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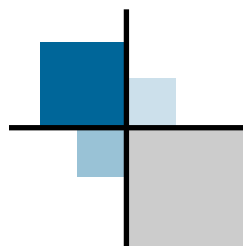
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How B.I.T.s May Offer a Legal Remedy in International Tax Disputes

By Paul Kraan

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SUMMARY

Traditionally, international tax disputes focus on provisions in income tax treaties, including reduction in tax on various types of investment income, increased threshold for imposing tax on business profits, and procedures to claim relief in the event of double taxation or the imposition of tax that is not in accordance with the terms of the treaty. However, income tax treaties may not be the only legal remedy available in an international tax dispute, as countries also conclude bilateral investment treaties (B.I.T.s) with the aim to protect and stimulate cross-border investment. Disputes under B.I.T.s generally are settled by an arbitration panel. This article sets out under which circumstances an international tax dispute may fall within scope of an investment treaty.

INTRODUCTION: SHORTCOMINGS IN LEGAL PROTECTION UNDER TAX TREATIES

Traditionally, bilateral income tax treaties are considered the appropriate means of redress for avoiding double taxation arising from a cross-border transaction. The allocation of taxing rights between states under such treaties is generally based on internationally accepted principles and methods. These are laid down in the model treaty (and related commentary) which is established under the auspices of the Organisation for Economic Cooperation and Development (O.E.C.D.)¹ and in the United Nations (U.N.) Model Convention².

O.E.C.D. Member States are predominantly prosperous countries with a high income per capita. However, in recent decades, the economic emergence of certain countries that are not O.E.C.D. Member States has resulted in the increased importance of investment in those countries and (economic) self-awareness, as well.

As regards foreign investment in such emerging economies, taxing rights are allocated in ways that strongly emphasize the position of the source state. This may concern source taxes in ways that are not entirely customary in international relations, such as the indirect levy of tax on capital gains (through a withholding tax that is imposed on the purchase price). Also, the interpretation of recognized international tax concepts differs in many cases

from the common international standards, such as those that define a permanent establishment and explain when it may exist.

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Initially, a foreign company that is confronted with such unique application of tax concepts will attempt to obtain relief by using legal remedies available in the relevant country. However, local judiciary authorities may not always be completely independent and, even when independent, may endorse the divergent views taken by the local tax administration.

In such circumstances, multinational companies may attempt to obtain relief through remedies outside the local legal system. An applicable income tax treaty may provide relief through a the mutual agreement procedure (M.A.P.) between the competent authorities of the contracting states concerned. However, the M.A.P. in most tax treaties only requires the contracting states to make an effort to resolve the issue and may not eliminate double taxation where the competent authorities maintain differing views on a particular provision of the income tax treaty. In many instances, pursuing this route does not lead to a satisfactory outcome for the taxpayer because, in part, the taxpayer is not even a party to the M.A.P. between the relevant states.

For this reason, an arbitration provision has been developed within the context of the O.E.C.D. Model Convention³ which makes it possible to proceed to compulsory binding arbitration if the competent authorities do not reach an agreement. The aim is to include binding arbitration in as many tax treaties as possible. Indeed, the Base Erosion and Profit Shifting (B.E.P.S.) Action Plan developed by the O.E.C.D. earlier this decade includes Action 14, which calls for effective dispute resolution mechanisms. Meanwhile, within the E.U. this has led to the adoption of a directive⁴ which offers a uniform mechanism to address tax treaty disputes among E.U. Member States in accordance with the B.E.P.S. Action 14 minimum standard. Nonetheless, there is little experience with arbitration under a bilateral income tax treaty.

However, international tax disputes are not governed solely by procedures of income tax treaties. With

regard to cross-border investment, states often conclude a B.I.T. that is intended to protect those investments from improper state action in the host country. If any disputes should result, the International Centre for the

Settlement of Investment Disputes (I.C.S.I.D.) of the World Bank can be requested to appoint an arbitration panel to resolve the dispute, absolutely. Such request can be made directly by the investor concerned. This article examines the extent to which international tax disputes may be resolved under the terms of a B.I.T.

INVESTMENT PROTECTION AGREEMENTS

Nature and content

The first B.I.T.⁵ was concluded in 1959 between Germany and Pakistan⁶. The current investment protection agreement network includes thousands of B.I.T.s, as well as a large number of multilateral investment protection agreements. The network of investment treaties, therefore, provides broad coverage. Often, a B.I.T. is concluded prior to consideration of an income tax treaty.

While income tax treaties are mostly based on the O.E.C.D. Model, there is no generally accepted model B.I.T. However, numerous countries have developed unique unofficial model agreements from which a B.I.T. is negotiated. These unofficial model agreements may form the basis of a multilateral agreement. As such, the legal form of investment protection agreements can differ⁷. Despite any differences, investment protection agreements often adopt a similar structure, pursuant to which investments are stimulated and protected by means of guarantees⁸.

This can be explained by the fact that the letter and spirit of every investment protection agreement is ultimately the same: the creation of a favourable investment climate by protecting and stimulating investments⁹. The provisions of nearly all investment protection agreements provide for the protection of investments against expropriation and unreasonable treatment, liberalization through the abolition of legal prohibitions on investment, and the creation of a level

playing field in the form of equal treatment¹⁰.

In general, the letter and spirit of an investment protection agreement is realized through a number of substantive rights¹¹.

