint the retention is merely a mechanism levied in the interest of the EU, rather than a tax at source for Swiss domestic law.

25 Art 1 STA.

26 German: 'Abgabebetrug'; French: 'escroquerie'; and Italian: 'frode fiscale' as defined under Swiss law.

27 The 'like' included only offences with the same level of wrongfulness, as is the case for fraud under the laws of the requested.

28 Under art 10 STA, Switzerland has agreed the exchange of information on 'tax fraud' or 'the like' for income covered by this agreement, whereby information will be exchanged under the procedures in the tax treaties between Switzerland and the Member State. Switzerland has agreed as well in the MoU to renegotiate the exchange of information (Art 26 OECD Model) of all its existing DTTs with EU Member State in order to provide for this more extensive exchange of information. A detailed discussion of this topic is beyond the scope of this dissertation. For a broader discussion, see: X Oberson, 'L'Echange de Renseignement sur la Base de l'Accord entre l'Union Européenne et la Suisse sur l'Imposition des Revenues de l'Epargne' [2006] Liber Amicorum 855; X Oberson, 'L'Accord entre la Suisse et l'Union Européenne pour Lutter contre la Fraude – Un Tournant' [2005] IFF Forum für Steuerrecht 167; X Oberson, 'L'Assistance International en Matière Fiscale – Les Accords Bilatéraux Bis entre la Suisse et l'UE' [2006] L'expert comptable Suisse 179; X Oberson, 'International Exchange of Tax Related Information' (2005) <http://www.swissnetwork.com/?page=ViewArti cle&id=53> (26 April 2007).

29 Council Directive 90/435/EC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States [1990] OJ L 225/6.

30 Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States [2003] OJ L 157/49.

31 Art 15(1) STA provides the abolition of taxation at source for dividends paid by subsidiary companies to parent companies. On the other hand, art 15(2) STA provides that interest and royalty payments made between associated companies or their permanent establishment (PE) shall not be subject to taxation in the source stare where: such companies are affiliated or both are held with a third companies by a direct minimum holding of 25% for at least two years; a company is a resident of, or a PE of it is located in a Member State and the other company is resident or a PE is located in Switzerland; under any DTT with third country neither company is resident in that third country; and all companies are subject to corporation

This dissertation will focus on the analysis of the implementation of the withholding tax and the extension to Switzerland of rules comparable to the EU Parent-Subsidiary, which the author believes to be the most relevant issues in relation to Switzerland as a place to do business in an international context. The aim of this dissertation is to analyse and present a critical review of the introduction of the Savings Tax Agreement. Another aim of this work is to discuss and analyse the special relationship between Switzerland and the European Union.

The dissertation will begin by examining the reasons that lead Switzerland and the EU to negotiate and conclude the STA. It will then look at the features and the introduction of the withholding tax, concentrating in particular on the problems of its implementation, as well as the weaknesses and loopholes of it and by offering a critical evaluation of this particular legislation's future. Furthermore, this work will be reviewing the main features and the interpretation of article 15 of the STA and comparing the old refund procedure for withholding tax with the new declaration procedure, as well as analysing the implementation of the agreement and the anti-abuse measures used by the Federal Tax Administration (hereinafter: 'FTA'). Finally, this dissertation will conclude with a discussion and some opinions on the recent conflicts between the EU and Switzerland and some critical considerations for the future of this particular relationship.

1 Implementing the retention

1.1 The Background on the EU's attack upon Swiss banking secrecy

Swiss banking secrecy, which prohibits any bank officials from disclosing any information that a bank customer entrusts to them in this capacity[32], has been one of the main benefits offered by the Swiss financial system, albeit by no means the only one[33]. Specially after banking secrecy was written into Swiss Federal Law on Banks, Switzerland became a key player in the sector of wealth management[34]. Banking secrecy is considered to be the core of the Swiss banking system which currently

---

tax without being exempt in particular on interest and royalty and each adopts the form of a limited company.

32 Art 47 of the Federal Law on Banks and Savings Banks (hereinafter: 'LB'), enacted on 8 November 1934, SR 952.0.

33 Other factors such as its neutrality, political stability, strong currency, high-quality service, above-average performance, as well as cost-transparency and good value have played an important part in enhancing the importance and attractiveness of Switzerland as a financial centre.

34 Wealth management encompasses asset investment, portfolio management, as well as estate, inheritance and tax planning advisory services; see L Canal, 'Switzerland, Capital of Wealth Management' (2006) <http://www.swissinfo.org/eng/swissinfo.html?siteSect=43&sid=6842718> (26 April 2007).

manages around Sfr.4,000 billion[35] or one third of the world's private 'offshore' wealth[36]. Inevitably, over the years, this successful and profitable position has attracted competitors' attention and envy.

Switzerland's banking network - specially since the 1990s when capital movements were liberalised[37] and fighting tax evasion on income arising on cross-border investments became an EU objective - have been attacked and put under pressure from the European Union, the United States and the Organisation for Economic Cooperation and Development (hereinafter: 'OECD') Member States[38]. These states have tried to force Switzerland to give up banking secrecy, which they believe allows criminals worldwide to lauder money in Switzerland with impunity[39]. EU and OECD Member States believe that by abolishing Swiss banking secrecy, they would achieve an important target in fighting tax evasion and fraud regarding savings income[40]. In the absence of the coordination of national tax systems for taxation of savings, residents of Member States are currently able to avoid any form of taxation in their state of residence on interests they receive in other Member States[41]. Full cooperation from third countries playing an important role in the wealth management sector is vital[42], because in absence of any coordinated action capital flight towards these countries could imperil the attainment of EU objectives[43]. EU Member States, in particular France, Germany and Italy have criticized Switzerland for allowing their citizens to move their money into Swiss banks without declaring

35 Ibid.

36 The term 'offshore' means any shifting of funds placed outside the country of origin for tax planning or tax evasion, see A Miller and L Oats *Principles of Internationals Taxation* (Tottel publishing Luton 2006) 174.

37 The capital movements were liberalised by Council Directive 88/361/EEC of 24 June 1988 for the implementation of art 67 of the Treaty [1998] OJ L 178/5; see S Bell, 'EU Directive on the Taxation of Savings Income' [2003] British Tax Review 475, 475.

38 Canal (n 33).

39 Ibid.

40 A Keiser, 'Banks are Prepared for Savings Tax' (2005) <http://www.swissinfo.org/eng/search/detail/Banks_are_prepared_for_savings_tax.html?siteSect=881&sid=5912835&cKey=1120161620000> (26 April 2007).

41 Art 5 ESTD Preamble.

42 As per art 17(2) STA, one of the provisions of the ESTD to enter into force was that the Swiss Confederation, as well as the Principality of Liechtenstein, the Republic of San Marino and the Principality of Andorra apply the same measures contained in this directive. This precondition was obviously intended to safeguard the aim of the ESTD by avoiding that interest payments could have circumvented the directive via investments with these financial institutions.

43 Art 24 ESTD Preamble.

them to their domestic authorities, resulting in an extremely large loss to their revenue[44].

However, Switzerland has always protected its bank customer secrecy[45], claiming that is not and has never been absolute, since it does not protect criminals[46]. In fact, Switzerland has always maintained that a Swiss judge can order the banks to lift banking secrecy in specific cases, like criminal investigations[47], when providing international assistance[48] in debt collection, in bankruptcy and in civil proceedings[49]. Nevertheless, bank customer secrecy is not lifted in cases of tax evasion and as an impediment to tax evasion[50]. It is interesting to note that Switzerland is the only OECD Member country that has entered an observation under which it is not the purpose of tax treaties to prevent tax avoidance or tax evasion[51].

Switzerland and the EU have argued for years in order to negotiate the second series of agreements[52]. Unlike most other countries, as previously seen, Switzerland does not consider tax evasion to be a crime so their banks do not have to provide tax authorities with information on their clients’ assets. The European Union has been very critical on this aspect and has tried for many years to obtain an exchange of information with Switzerland[53]. The *Confoederatio Helvetica*[54] has been very firm

44 Germany for instance claimed that the undisclosed capital moved into Swiss banks amount to approximately Eur 300 billion.

45 The legal purpose of the banking customer secrecy is to protect the bank customer’s privacy with respect to financial affairs, thus protecting customers and not banks. For this reason using the definition ‘bank customer secrecy’ is a more appropriate and accurate definition than ‘bank secrecy’.

46 ‘Some Facts about Swiss Banking Secrecy’ (2005) <http://www.assetprotectioncorp.com/swissbanking.html> (26 April 2007).

47 eg suspicion of money laundering, membership in a criminal organization, theft, fraud, blackmail, etc.

48 eg in criminal investigations conducted abroad.

49 eg inheritance, divorce, etc; see L Canal, ‘Banking Secrecy Weathers Storms’ (2006) <http://www.swissinfo.org/eng/search/detail/banking_secrecy_weathers_storms.html?siteSect=881&sid=6859438&cKey=1163082084000> (26 April 2007).

50 ‘The Limits to Swiss Bank Secrecy’ <http://switzerland.isyours.com/e/banking/secrecy/limits.html> (26 April 2007).

51 Para 27.9 of the OECD Commentary on art 1

52 Keiser (n 39).

53 B Beck, ‘Switzerland and the European Union’ (2005) <http://www.swissnetwork.com/?page=ViewArticle&id=15&category=> (26 April 2007).

54 Official Latin name of Switzerland, which means ‘Swiss Confederation’.

on its position and, since sharing information about tax evasion would have threatened its banking secrecy, Swiss negotiators have confirmed that they would never have signed the dossier on the taxation of savings, unless Brussels had agreed to guarantee Swiss banking secrecy[55]. Swiss negotiators have always made it perfectly clear that neither bank-client confidentiality nor national tax sovereignty would be sacrificed to satisfy the EU's demands[56], but; after almost two years of negotiation[57], a fair compromise has been reached on the taxation dossier with Switzerland agreeing to transfer withholding tax on EU residents' savings income to Brussels[58]. Switzerland won concessions on this dossier, after the EU dropped its demands that Bern hand over information about account holders[59]. This solution allowed Switzerland to preserve its vital banking secrecy while allowing a successful conclusion to all the other dossiers under discussions[60]. At the same time, as for Austria, Luxembourg and Belgium[61], the withholding tax system will ensure at least a minimum level of taxation of the interest derived by EU residents[62], thus satisfying the EU's tax collectors[63].

55 Swissinfo with agencies, 'EU Agrees Guarantees over Swiss Banking Secrecy' (2004) <http://www.swissinfo.org/eng/search/detail/EU_agrees_guarantees_over_Swiss_banking_secrecy.html?siteSect=881&sid=4933606&cKey=1084471474000> (26 April 2007).

56 'Swiss Press Coverage of the Taxation of Savings Income', *94th Annual Report of the Swiss Bankers Association for the year 1 April 2005 to 31 March 2006*.

57 However the general negotiation on exchange of information between Member States and third countries, especially Switzerland, lasted for fourteen years.

58 Swissinfo with agencies (n 54).

59 Ibid.

60 As previously seen, the Swiss politicians set the precondition that all the dossiers of 'Bilateral II' had to be negotiated and signed simultaneously.

61 As per art 10 of the ESTD, Austria, Belgium and Luxembourg - which, like Switzerland, were not eager to undercut their bank secrecy rules and exchange information with the EU - had the same concession from the EU and shall not, during a transitional period starting on 1 January 2005 (Art 17(2) ESTD) be required to exchange information between Member States (Chapter II of the ESTD), but shall levy a withholding tax (Art 11 ESTD) at the same rate as the Swiss Confederation.

62 As per art 10(1) of the ESTD: "During the transitional period, the aim of this Directive shall be to ensure minimum effective taxation of savings in the form of interest …".

63 Swissinfo with agencies (n 54).

1.2.1 The retention on interest payments

The rate of the withholding tax is 15% for the first three years from the date of acquisition of the STA, 20% for the subsequent three years and 35% thereafter[64]. Switzerland will keep 25% of the revenue generated by the withholding tax and transfer 75% of the revenue to the Member State of residence of the beneficial owner[65]. However, if express authority is given by the beneficial owner, the withholding tax may be replaced by a voluntary disclosure[66] of the interest payment via the Swiss Federal Tax Administration to the tax authority of the State of residence of the beneficial owner[67]. This procedure entails a waiver of the Swiss banking secrecy which is, however, admissible as it is voluntarily requested by the beneficial owner of the interest[68].

Four conditions need to be met in order for the retention to be applied[69]. Firstly, there must be an interest payment to the beneficial owner[70]. Secondly, the retention only applies to interest paid by a Swiss paying agent[71]. Thirdly, interest must be paid to an individual resident of an EU Member State, including states which have joined the EU on 1 May 2004[72] and Romania and Bulgaria, which joined the EU on 1 January 2007[73]. Therefore, interests paid within Switzerland are not subject to the retention[74] and the same is true for interest paid to non-EU States. Finally, the

64 Art 1(1) STA.

65 Art 3(1) STA.

66 Art 2(1) STA.

67 As per art 2(2) STA, the minimum amount of information to be reported consists of: the identity and residence of the beneficial owner (Art 2(2)(a)); the name and address of the paying agent (Art 2(2)(b)); the account number of the beneficial owner (Art 2 (2)(c)); the amount of the interest payment calculated (Art 2(2)(d)).

68 X Oberson, ‘Le Secret Bancaire et l’Accord entre l’Union Européenne et la Suisse sur la Fiscalité de l’Epargne’ [2006] UE dossier de droit européen 557, 567.

69 Art 1(1) STA.

70 Art 7 STA. This interest definition is the same as per art 11(3) of the OECD Model Double Taxation Convention on Income and Capital (hereinafter: ‘OECD Model’).

71 Art 6 STA.

72 (n 1).

73 As per FTA’s instructions ‘Fiscalità del risparmio dell’EU/Adeguamento delle istruzioni’ (23 November 2006).

74 Art 1(2) STA.

retention applies only if the payment of interest is made to the beneficial owner[75], which implies that payments to a legal entity are not covered by this agreement.

1.3 The problems of the retention for the Swiss banking system

Introducing the retention on payments of interest from Swiss paying agents to EU citizens has allowed Switzerland to preserve its important banking secrecy and reduce accordingly, at least for the time being, the EU pressure on its banking system[76]. However, the implementation of this new legislation has put the Swiss banking system under an excessive administrative burden[77].

The main problems stem from the fact that the retention must be applied to all EU citizens[78] and only to payments of interest[79], therefore Swiss banks have to take into account the various conditions in which the retention should apply and those transactions on which it should have no impact, as well as the difficult aspect of having to establish the domicile of all banking clients, and in particular the retrieval of information on former clients, as well as contacting clients for updated information at any time[80]. Banks will need to make sure that the right people are taxed and that the retention is correctly applied. No problems arise for a simple situation like a French citizen living in France receiving interests from a Swiss bank; nevertheless, the situation can become complicated and create confusion when, for example, the same French citizen is living outside France, say Algeria or Tunisia. In this case, the FTA will not apply the retention if it receives confirmation on the recipient's residence status and liability to tax there[81]. The situation can become even more complicated, when banks are dealing with investments funds and hybrid products.

In order to be ready to deal with the new challenge, Swiss banks have had to update their IT systems and adapt their software to the new rules[82]. In addition, they have had to invest not only in back-office functions, but also in front-office activities, such as advising their clients, opening new client accounts or re-classifying old and

75 Art 4 STA.

76 L Canal (n 48).

77 F Citterio, 'Euroritenuta e Banche Svizzere' *Corriere del Ticino* (Lugano Switzerland 11 August 2006) 7.

78 Art 1(1) STA.

79 Art 7 STA.

80 'EU savings tax from Feira to Bern', *93rd Annual Report of the Swiss Bankers Association (SBA) for the year 1 April 2004 to 31 March 2005*, 14.

81 Art 5 STA.

82 Swissinfo with agencies (n 54).

new products[83]. Nevertheless, despite probably being the most expensive and labour-intensive set of tax legislation ever seen, the Swiss Bankers Association has confirmed that the new withholding tax has been successfully implemented into the Swiss banking system[84].

1.4 The weaknesses of the new withholding tax

In the first six months (from 1 July 2005 to 31 December 2005) since the introduction of the retention, the payments to the EU have been below expectations[85] and only Sfr.159 million (Eur 100 million)[86] have been cashed[87]. The amount cashed for the year 2006, although showing an increase to Sfr.536.7 million, confirms this low result[88]. Considering the result of the first six months on an annual basis, we obtain an amount of Sfr.318 million, which - with a retention of 15% - achieves a total amount of taxable interest slightly above Sfr.2 billion[89]. Assuming an average interest of 3%, we reach a total value of bonds of approximately Sfr.70 billion[90]. It is hard to believe that such a strong banking system with an estimated 35% of the world's private wealth[91] could have collected so little[92]. However, an analysis of the 'loopholes' of such retention can explain this and lead us to a better understanding

83 SBA report (n 79).

84 Ibid, it has been calculated, that the implementation costs for the Swiss banks amount to some Sfr.300 million.

85 U Lomas, 'Swiss Figures Expose Flaws in EU Savings Tax Directive' (2006) <http://www.lawandtax-news.com/asp/story.asp?storyname=24164> (26 April 2007).

86 The main part of the amount derives from Italy (26.5%), Germany (20.1%), France (12.6%), United Kingdom (10.8%), Spain (8.6%), Belgium (5.3%) and Greece (4.6%). It is noteworthy how these results confirm the importance of Italian investors for the Swiss banking system.

87 As per art 8 STA, 75% of the revenue generated by the retention (75% of Sfr.159 mio = Sfr.119 mio) to be transferred to the member states of residence of the beneficial owner and 25% (25% of Sfr.159 mio = Sfr.40 mio) to be kept by Switzerland.

88 FDF Press release 23 April 2006 <http://www.admin.ch> (26 April 2007).

89 Citterio (n 76).

90 Ibid.

91 As Switzerland applies the banking secrecy, it is not possible to estimate the exact amount of capital invested there.

92 U Lomas (n 84).

of the various ways with which the new legislation can be avoided[93]. The withholding tax can be eluded through a number of loopholes and weakness exploited by banks in different ways[94]. It is noteworthy that none of the loopholes can be blamed on Switzerland, because they are part of the EU Directive which were consciously accepted by the EU Member States[95].

A first weakness of the new legislation occurs from the fact that - as the retention applies only to individual savings interest, income from bonds or debentures[96] and not to income from dividends, share funds, insurance policies, derivates and gold - account holders can avoid the withholding tax by manoeuvring their assets into new financial products expressively designed to avoid the narrow terms of the agreement[97]. In April 2004, the private Bank Leu launched a new fund that will invest in Euro bonds and allow customers to avoid the retention[98]. Moreover other banks, including Credit Suisse and UBS, have reportedly also been working on ‘individual solutions’ for clients[99] as a consequence of which most of their foreign investors will elude the new legislation by shifting their investments into new specialised financial products[100].

A second source of weakness is the fact that the agreement requires the individual to be the beneficial owner and to receive the income directly. Therefore, for example, an individual who transfers his portfolio investments into an offshore entity or a

---

93 Other countries which have applied the retention have confirmed these low revenues for the first 6 months of the retention: Luxembourg (Eur 48 million), Jersey (Eur 13 million), Belgium (Eur 9.7 million), Guernsey (Eur 4.5 million) and Liechtenstein (Eur 2.5 million); see AM Jiménez, ‘Loopholes in the EU Savings Tax Directive’ (2006) 60 Bulletin for International Fiscal Documentation 480.

94 M Allen, ‘First Savings Tax Instalment May Disappoint’ (2006) <http://www.swissinfo.org/eng/search/detail/First_savings_tax_instalment_may_disappoint.html?siteSect=881&sid=6593248&cKey=1144245170000> (26 April 2007).

95 ‘EU savings tax from Feira to Bern’ *93rd Annual Report of the Swiss Bankers Association (SBA) for the year 1 April 2004 to 31 March 2005*, 14.

96 Art 7(1) STA.

97 The Guernsey Guidelines on the application of the agreement entered into between Guernsey and each EU Member State, in support of the EU Directive on the taxation of savings income, provides a list of income that may act as substitutes for interest and thus used by investors, who would like to avoid the retention, <http://www.commerce.guernsey.gg/FSD/Guidance%20Notes.pdf> (26 April 2007).

98 J Greber, ‘Banks Seek Ways to Exploit EU Tax ‘Loopholes’’ (2004) <http://www.swissinfo.org/eng/search/detail/Banks_seek_ways_to_exploit_EU_tax_loopholes.html?siteSect=881&sid=4962356&cKey=1085754620000> (26 April 2007).

99 Ibid.

100 It has been recently estimated that at least Sfr.200 billion could be ‘re-allocated’ in this way.

company[101], will not be subject to the retention, simply because he will not receive the income directly. However, it would only be profitable to shift the capital into an offshore company if the investor has enough capital to restructure his or her fortune[102]. As a consequence the implementation of the withholding tax has had a major negative impact on investors having relatively small portfolios, since the costs of setting up a legal entity or transferring their capital into other countries exceeds the amount of the retention which has deterred them from shifting their investments into other jurisdictions.

It is worth mentioning that few beneficial owners have opted for the voluntary disclosure provision of the interest payment to the tax authority of their State of residence[103]. This confirms the lack of efficacy of this new legislation and the fact that beneficial owners, who are unable to avoid the retention, prefer to pay it rather than disclose any information to the relevant authorities of their Residence State. Nevertheless, in these cases beneficial owners will be subjected to tax in the Source State rather than in the Residence State, conflicting inevitably with the main aim of the EU of guaranteeing an effective taxation of savings income in accordance with the laws of the beneficial owner's Member State of residence[104].

1.5 Future perspective and critical evaluation

With the introduction of the retention, Switzerland, and especially its banking system, have borne an excessive burden in order to preserve banking secrecy. Nevertheless, thanks to the opportunities to differentiate and invest in products or structures beyond the scope of the withholding tax, not many EU clients are taking their money abroad[105]. It is however impossible to predict customer behaviour and what Swiss banks fear is the fact that there is nothing stopping investors from transferring their money into new accounts and portfolios in other advantageous countries, like Singapore, Dubai or Hong Kong. For the time being the costs of transferring money from one country to another could probably exceed the retention of 15% and thus deter individuals from shifting their investments, but the situation might change when the withholding tax will increase to 35% from 1 January 2011[106].

---

101 'Flaws in the EU Savings Directive will Cost Member States Dearly' (2005) <http://www.thebanker.com/news/categoryfront.php/id/136/Comments___Analysis.html> (26 April 2007), it is said that more than 100,000 companies have been set up in the first six months in order to allow wealth investors to avoid the retention.

102 Greber (n 97).

103 Citterio (n 76).

104 Art 1 ESTD.

105 Allen (n 93).

106 Art 1 STA.

During the first year of the EU Savings Tax Directive other countries have shown low returns[107]. This obviously demonstrates that some investors have already started shifting their capital into jurisdictions where the ESTD does not apply[108]. As a consequence, the European Commission[109] is now aiming to strengthen and extend the scope of the ESTD to territories where it currently does not apply[110]. EU tax commissioner, Mr. Kovacs, and EU tax experts are currently assessing the opportunity of extending the geographical scope of the Savings Tax Directive to the Asian financial markets, in particular to Hong Kong, Singapore and possibly Macao[111]. However, it is unlikely that these countries will open negotiations on the possibility of sharing tax information[112] and subject offshore savings held by EU citizens to withholding tax as required by the ESTD[113]. These countries have benefited from the outflow of money from the European market and accordingly have little incentive to cooperate.

For the time being, Switzerland has reached the important and vital objective of preserving its banking secrecy. Thanks to new investment solutions, foreign investors are still appreciating the traditional strengths of the Swiss financial sector and the quality of its private banking, as well as its international diversification and the security of the Swiss financial sector as a whole[114].

However, the European Community will be likely keep up the pressure on the taxation of savings and in 2011, or when both sides decide to negotiate and talk[115], European negotiators could again try to force Switzerland to give up its banking system and obtain an extended exchange of information. As previously seen, the

107 'The EU Savings Tax Directive - One Year on' (2006) <http://www.investorsoffshore.com/html/specials/july06_std.html> (26 April 2007).

108 'EU in Talks to Extend Savings Tax 'Net' to Asia' (2006) <http://tdctrade.com/alert/eu0619f.htm> (26 April 2007).

109 Under art 18 ESTD, the EU Commission must report every three years on the ESTD's operation and propose to the Council any amendments that are necessary to ensure its main aims.

110 R Goulder, 'Kovacs Begins Consultations Designed to Strengthen EU Savings Tax Directive' (2007) <http://services.taxanalysts.com/taxbase/tbnews.nsf/Go?OpenAgent&2007+WTD+70-1> (26 April 2007).

111 G Parker, 'EU Tax Officials Set Sights on Asia' *Financial Times* (3 September 2006).

112 Hong Kong has actually stated that they will exchange information only within the context of comprehensive income tax treaty; see P Verbeek, 'EU Eyes Asia on Tax Cooperation' (2006) 42 Tax Notes International 9.

113 (n 107).

114 Allen (n 93).

115 Art 13 STA.

amounts cashed with the retention have not produced the result expected by the EU and the revenue will probably not increase significantly even when the withholding tax rates will raise first to 20% and subsequently to 35%. This is because by this time, the investors' and banks' knowledge of the new system will have improved so there will be many alternatives and structures available, which will make it difficult to find old investments where the retention still applies. Hence, the European Commission will try to close the loopholes[116] incorporated in the STA and strengthen its application. In order to increase its revenue, the EC could possibly try to set other retentions, perhaps trying to levy a withholding tax even on dividends or on distributions and payments derived from investments funds, which do not fall within the current definition of *interest*[117]. Nevertheless, it is questionable whether Switzerland would agree to such changes: diplomats say that Switzerland only agreed to the STA precisely because it contained so many loopholes[118].

EU political actions, such the introduction of the ESTD, will hardly eliminate the flight of undisclosed capitals into countries that provide for banking secrecy like Switzerland, without coordinated action at the international level[119]. The broader the economic grouping of countries engaged in this dialogue, the greater the efficacy of any solutions proposed, since this would minimise any displacement[120] of capital into jurisdictions where the retention does not apply. However, as previously stated, extending the scope of the ESTD will be difficult as other countries may have no incentive in cooperating with the EU and so its original aim will be difficult to achieve.

Clearly the new legislation has proved weak and ineffective. In the future a far better solution for the EU could be to concentrate on internal solutions and direct its efforts towards trying to implement a better and more competitive tax system within its internal market[121]. The EU has launched - with the Code of Conduct[122] - a

---

116 A deep analyse of the loopholes and possible solutions is beyond the scope of this dissertation. For a broader analyse see: AM Jiménez (n 92).

117 Art 7 STA.

118 'Savings Tax Loopholes Come under Increased EU Scrutiny' (2007) <http://home.eircom.net/content/irelandcom/biznews/10187346?view=Eircomnet> (26 April 2007).

119 The same approach has been suggested in the OECD 1998 Harmful Tax Competition Report (hereinafter: '1998 OECD Report').

120 Para 13 1998 OECD Report.

121 T Tettamanti, 'Imposta Preventiva UE: Fallimento Programmato' *Corriere del Ticino* (Lugano Switzerland 7 August 2006) 2.

122 Resolution of the Council and the representatives of the Governments of the Member States, meeting within the Council of 1 December 1997 on a Code of Conduct for business taxation (hereinafter: 'Code of Conduct') [1998] OJ C 2/2.

coordinated action to reduce continuing distortions in the single market and curb harmful tax measures, as well as prevent significant losses of tax revenue and help tax structures to develop in a more employment-friendly way[123]. This solution could achieve a better result and is the way to follow in order to consolidate competitiveness within the EU single market and increase its tax efficiency[124]. Furthermore, by taking advantage of the advance know-how of Swiss and European banks, the EU could obtain an inversion of the flight of capital so that, rather than having European capital emigrate into the Middle East market, Asian capital would move towards Europe[125]. In conclusion, having a better coordinated and more efficient tax system would help Member States to build a fair competition system so as to ease tax avoidance and tax fraud and to increase the confidence of EU and foreign investors.

2 Swiss companies achieve access to the EC Parent-Subsidiary Directive

2.1 Abolition of withholding tax on cross-border dividend payments between affiliated entities

In exchange for the concession made with the introduction of the retention on payment of interests, Swiss companies achieve access to the advantages of the EC Parent/Subsidiary Directive (hereinafter: 'PSD')[126]. Accordingly, qualifying dividends will no longer be subject to a non-recoverable withholding tax[127] provided that the respective requirements are met[128]. Article 15(1)[129] of the STA provides that dividend[130] payments by a subsidiary to its parent company shall not be subject to taxation in the source State where the following four conditions are satisfied.

---

123 Code of Conduct Preamble.

124 Ibid.

125 Tettamanti (n 120).

126 Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States [1990] OJ L 225/6.

127 It is worth remembering that Swiss companies get accessed to the EC Interest/Royalty Directive too, therefore qualifying interest and royalty will no longer be subject to a non-recoverable withholding tax if the conditions in art 15(2) are satisfied.

128 Art 15(1) STA.

129 There seems to be a common understanding between the FTA and the EU Commission that art 15 represents EC law. Consequently, art 15 should be applicable to new Member States joining the EU as part of the '*acquis communautaire*'.

130 Unlike the PSD that refers to 'distributions of profits', the STA uses the term of 'dividends'.

The first condition requires the parent company to have a minimum direct holding of 25%[131] of the capital of such a subsidiary for at least two years. The minimum participation threshold of 25% is binding and will not automatically be aligned with the lowering of the respective thresholds for the purposes of the PSD[132]. This is consistent with the 25% of the dividend article in the OECD Model[133] and the fact that, from a Swiss point of view a threshold of 10% cannot be considered a substantial holding that would allow affiliated companies to access the benefits of article 15(1) of the STA. The minimum period holding of 2 years is an anti-abuse provision designed to prevent dividend stripping by way of a short-term concentration of small non-qualifying holdings in one hand in order to temporarily pass the 25% threshold[134]. This provision is similar to article 3(2) of the PSD, which allows each Member State to unilaterally deny the parent-subsidiary status to companies that do not hold shares for an uninterrupted period of at least two years[135]. Switzerland has confirmed that the holding period is '*grandfathered*'[136]. In other words, if a dividend is distributed by a Swiss company immediately after the entry into force of the STA, it can qualify for relief, if the otherwise qualifying shares have been held for at least two years at the time of the dividend distribution[137]. It has also been confirmed that the participation needs not necessarily have been held for two years before the dividend distribution[138]. Therefore, as long as the two-year requirements are satisfied, the dividend distribution might occur at any time during the two-year period[139]. It is interesting to note that, in order to

131 The notion of 'direct holding' includes investments held through fiscally transparent entities.

132 As per art 3(1)(a) PSD, the minimum holding percentage has been reduced to 20% from the 1 January 2005, will be 15% from 1 January 2007 and will be reduced further to 10% from 1 January 2009.

133 Art 10(2) OECD Model.

134 B Terra and P Wattel, *European Tax Law* (Kluwer Law and Taxation Publishers Boston 1993) 179.

135 The two-year requirement is not consistently applied, i.e. Germany requires only one year and the Netherlands has no such requirement.

136 HR Hull, 'Switzerland and European Union - Tax Treatment of Intra-Group Cross-Border Dividends' (2006) 60 Bulletin for International Fiscal Documentation 73, 78.

137 Ibid.

138 Circular No. 10, 'Procédure de declaration pour dividendes de source suisse versés à des sociétés étrangères détenant des participations importantes, basée sur l'Article 15(1) de l'accord sur la fiscalité de l'épargne avec la CE (complément à la circulaire no 6 du 22 December 2004)', Swiss Federal Tax Adiministration (15 July 2005).

139 Ibid.

justify its position, the FTA has referred to the ECJ's decision in *Denkavit*[140]. In its judgment of 17 October 1996, the ECJ concluded that it is for the Member States to draw up rules for ensuring compliance with this minimum period, in accordance with the procedures laid down in their domestic law[141]. On no view are those states obliged under the Directive to grant the advantage immediately on the basis of a unilateral undertaking by the parent company to observe the minimum holding period[142]. Switzerland has taken the position that if dividends are paid before the minimum period had expired, Swiss companies are required to pay the amount of Swiss withholding tax that would normally have been levied in the absence of the Swiss-EU Agreement, that is, either Swiss withholding tax at the domestic rate of 35%, or a more favourable treaty rate[143]. Once the two-year holding period has expired, this amount will be reimbursed by the Swiss FTA upon request[144] by filing Form 70[145].

The second condition requires one company to be resident for tax purposes in an EU Member State and the other one in Switzerland. Residence is to be confirmed by application of article 4 of the OECD Model, as well as a relevant comprehensive tax treaty[146]. In the case where a company is a resident of both contracting states, the 'tie-breaker rule' applies and the company shall be deemed to be resident only of the state in which its place of effective management[147] is situated[148].

To satisfy the third condition, under any double tax agreement with any third state neither company should be resident for tax purposes in that third state. The STA applies only to Member States and related countries[149] and any other third country is thus excluded from the scope of this Agreement.

---

140 Joined Cases C-283/94, C-291/94 and C-292/94 *Denkavit International BV, VITIC Amsterdam BV and Voormeer BV v Bundesamt für Finanzen* [1996] ECR I-5063.

141 Ibid para 33.

142 Ibid para 36.

143 Circular No. 10 (n 137).

144 Ibid.

145 Form available at <http://www.estv.admin.ch/data/dvs/druck/forms/forms/70f.pdf> (26 April 2007).

146 Circular No. 10 (n 137).

147 Relevant factors are: management of the day-to-day business, meetings of the board of directors, etc.

148 Art 4(3) OECD Model.

149 Art 20 STA.

The fourth condition requires both companies to be subject to corporation tax without being exempted and both adopting the form of a limited company[150]. Both the parent and the subsidiary must be subject to corporation tax without being exempt[151]. In the case of an exempt company, the risk of double taxation does not arise and therefore there is no reason to compel a contracting state to prevent it[152]. The typical example of a non-qualifying company is a Luxembourg holding company falling under the Law of 31 July 1929[153] and therefore fully exempt from corporation tax[154].

Relief will be denied on the basis of the subject-to-tax requirement only if a company is totally exempt or almost totally exempt following to a ‘tax holiday’ regime[155] or if companies enjoy a subjective exemption from corporate tax[156]. Relief will however be granted to all other non-exempt Swiss limited companies regardless of any corporation tax relief they may be granted under Swiss domestic legislation[157] or administrative practice[158]. Therefore, companies taking advantage of relief for

150 With regard to Switzerland, the term ‘Limited company’ covers: Aktiengesellshaft/ société anonyme/società anonima; Gesellschaft mit beschränkter Haftung/société à responsabilité limitée/società a responsabilità limitata; Kommanditaktiengesellschaft/ société en commandite par actions/ società in accomanidita per azioni.

151 The requirement is similar to art 2(c) PSD, where relief is granted if a company “is subject to … taxes, without the possibility of an option or of being exempt”.

152 Terra and Wattel (n 133).

153 It is worth remembering that the European Commission announced on 19 July 2006 that the Holding 1929 regime has to be cancelled by the end of 2010 as the regime granted by the law of 31 July 1929 is not compatible with community state aid rules (Art 88(2) EC Treaty).

154 HR Hull, ‘The EC Parent Subsidiary Directive in Switzerland - Swiss Outbound Dividends’ (2005) 59 Bulletin for Fiscal Documentation 63, 71.

155 Foreign industrial or commercial enterprises moving into Switzerland might be granted in several cantons a special incentive called ‘Tax holiday’, which exempts them from federal and cantonal (including communal) taxes for a period of up to ten years after inception of business. Important conditions are: investments and creation of jobs in Switzerland; innovative strategy; focus on international markets; importance for the local and national economy. Companies that do not receive the maximum relief can expect tax reductions of 30-40% over varying periods of up to 10 years.

156 As per art 56 of the Direct Federal Tax Act (DFTA), 14 December 1990, SR. 624.11, legal entities with public, non-profit or cultural objects, pension and social security organisation are exempt from corporation tax.

157 Most relief is granted to companies for cantonal and communal tax purposes rather than for Swiss federal tax purposes.

158 HR Hull (n 153) 73.

qualifying dividends, holding company relief, or auxiliary company relief may all benefit from the STA[159].

2.2 Jurisdiction and interpretation of art 15

The European Court of Justice (hereinafter: 'ECJ') does not have jurisdiction to enforce the Savings Tax Agreement and the Federal Supreme Court has stated that ECJ case law after the date of signature is not binding[160]. Nevertheless, the decisions of the ECJ will almost certainly influence the Swiss courts in interpreting the STA[161]. Since Switzerland and the European Union based their negotiation on the PSD, it can be presumed that they will refer to the ECJ's decisions in interpreting the Agreement, even though such decisions are not binding for Switzerland[162].

It should be borne in mind that article 15(1) forms part of an international agreement[163] and thus subject to the interpretative provisions (Arts 31 to 32) of the Vienna Convention on the Law of Treaties[164] (hereinafter: 'VC')[165].

Interpreting the STA is particularly difficult, as there are no international courts offering legally binding interpretations[166]. The contracting parties agree to consult each other at least every three years or at the request of either party with a view to examining and, if deemed necessary, improving the technical functioning of the STA and assessing international developments[167]. Regarding the interpretation of the STA, the MoU includes a declaration of intent requiring that the contracting parties consider the STA and its Memorandum of Understanding to provide an acceptable and balanced arrangement that can be considered as safeguarding the interests of the

159 X Oberson, 'Agreement between Switzerland and the European Union on the Taxation of Savings - A Balanced '*Compromis Helvétique*'' (2005) 59 Bulletin for Fiscal Documentation 109, 113.

160 See for example, Federal Supreme Court, BGE 129 II 215, para 4.2, BGE 129 II, para 5.2 and BGE 130 II 176, para 2.1

161 HR Hull (n 153) 75.

162 Ibid.

163 K Eicker and R Obser, 'The Impact of the Swiss-EC Agreement on Intra-Group Dividend, interest and royalty payments' [2006] EC Tax Review 134, 135.

164 Vienna Convention of 23 May 1969 on The Law of Treaties, RS 0.111.

165 R Danon and PM Glauser, 'Cross-Border Dividends from the Perspective of Switzerland as the Source State - Selected Issues under Article 15 of the Swiss-EU Savings Agreement' (2005) 33 Intertax 503, 505.

166 H Hull (n 153).

167 Art 13 STA.

parties[168]. They will therefore implement the agreed measures in good faith[169] and will not act unilaterally to undermine this arrangement without due cause[170].

If the Swiss competent authority[171] and one or more of the EC competent authorities[172] disagree on the interpretation or application of the STA, the disagreement must be resolved by mutual agreement[173]. The mutual agreement procedure aims at resolving the dispute on an amicable basis[174], without going through diplomatic channels[175], and thus allowing the dispute to be settled in a timely and efficient manner.

Finally, it is noteworthy that the Savings Tax Agreement does not resolve the issue of whether it must be interpreted according to the *static approach* (i.e. the interpretation at the time the agreement was entered into force) or the *ambulatory approach* (i.e. the interpretation as amended on an ongoing basis). However, the *ambulatory approach* would appear more appropriate as it would allow the agreement to incorporate changes in interpretation without having to be renegotiated[176]. Both parties would definitely benefit in using an *ambulatory approach*, since not only changes would be incorporated without renegotiating the agreement, but also an ongoing approach, accepting the fact that the meaning of words can change, would limit possible conflicts on its interpretation. In addition, at the time of signing the STA, Switzerland and the EC believed that the agreement would endure over a period of time in an environment of changing domestic law, where the *ambulatory approach* is the most appropriate approach.

---

168 Para 4 MuO.

169 Art 31(1) VC.

170 Para 4 MoU.

171 As per annex 1 of STA, para A, the competent authority of Switzerland is the Director of the Swiss Federal Tax Administration or his proxy or agent: German: 'Der Direktor der Eidgenössischen Steuerverwaltung'; French: 'Le Directeur de l'Admistration fédérale des contributions'; Italian: 'Il Direttore dell'Amministrazione federale delle contribuzioni'.

172 Art 11 STA.

173 Art 12 STA.

174 Para 6 of the OECD Commentary on art 25.

175 Ibid para 4.

176 X Oberson and HR Hull, *Switzerland in International Tax Law* (3rd edn IBFD Publications Amsterdam 2006) 291.

2.3 Old refund procedure for the withholding tax

The Federal withholding tax[177] is levied on certain incomes, namely: dividends (liquidation proceeds are also included), interest on bank loans and bonds, lottery prizes and some insurance payments[178]. The main aim of the Federal withholding tax is to secure the recipients' compliance with their own income tax reporting and payment obligations[179]. In general, Switzerland levied, *inter alia*, a 35%[180] withholding tax of the gross amount paid on distributions on profits made by Swiss[181] companies[182], irrespective of whether or not the recipient was entitled to a full or partial refund, according to his or her residence[183]. The withholding tax must be shifted to the shareholder[184]; thus, the company must only pay out 65% of gross dividends and the 35% withholding tax must be remitted to the Federal Tax Administration. The tax withheld should to be paid to the FTA within 30 days after the dividend became due[185]. In case of a late payment, a 5% interest would be charged[186].

Since Switzerland introduced the withholding tax in the early 1940s, a refund procedure has always applied for Swiss withholding taxes levied on payments to beneficiaries, irrespective of their residence, therefore even for payments to Swiss residents[187]. However, a Swiss legal entity was entitled to a full refund of the withholding tax, provided it duly reported the underlying income in the financial statements[188]. If the country where the company was resident had concluded a

177 German: 'Verrechnungssteuer'; French: 'impôt anticipé'; and Italian: 'imposta anticipata' as per Swiss Federal Withholding Tax Law (WHTL) of 13 October 1965, RS 642.21.

178 Art 1(1) WHTL.

179 P Reinarz, 'Treaty Shopping and the Swiss Withholding Tax Trap' (2001) 41 European Taxation 415, 415.

180 Art 13(1)(a) WHTL.

181 For withholding tax purposes, a 'Swiss company' is a company whose statutory seat is in Switzerland or a company incorporated abroad, but which is effectively managed from within Switzerland and exercises an activity therein (Art 9(1) WHTL).

182 Art 4(1)(b) WHTL.

183 Art 14 WHTL.

184 Ibid.

185 Art 12(1) and 16(1)(c) WHTL.

186 Art 16(2) WTHL and art 1 of Withholding Tax Ordinance (WHTO), RS 642.211.

187 Art 22(1) WHTL.

188 Art 24(1) WHTL.

double tax treaty (hereinafter: 'DTT') with Switzerland and if all the conditions set forth in such treaty were fulfilled, the beneficiary could claim, depending on the treaty, a partial or full refund of the withholding tax paid[189].

However, this procedure resulted in several burdens[190]. First, in order to fully or partially reclaim the withholding taxes, the beneficiary had to complete all the necessary formalities, thus creating a further administrative burden. Moreover, due to the substantial amounts of money involved, this procedure could raise cash-flow problems, since the refund procedure could take several weeks. Furthermore, the withholding tax deposited with the FTA was non-interest bearing. Finally, as the withholding tax was remitted in Swiss Francs, foreign exchange issues might be created.

2.4 Net Remittance Procedure

The Swiss Federal Tax Administrator, in order to facilitate the payment of dividends by Swiss companies, decided to publish new regulations, which applied to qualifying dividends as of 1 January 2005[191]. The OECD Model does not contain provisions on the procedure for obtaining a full or partial refund of the withholding tax[192]. As a consequence, this procedure needs to be solved by domestic legislation of the Source State[193] or by bilateral negotiations[194]. As previously seen, treaty relief of the withholding tax paid in excess was available only by a refund procedure. There were however two exceptions where a 'Net Remittance Procedure' was already available; in the tax treaties with the United States[195] and Germany[196].

Nevertheless, according to a new procedure called 'Net Remittance Procedure', dividends paid to parent companies resident in treaty states can now qualify for

189 Depending on the income, the relevant article in the DTTs are: art 10 for dividend payments; art 11 for interest payments and art 12 for royalty payments.

190 Ernst & Young LLP, 'Landmark Reform of Swiss Withholding Tax Rules; Refund Procedure to Be Abolished 1 July 2005' (2004) <www.ey.com/global/download.nsf/Sweden/EU_Tax_News_2004_0910/$file/EU_Tax_News_Sept-Oct%202004.pdf> (26 April 2007).

191 Circular No. 6, 'Procédure de déclaration pour dividends de source suisse versés à des sociétés étrangères déténant des participations importantes', Swiss Federal Tax Administration (22 December 2004).

192 HR Hull, 'The Dividend Withholding Tax and Net Remittance Procedures in Switzerland' (2005) 59 Bulletin for International Fiscal Documentation 152, 153.

193 Para 19 of the Commentary on art 10.

194 Art 10 (2) of the OECD Model.

195 Ordinance of 15 June 1998 on the Switzerland - United States tax treaty, RS 672.933.610.

196 Ordinance of 30 April 2003 on the Switzerland-Germany tax treaty, RS 672.913.610.

treaty relief without having to make the 35% Swiss withholding tax prepayment, provided authorisation is granted[197]. The Net Remittance Ordinance (hereinafter: 'NRO')[198] covers the remittance procedure for substantial participations[199] for which a comprehensive tax treaty, or other international treaties, provide for a relief at source[200]. Henceforth, Swiss companies intending to distribute dividends under this new procedure are required to obtain a ruling from the FTA[201], which is done by means of Form 823C[202]. The Swiss authorities, after verifying that all the conditions are satisfied and that there is no risk of tax evasion, will grant a written authorization[203]. Thereafter, dividends paid must be declared on Form 108[204] (along with the other usual forms) within 30 days after the due date of the dividends[205]. This ruling is valid for three years[206], but it is subject to the requirement that any changes in the facts and circumstances be reported immediately by the company paying the dividend[207]. The company will levy the full 35% of withholding tax, if it is in doubt whether the shareholders qualify for treaty relief or not and withholding tax and interest on late payment will be levied by the FTA if they believe that the net remittance basis has been abused[208].

The Net Remittance Procedure, which requires the existence of a tax treaty or other international treaties providing relief at source[209] and which applies only to

---

197 Art 3(1) NRO.

198 Federal Ordinance in the cases of dividend payments in a treaty context and for qualifying participations, 22 December 2004, RS 672.203.

199 Art 2 NRO.

200 Art 1(1) NRO.

201 Art 3 NRO.

202 Form available at <http://www.estv.admin.ch/data/dvs/druck/forms/forms/823Ce.pdf> (26 April 2007).

203 See next section for a better analysis of the FTA's procedure.

204 Form available at <http://www.estv.admin.ch/data/dvs/druck/forms/forms/108f.pdf> (26 April 2007).

205 Art 5(1) NRO.

206 Art 3(4) NRO.

207 Art 4 NRO.

208 Art 5(2) NRO.

209 Art 1 NRO.

corporate shareholders[210], will not apply to residents of countries with which Switzerland has not concluded any tax treaties. Therefore, the STA will extend the benefits of the net remittance basis even to countries like Malta[211] and Cyprus, with which Switzerland did not have any tax treaty. If the dividend flows to an EU Member State with which Switzerland has concluded a DTT, the dividend paying company can choose between the application of the EU guideline or the relevant DTT[212]. It is worth remembering that the STA does not nullify the existing double taxation treaties, thus a DTT that provides for a more favourable tax treatment for dividends will remain unaffected[213].

Switzerland has a network of tax treaties with more than 70 countries[214] and its efficacy has been extended even further with the conclusion of the Savings Tax Agreement. Furthermore, the Net Remittance Procedure, which replaces the refund procedure by a declaration procedure, gives profit repatriation several advantageous aspects[215]. First, potential cash-flow problems that could arise when the amounts were large because of the time delay between payment and refund of the tax are now eliminated. Moreover, the risks of losses in exchange rate are abolished. Furthermore, as the Swiss withholding tax levied does not carry interest, this loss of income is eliminated under the new procedure. In addition, the beneficiary is not required to file all the forms for the refund of the withholding tax paid, thus the administration and timing problems are reduced. Finally, all the foreign shareholders resident in countries with which Switzerland has a tax treaty will benefit from the advantage of the Net Remittance Procedure in the same way Swiss, US and German residents previously enjoyed[216], so avoiding thus any possible discrimination issue.

In conclusion, it can confidently be said that Switzerland will benefit from the free movement of capital in the form of dividends from Switzerland to treaty partners. The elimination of the problematic aspect of the refund of withholding tax will clearly improve Switzerland's competitive position as a tax-friendly environment[217].

---

210 Art 2(1) NRO.

211 Switzerland signed an agreement with Malta on 30 March 1987 on the taxation of shipping and air transport.

212 Art 3(1) NRO.

213 Art 15(3). The same it is valid for DTTs providing for more favourable tax treatment for interest and royalty payments.

214 'Switzerland Double-Tax Treaties' <http://www.lowtax.net/lowtax/html/jsw2tax.html> (26 April 2007).

215 Hull (n 191) 155.

216 (n 194) and (n 195).

217 Hull (n 191) 156.

2.5 Conditions for approval of the Notification Procedure and Anti-Abuse Measures

Even if all the conditions for the relief of the Swiss withholding tax are met, the FTA may still deny such relief in cases where the tax advantage would result in tax avoidance[218]. The notion of 'tax avoidance' has been construed in line with the long-standing practice of the Federal Supreme Court whose definition includes three cumulative tests[219].

1. The legal form chosen by the taxpayer is apparently unusual or inappropriate, as well as inadequate to achieve the economic target and contrary to ordinary business practice (the 'objective element');

2. The taxpayer's sole reason of adopting such legal structure was the intention of saving tax (the 'subjective element'); and

3. The legal form chosen would effectively lead to a substantial reduction in tax (the 'factual element').

The Swiss subsidiary intending to distribute dividends to its parent company applying the new procedure must submit a form (Form 823B[220]) and the FTA will grant permission once several conditions are met. Firstly, the investment must be substantial[221], i.e. the foreign company must own a substantial holding in the Swiss company[222]. The percentage for a substantial holding is determined by the applicable DTT or by another interstate treaty that confers entitlement to additional or complete relief from withholding tax[223]. Moreover, if the applicable DTT or other interstate treaties do not define 'substantial', the foreign company must hold a direct interest of at least 20% of the capital of the Swiss company[224]. Furthermore, the application of the new regulations can be refused, if the residence state of the beneficiary does

---

218 Art 21(2) WHTL. This article is the basis of the express anti-abuse by the FTA.

219 Reinarz (n 178) 416.

220 The general form used for all countries (including Germany) except the United States (Form 823).

221 Art 2(1) NRO.

222 According to Circular No. 10 (n 137), the Swiss Federal Tax Administration confirmed that the shareholder must be the actual beneficiary of dividends in order to qualify for relief.

223 Art 2(1) NRO. To give an example, in the case of DTTs with Luxembourg and Great Britain, only a holding of at least 25% qualifies as a substantial investment.

224 Art 2(2) NRO.

not grant reciprocity[225]. In addition, the foreign company receiving the dividend must be entitled to claim treaty benefits[226] and the information in Form 823B must be confirmed by the foreign authority[227].

The Federal Tax Administration, before granting permission to apply the new procedure, must analyse the Swiss company and its parent company in accordance with Swiss law and if both satisfy the requirements, authorisation will be granted[228]. Moreover, in order to review a request, the Federal Tax Administration may require supplementary information and documentation from the beneficiary[229]. The FTA when approving a procedure must check whether the claim of the advantageous DTT's provision is in any way unlawful[230]. It is still possible for foreign ultimate owners to set up a Swiss company, with the mere goal of escaping the tax normally due on the profits made on national territory, since Switzerland offers domestic fiscal advantage, as well as an extended tax treaty network, which can favour the repatriation of profits[231], thus foreign investors could pay a modest tax in the Source State and, by taking advantage of the DTTs with countries with which Switzerland provides 0% rate on dividends[232] (and since the introduction of the STA, with all the EU countries), be granted full relief from Swiss withholding tax. The FTA may deny or reduce the amount of treaty relief granted if the relationship between the Swiss company and the EU company is fictitious or set up with the mere intention of securing treaty relief[233].

As a consequence, Switzerland has had to introduce strict rules of application in its international tax treaties[234] which aim to prevent treaty abuse by Swiss companies

225 Art 8 NRO. According to art 8(2), the FTA maintains a list of the states, which do not grant this relief. However, at the moment no such states are known in Switzerland.

226 Art 3(3) NRO.

227 Circular No. 10 (n 137).

228 This procedure has been confirmed by the FTA.

229 Circular No. 6 (n 190).

230 Reinarz (n 178) 415.

231 H Rüdisühli, 'The Benefits of Swiss Companies in International Tax Planning' (2006) 44 Tax Notes International 619, 623.

232 DTTs with the Netherlands, Denmark, Sweden, Luxembourg, France and Austria all provide 0% withholding tax on distribution of dividends under their specific conditions.

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

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

and to thwart an easy way out of Switzerland by interposing 'letterbox'[235] companies in treaty countries[236]. Essentially, letterbox companies are wholly artificial arrangements which do not reflect economic reality, with a view to escaping tax liability, without having either an actual establishment, in terms of premises, staff and equipment[237], or carrying out any genuine activities in the territory of the host Member State[238]. Within this procedure may be seen the increasing importance given to a proper economic structure in international tax in order to avoid 'treaty shopping', that is "the use of tax treaties by persons the treaties were not designed to benefit, in order to derive benefits treaties were not designed to give them"[239]. This recognises that an international tax structure must be economically justifiable (valid business purpose) and give weight to the overall business in order to avoid all doubts as to the reason for setting up the Swiss company. Hence, the FTA will analyse the situation to determine whether the structure is a 'wholly artificial arrangement' set up with the sole or primary purpose of granting the tax relief.

The FTA[240], when analysing an international structure, will be likely to pay particular attention to countries where the risk of 'treaty shopping' is higher, so when the FTA analyses the request of application of the net remittance basis for dividend payments to a Maltese Holding[241], which it is known to provide favourite tax treatment, it will analyse the situation in more detail comparing it, for instance, with an Italian Holding's request[242]. This follows from the fact that if an investor is trying to avoid tax, they might avoid locating the company in countries where tax treatments are high and unfavourable, but would rather move into countries like Malta, which provides a better treatment. This is an understandable practice but can

---

235 For a broader discussion on letterbox companies and wholly artificial arrangement, see Case C-196/04 *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd and Commissioners of Inland Revenue* [2006], ECR I-0000, as well as C-341/04 *Eurofood IFSC* [2006] ECR I-0000, paras 33-36 and T O'Shea, 'The UK's CFC Rules and the Freedom of Establishment: Cadbury Schweppes plc and its IFSC Subsidiaries -Tax Avoidance or Tax Mitigation?' [2007] EC Tax Review 13.

236 Rüdisühli (n 230) 622.

237 *Cadbury Schweppes* (n 234), para 67.

238 Ibid para 68.

239 United Nations, *Report Contributions to international co-operation in tax matters: treaty shopping, thin capitalization, co-operation between tax authorities, resolving international tax disputes* (1988) 2.

240 The author's opinion reflects the FTA's view.

241 The effective rate of corporation tax can be at 4.2%. It is worth noting that following, Malta's acceptance into EU in 2004, the EC has described several 'harmful' tax measures that it wants the Maltese government to abolish.

242 The corporate tax rate in Italy (Imposta sul reddito delle persone giuridiche 'IRPEG') is 33%.

lead to discrimination within the meaning of EC Treaty[243], as the Maltese Holding could be put under an excessive burden compared to other companies established in other Member State[244]. Such differentiated and detailed approach by the FTA is completely understandable for being in line with the procedure to tackle ‘treaty shopping’, since such procedure allows the FTA to concentrate more on situations where the risk of having a ‘wholly artificial arrangement’ and thus tax avoidance are higher, compared to situations where genuine economic activities are carried out.

Nevertheless, it is worth noting that establishing a subsidiary in another country having a low rate of tax with a view to reducing the group overall tax burden does not in itself constitute tax avoidance[245]. Therefore, the fact that a foreign investor sets up a Swiss company in order to take advantage of its favourable tax treatment does not immediately trigger tax avoidance, unless it can be proved that the Swiss company is fictitious and does not carry out any genuine economic activity there.

In addition to these general principles, Switzerland, under the pressure of influential foreign governments, introduced on 31 December 1962 an unilateral anti-abuse rule[246]. The Treaty Shopping Decree of 1962 (hereinafter: ‘1962 Decree’)[247] aimed at enhancing treaty protection by preventing the unjustified and unlawful use of Swiss tax treaties[248] by people who are not entitled to the benefits[249]. In the case of treaty-shopping practises[250], the FTA can refuse the claim form[251] or if a certification

243 See Case C-279/93, *Finanzamt Köln-Altstadt v Roland Schumacker* [1995] ECR I-00225, para 30: “[d]iscrimination can arise through the application of different rules to comparable situations or the application of the same rule to different situations”. This is the definition used by the ECJ to describe discrimination.

244 See Case C-250/95, *Futura Participations SA and Singer v Administration des contributions* [1997] ECR I-2471, as per para 26: [C]onsequently, the imposition of such a condition, which specifically affects companies or firms having their seat in another Member State, is in principle prohibited by art 43 EC …”. In this case, the additional administrative burden was the request from Luxembourg that the French branch set up there, must keep a set of accounts complying with the relevant national rules. The ECJ stated that art 43 EC precludes the request of such condition and the same reasoning is valid for freedom of movement of capital (Art 56 EC Treaty), which it is worth remembering applies to third countries too.

245 *Cadbury Schweppes* (n 234), para 50.

246 Reinarz (n 178) 415.

247 Federal Decree on measures against the improper use of tax treaties concluded by the Swiss Confederation, adopted on 14 December 1962, RS 672.202.

248 This anti-abuse rules have been incorporated into Switzerland’s tax treaties with Belgium (Art 22), France (Art 14) and Italy (Art 23).

249 Art 1 1962 Decree.

250 For the treaty-shopping practises described by the FTA, see: P Reinarz, ‘Revised Swiss Anti-Treaty Shopping Rules’ (1999) 53 Bulletin for International Fiscal Documentation 116.

has already been given, it can be repealed[252]. In addition, the Swiss authority has the obligation to inform the foreign contracting state that a tax relief has been improperly claimed[253].

On 17 December 1998, the FTA issued an additional Circular under the 'Abuse Decree'[254], which amends the Circular of 1962[255]. The 1998 Circular relaxed the unilateral measures of the 1962 Circular and granted facilitations especially for active companies[256], listed Swiss companies[257] and Holding companies[258]. On 27 January 2006, the FTA announced that the Swiss anti-abuse rules, would also apply to dividend, interest and royalty payments, which are subject to article 15 of the STA[259].

After the FTA has ascertained that the company qualifies for treaty relief, the treaty rate is not systematically applied to the entire amount of dividends distributed[260]. The FTA has developed a specific anti-abuse concept in the context of transfer of shares in Swiss resident companies with undistributed earnings[261]. If for example, the shares of a Swiss company are transferred to EU residents after being held by non-EU residents for a previous period, the reduced treaty rate will often be denied with respect to any open reserves at the time of the share transfer[262]. The tax effect of the 'old reserves' approach materializes only when the Swiss target company

251 Art 4(1)(a) 1962 Decree.

252 Art 4(1)(c) 1962 Decree.

253 Art 4(1)(e) 1962 Decree.

254 As per para 5 Circular 1998/99, since this Circular constitutes unilateral law, the 1998 facilitations do not apply to the tax treaty mentioned above with Belgium, France and Italy.

255 Mesures contre l'utilisation sans cause légitime des conventions conclues par la Confédération en vue d'éviter les doubles impositions (ACF 1962/ Circulaire 1998).

256 Para 1 1998 Circular.

257 Ibid para 2.

258 Ibid para 3.

259 AM Widrig-Giallourak and A Marti, 'EU-Switzerland – Update on Article 15 of the Swiss-EU Savings Agreement', PricewaterhouseCoopers EU Tax News 2-2006, see <http://www.pwc. ch/en/publications/newsletters/taxenews_europe/archive_2006.html> (26 April 2007).

260 Hull (n 135) 79.

261 Reinarz (n 178) 417 and M Bauer-Balmelli, 'Die Steuerumgehung im Verrechnungs-steuerrecht' [2002] IFF Forum für Steuerrecht 175.

262 Hull (n 135) 79.

makes taxable distributions to its new shareholders[263]. In this situation the FTA would deny the acquirer the 'better' withholding tax relief up to the amount of undistributed, non-working reserves ('old reserves')[264] on the transfer[265]. This practise is specifically justified in cases where company restructuring is motivated by tax avoidance so the old reserves should apply because the undistributed profits belonged to the previous shareholder so should have been distributed to the previous beneficiary without granting any relief from Swiss withholding tax. In these cases the previous shareholder did not qualify for any treaty relief so the old reserves should remain subject to the higher withholding tax rate because no relief should be granted. This principle of the 'old reserves', which has no express basis in Swiss tax statutes, is a practical application of the Swiss anti-avoidance provisions[266] and the procedures to reduce 'treaty shopping' and cross-border tax avoidance. It is, however, doubtful whether the 'old reserves' doctrine is compatible within an EU market, as it could constitute an obstacle to free movement of capital[267].

It is worth noting that the Federal Tax Administration grants full relief to the new shareholder in relation to the profit accrued after the acquisition of the shares[268]. In order to achieve its target, the FTA applies a 'first-in-first-out' approach; that is the Swiss company is obliged to distribute the 'old reserves' before being able to distribute the 'new profit' and applying for the grant of full relief[269].

In conclusion, the Savings Tax Agreement, having extended the scope of withholding tax relief, has virtually abolished the applicability of the old reserve theory and profits that were subject to this specific anti-abuse concept in the past may now be distributed freely to the new shareholders within the scope of the STA. However, a case-by-case procedure must be applied and in circumstances of tax avoidance, the old reserve theory will still apply.

263 Reinartz (n 178) 417.

264 While the 'old reserves' doctrine has no express basis in the Swiss tax statutes, it was developed by the FTA as a practical application of the anti-avoidance provision of art 21(2) WHTL.

265 M Jung, 'Art 15 of the Switzerland-EC Savings Tax Agreement: Measures Equivalent to those in the EC Parent-Subsidiary and Interest and Royalties Directive - A Swiss Perspective' (2006) 46 European Taxation 112, 115.

266 Art 21(2) WHTL.

267 Art 56 EC Treaty.

268 Reinarz (n 178) 417.

269 Ibid.

3 Switzerland in an international context

3.1 Pressure from the European Union

Swiss domestic law and its extensive treaty network have contributed to placing Switzerland in one of the top positions as a place to locate a business[270] and the conclusion of the Savings Tax Agreement has enhanced this position further. Moreover, the Swiss Confederation has a combination of non-tax related factors that contribute to make Switzerland an attractive location in an international context[271].

However, the EU has lately put pressure on the beneficial and advantageous Swiss tax system[272]. In this the Swiss Confederation has been attacked by the European Commission, which considers that Swiss domestic law, and in particular its holding regime[273], violates the Free Trade Agreement concluded between Switzerland and the EU[274]. The Commission stated that the corporation tax rates applied to holding

---

270 Ernst & Young, 'Swiss Attractiveness Survey' (2006) <www.eycom.ch/publications/items/2006_swiss_attractiveness_survey/200609_ey_attractiveness_survey_e.pdf> (26 April 2007). For a good discussion of the benefits of Swiss companies, see H Rüdisühli, 'The Benefits of Swiss Companies in International Tax Planning' (2006) 44 Tax Notes International 619.

271 A detailed discussion of this topic is beyond the scope of this dissertation. For a broader discussion, see: B Nägeli, 'Information Concerning Switzerland for Entrepreneurs, Advisers and Decision Makers' (2003) <http://business-valais.ch/upload/files/handbookconcerning_Switzerland.pdf> (26 April 2007); S Schanda, 'Leuthard Puts Focus on Swisscompetitiveness'(2006) <http://www.swissinfo.org/eng/front/detail/Leuthard_puts_focus_on_Swiss_competitiveness.html?siteSect=105&sid=7137865&cKey=1160313428000> (26 April 2007); Swissinfo with agencies, 'Swiss Top Global Competitiveness Rankings' (2006) <http://www.swissinfo.org/eng/front/detail/Swiss_top_global_competitiveness_rankings.html?siteSect=105&sid=7103514&cKey=1159277421000> (26 April 2007); Ernst & Young, 'Swiss Attractiveness Survey' (2006), <www.eycom.ch/publications/items/2006_swiss_attractiveness_survey/200609_ey_attractiveness_survey_e.pdf> (26 April 2007); CH Kalin, 'Why Switzerland' (2005) <http://www. swissnetwork.com/?page=ViewArticle&id=19> (26 April 2007).

272 Swissinfo with agencies, 'EU Prepares to Fire Next Salvo in Tax War' (2007) <http://www.swisspolitics.org/en/news/index.php?page=dossier_artikel&story_id=7562876&dossier_id=246> (26 April 2007).

273 In order to avoid any double or multiple taxation, relief is granted at cantonal and communal levels (Art 28(2) of the Swiss Tax Harmonisation Law), provided that the conditions to qualify as a holding are met; HR Hull, 'New Developments in the Taxation of Holding Companies in Switzerland' (2003) 57 Bulletin for International Fiscal Documentation 537.

274 Free Trade Agreement between Switzerland and European Union [1972] OJ L 300, 189. The agreement was signed on 22 July 1972 and is available at <http://www.admin.ch/ch/d/sr/0.63.html#0.632.4> (26 April 2007).

companies in some Swiss cantons[275] are the lowest corporate tax rates in the world and thus attract multinational companies to set up companies there[276], so the EU is trying to convince Switzerland to abolish the cantonal advantages given to holding and domiciliary companies.

Despite this attack, Bern has firmly rejected these accusations, arguing that cantonal tax systems do not fall within the scope of the agreement and do not affect bilateral trade[277]. The EU has lodged complaints claiming that the low level of corporation tax of some Swiss cantons not only attracts investment, but also constitutes a form of subsidy[278] for business[279]. In particular, the European Commission's president, José Manuel Barroso, has sharply criticised the tax advantages given to companies by some Swiss cantons, describing them as 'clearly discriminatory'[280]. These complaints are a typical example of the way that the EU is trying to put pressure on Switzerland to change its tax system. Many international groups are locating their headquarters in Switzerland so depriving EU Member States of billions in tax revenue[281]. EU Member States are obviously not keen on allowing a neighbour to attract business, especially as they consider these holdings to be mainly wholly artificial arrangements aiming at circumventing national law to obtain a reduction of tax liabilities in their State of origin.

---

275 To give some examples of the advantageous rates at cantonal level: Obwald 13.1%, Schwyz 15.6%, Zug 16.4%.

276 Swissinfo with agencies, 'Cantons Oppose Unhealthy Tax Competition' (2006) <http://www .swissinfo.org/eng/search/detail/Cantons_oppose_unhealthy_tax_competition.html?siteSect=881&sid=6400398&cKey=1137788949000> (26 April 2007).

277 R Brookes, 'Swiss Stick to their Guns in Tax Dispute with EU' (2006) <http://www.swissinfo .org/eng/politics/detail/Swiss_stick_to_their_guns_in_tax_dispute_with_EU.html?siteSect=111&sid=6690326&cKey=1146848534000> (26 April 2007).

278 The same accusations have been lodged towards Luxembourg 1929 Holding regime and Maltese Holding regime, which opposite to Swiss Holding, have to comply with EC Treaty and state aid rules.

279 Brookes (n 276).

280 Swissinfo with agencies, 'Tax Privileges Come under Fire from Brussels (2006) <http://www.swissinfo.org/eng/politics/detail/Tax_privileges_come_under_fire_from_Brusse ls.html?siteSect=111&sid=6873678&cKey=1152259744000> (26 April 2007).

281 Swissinfo with agencies, 'EU Relations with Switzerland' <http://ec.europa.eu/comm/exter nal_relations/switzerland/ intro/index.htm> (26 April 2007).

The Swiss position is, however, absolutely clear and from their standpoint there is no room for negotiation[282]. Switzerland considers that cantonal taxes do not constitute a subsidy, indirect or direct, to the exchange of goods, and as such do not affect the Free Trade Agreement[283]. There are no links with the free trade agreement and even if some links might exist, they are indirect and irrelevant. The aim of the Free Trade Agreement was to create a free trade zone between Switzerland and the EU[284] and no agreement on direct tax harmonisation was negotiated. The Swiss government firmly defends its position, confirming that article 23 of the Free Trade Agreement[285] cannot be interpreted in the same way as if Switzerland was part of the EU's competition legislation[286]. Furthermore, the Commission's attack is weak in its argument and without any legal basis, as the Commission is trying to apply Community law to Switzerland, which is not part of the internal market[287].

The Cantons are sovereign because their sovereignty is not limited by the Federal Constitution so exercise all rights which are not entrusted to the federal power[288]. Switzerland's 26 cantons, which are responsible for setting up their own tax rates[289], compete against each other to attract business and wealthy residents which tax competition is considered a fundamental element of the competitiveness of the Swiss fiscal system[290]. In addition, cantonal taxes are an important characteristic of their sovereignty and these tax regimes have been playing a significant role in the

---

282 As mentioned by Micheline Calmy-Rey, Swiss foreign minister, see M Allen, 'EU Renews Tax Offensive Against Switzerland' (2006) <http://www.swissinfo.org/eng/front/detail/EU_renews_tax_offensive_against_Switzerland.html?siteSect=105&sid=7339709&cKey=1166107436000> (26 April in 2007).

283 A Beaumont, 'Swiss Give EU Short Shrift in Tax Stand-off' (2006) <http://www.swissinfo.org/eng/search/detail/Swiss_give_EU_short_shrift_in_tax_stand_off.html?siteSect=881&sid=7318814&cKey=1165251633000> (26 April 2007).

284 Art 1 Free Trade Agreement.

285 Art 23 (iii) states: "any public aid which distorts or threatens to distort competition of favouring certain undertakings or the production of certain goods is incompatible with the proper functioning of the agreement".

286 R Brookes (n 276).

287 It is worth remembering that arts 87 to 89 EC Treaty on state aid have not been extended to third countries, thus they do not apply to Switzerland.

288 Art 3 of the Federal Constitution of the Swiss Confederation of 29 May 1874, RS 101.

289 Swiss cantons are free to set their own tax rates within the framework of the Federal Tax Harmonisation Act (THA), 9 Mars 2001, RS 642.141.

290 As mentioned by finance minister Hans-Rudolf Merz, see Swissinfo wit agencies, 'Cantons Oppose Unhealthy tax Competition' (2006) <http://www.swissinfo.org/eng/swissinfo.html?site Sect=43&sid=6400398> (26 April 2007).

Swiss tax system for many decades and are a specific characteristic of it. As a consequence, Switzerland will always protect them firmly.

Switzerland is the number two client of the European Union[291] and both sides have a reciprocal interest in avoiding troubles in this mutually beneficial partnership[292]. History tells us that even when long and tough negotiations have been necessary, an agreement has always been reached between the two parties[293]. When, during a bilateral negotiation, the two parties face differences of opinion, neither side wishes to put itself under pressure, because of the risk of making concessions as a result of making hasty decisions. As previously discussed, the Swiss government chose the bilateral route after a ballot in 1992, when Swiss citizens refused the plan to join the European Economic Area, which would have given Switzerland the opportunity to participate in the EU’s internal market[294] but bilateral agreement will continue to be on Switzerland’s agenda, since Swiss membership in the EU is not imminent[295].

Nevertheless, it is likely that future negotiations with an enlarged European Union will be even tougher and longer, since the EU itself, now composed of 27 Member States, will have to spend more time and face more difficulties to reach internal agreements. Moreover, Brussels will have to concentrate more time on internal issues, so having less time to spend in negotiations with non-members, such as Switzerland. As a consequence Swiss politicians might choose to consider again the possibility of joining the EU, although Swiss citizens do not appear to be ready for that[296].

At the moment, a scorecard of the economic pros and cons of Swiss accession would be fairly evenly balanced[297]. However, in ten or twenty years the situation may have changed and the balance of advantages may have tilted enough for the Swiss citizens to consider joining the EU[298]. In the case of a Swiss accession to the EU, three main

291 After United States of America and before China.

292 ‘European Union’ <http://www.eda.admin.ch/eda/en/home/topics/intorg/eu.html> (26 April 2007).

293 ‘Bilateral I and II’ are two examples of these tough negotiations.

294 J Summerton, ‘Bilateral Route Unlikely to Survive EU Enlargement’ (2004), <http://www.swissinfo.org/eng/front/detail/Bilateral_route_unlikely_to_survive_EU_enlargement.html?siteSect=105&sid=4840545&cKey=1080921483000> (26 April 2007).

295 T Wright, ‘Swiss Riled by EU Role on Workers’ International Herald Tribune (2005).

296 D Hannan, ‘Lesson of the Mountain Republic’ The First Post (2007) <http://www.thefirstpost.co.uk/index.php?menuID=1&subID=1310> (26 April 2007).

297 B Beck, ‘Switzerland and the European Union (2005) <http://www.swissnetwork.com/?page=ViewArticle&id=15&category=> (26 April 2007).

298 Ibid.

disadvantages would have to be considered. First, being Switzerland such a rich country, hefty membership contributions would need to be paid[299]. Second, assuming that Switzerland would at some point adopts the Euro as its currency, the Swiss Confederation would be forced to give up the Swiss franc and the right to conduct its own monetary policy, which would be likely to lead to serious economic consequences in monetary and currency policy. Third, the EU would force Switzerland to give up its banking secrecy, affecting as a consequence its entire banking and financial system.

Switzerland has a unique political system, where national cohesion is achieved by involving the whole population in the decision-making process and by allowing citizens to participate in direct democracy through referenda[300]. The EU's mechanism, where all the decisions are made without popular vote, would go against the long-term established Swiss political system. Furthermore, considering an hypothetical Swiss membership in the EU, Brussels would impose Community law upon Switzerland with the aim of abolishing the advantages of its financial system and Swiss Confederation would likely end up with loosing its fiscal beneficial position and foreign investors would consider moving away towards other jurisdictions.

Conclusions and Final Thoughts

The Savings Tax Agreement, which entered into force on 1 July 2005, represents a politically positive result. Firstly, Switzerland accepted the introduction of a withholding tax in order to secure the taxation of interests within the EU. This solution has allowed Switzerland to preserve its vital banking secrecy and guaranteed at least a minimum level of taxation of the interest derived by EU residents, thus satisfying the EU's tax collectors.

Despite being extremely expensive and onerous tax legislation Switzerland, thanks to the intense work and high quality of its banking system, has been able to implement the withholding tax without damaging its financial position nor its banking system. Furthermore, in exchange for the concessions made by Switzerland in the area of interest taxation, the Swiss negotiating delegation succeeded in securing the access to the Parents-Subsidiary Directive (and the Interest and Royalty Directive) whose aim is to eliminate the withholding tax on intra-group cross-border dividend payments between Switzerland and EU Member States. As a consequence, the STA has fostered Switzerland's position as a premier holding company location

299 A Swiss government report a few years ago estimated these at around Sfr.3-4 billion a year net; some private calculations put them even considerably higher

300 'Direct Democracy in Switzerland' (2004) <http://www.swissworld.org/dvd_rom/eng/direct _democracy_2005/index.html> (26 April 2007).

and has thus enhanced its international position as a place to locate and conduct business.

Nevertheless, the European Union and in particular the European Commission have recently attacked Switzerland and put pressure on some aspects of its advantageous tax system. The Commission has argued that the corporation tax rates of some Swiss cantons, as well as their holding regimes, violate the Free Trade Agreement. However, Switzerland has clearly stated that it disagrees with the Commission's arguments. Switzerland will never surrender a specific characteristic of its tax system. In pushing for such changes, the EU is following its own political agenda whose ultimate aim is that of convincing Switzerland to join the EU as a full member. This would obviously be profitable for the Union, simply because Switzerland would become the EU's biggest net payer per head[301]. However at least for the time being there are no valid economic motivations for joining.

In addition, a decision to join the EU would jeopardise the Swiss financial and banking system as well as its state revenue and its economic and monetary policy in case the Euro were adopted. Bilateral agreements with the EU are still the way forward at least for the short/medium term, since they reflect the scope of their common interest and they acknowledge each other's difference[302] as well as satisfying the need of Switzerland to access the vital European market and the EU request to discuss with the Swiss Confederation on the issues it considers important for its agenda.

In conclusion, for the reasons explained above, it is in Switzerland's best interest to maintain its independent position as the economic counterpart of its long-cherished political neutrality[303].

List of Abbreviations

Art	Article
BIFD	Bulletin for International Fiscal Documentation
CFC	Controlled Foreign Company
DFTA	Direct Federal Tax Act
DTT	Double Taxation Treaty

301 B Beck, 'Switzerland and the European Union' (2006) <http://www.swissnetwork.com/?page=ViewArticle&id=15&category=> (26 April 2007).

302 'Bilateral Agreement II' Integration Office DFA/DEA Information (2004) <http://www.europa.admin.ch> (26 April 2007).

303 The author's view reflects the one of the Swiss citizens. On 4 March 2001, 77.3% of the Swiss people have rejected in a popular vote an initiative to join the EU <http://www.commerce.guernsey.gg/FSD/Guidance%20Notes.pdf> (26 April 2007). This is a clear expression of the people's will.

EC	European Community
ECJ	European Court of Justice
EC Law	European Community Law
EC Treaty	European Community Treaty
EU	European Union
Eur	Euro
EEA	European Economic Area
ESTD	European Union Savings Tax Directive
FTA	Federal Tax Administration
GDP	Gross Domestic Product
IBA	International Bar Association
IMAC	International Mutual Assistance in Criminal Matters
LB	Federal Law on Banks and Savings Banks
MoU	Memorandum of Understanding
NRO	Net Remittance Ordinance
OECD	Organization for Economic Cooperation and Development
OJ	Official Journal of European Community
Para	Paragraph
PE	Permanent Establishment
PSD	Parent-Subsidiary Directive
SBA	Swiss Bankers Association
SCO	Swiss Code of Obligations
SFR	Swiss Francs
STA	Savings Tax Agreement
THA	Federal Tax Harmonisation Act
THL	Federal Tax Harmonisation Law
VC	Vienna Convention on the Law of Treaties
WHTL	Federal Withholding Tax Law
WTHO	Federal Withholding Tax Ordinance