- Expropriation is prohibited unless the expropriation is non-discriminatory and in the general interest. In that event, the affected investor is entitled to adequate compensation. (This is the most important substantive right.)
- Investments are entitled to be treated in a fair and equitable manner and to complete protection and security.
- Investors are entitled to equal treatment and the right against discrimination based on nationality. (A most-favoured-nation (M.F.N.) clause is often included.)
- Repatriation of income earned from the relevant investments cannot be prevented.
- Provisions of international law that are more favourable than the investment protection agreement are given preference over the provisions in the investment protection agreement, provided a reference to international law is part of the agreement.
- An umbrella clause may be included in the investment protection agreement¹² under which the contracting states are obligated to fulfil all the undertakings given in respect of an investment. (By means of these substantive rights, contracting states can guarantee investors that their investments will be free of specified sovereign risk¹³.)

Legal protection

In addition to substantive rights, investment protection treaties contain procedural rights that make the realization of substantive rights possible¹⁴. The legal structure of the investment protection agreement allows the aggrieved party to enforce its rights directly by means of an arbitration panel specifically appointed

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for that purpose, without the need to obtain government approval in the host state. This differs considerably from the situation under income tax treaties, where disputes must generally be resolved through a M.A.P., where the

taxpayer has little or no influence. Instead, an investment protection agreement allows the taxpayer to maintain control over all facets of the procedure, from commencement of the action to the hearing, itself¹⁵. This can be particularly advantageous if the host country cannot provide fair and balanced legal protection due to corruption, the absence of an independent judiciary, or stonewalling by the taxation agency¹⁶. In this way, an investment protection agreement guarantees permanent and adequate legal protection.

The investment protection agreement designates the body, or bodies, that are competent to decide investment disputes under the applicable agreement. In most cases, the body will be an arbitration panel appointed by the International Centre for Settlement of Investment Disputes (I.C.S.I.D.), which is part of the World Bank. More than 140 countries recognize the I.C.S.I.D.¹⁷. As these agreements can differ, case law under other agreements is not controlling. Nonetheless, case law provides guidance for the interpretation of agreements. Investment protection agreements have similar purposes and provide similar protection in many ways. As a result, decisions under other comparable agreements may be taken into account according to the Vienna Convention on the Law of Treaties¹⁸.

Accessibility

Three facts must exist to successfully invoke protection offered by an investment protection agreement:

- A qualifying investment is made in the territory of one of the contracting state.
- The qualifying investment is made by a qualified investor from the other contracting state.
- As to the investment and the investor, an obligation contained in the investment protection agreement purportedly has been violated.



Almost all investment treaties define the term 'investment'¹⁹. The definition generally is broad, such as 'every kind of asset invested in accordance with the national laws and regulations of the Contracting Party in the territory of which the investment is made' or 'every kind of asset' — followed by a non-exhaustive list of qualifying investments²⁰.

It is not surprising that the broad definition of 'investment' has led to broad interpretations in the case law²¹. Arbitration panels are prepared to give broad interpretations to the term 'investments' to ensure the scope of protection is extensive²².

Investor activities must be assessed on an aggregate basis. Consequently, if the activities consist of separate elements that can only be considered an investment when viewed as a whole, protection under an investment protection agreement is possible even if host country obligations to only one of those elements has been breached²³.

A territorial factor must also be present for an investment to qualify for protection. The investment must relate to one of the contracting states for an investment protection agreement to be applicable. Hence, there must be a sufficient nexus with the host country. Courts have applied a relatively low threshold when determining whether nexus exists²⁴. This is evidenced by the fact that a large number of treaties include a provision that makes the agreement applicable to investments that are made through a business resident in a third state.

Once a particular investment has been found to be covered by an investment protection agreement, the next issue is whether the holder of the investment has access to the investment protection agreement. Traditionally, the definition of 'investor' included in most investment protection agreements applies to natural persons, legal entities, and partnerships²⁵. Natural persons qualify as an investor if they hold the nationality of one of the contracting states. This must be determined according to the domestic law of the investor state²⁶. Different criteria are used to determine if a legal entity or partnership qualifies as an investor. Included are the place of incorporation and

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the place where control is exercised. Other criteria may be used where the facts are unique.

E.U. situations

Specifically with regard to B.I.T.s concluded by and between E.U. Member States, the *Achmea* case²⁷ of the European Court of Justice (E.C.J.) found an arbitration clause in a B.I.T. to be incompatible with community law, as tribunals essentially remove disputes from the jurisdiction of the Member States' courts and consequently from the E.U.'s judicial system. This ruling has significant consequences for arbitration clauses in B.I.T.s concluded by the Member States.

Under the E.U. treaties, the Member States' courts and the E.C.J. collaborate in resolving disputes involving aspects of community law. Through the preliminary reference mechanism under Article 267 of the Treaty on the Functioning of the European Union (T.F.E.U.), domestic courts refer questions on community law to the E.C.J. and are required to follow the answers provided by the E.C.J. This system should ensure that community law is applied effectively and uniformly throughout the E.U. and preserves the essential characteristics of the legal order in a uniform way within the E.U. To ensure the effectiveness of community law, courts in Member States must make preliminary references to the E.C.J. To that end, community law must always prevail over other sources of law, whether international or domestic.

TAXATION IN INVESTMENT PROTECTION AGREEMENTS

General

Having outlined the general contours of a B.I.T., the next issue is whether a B.I.T. can provide protection in regard to tax measures. As previously described, in certain cases, the legal protection provided by an income tax treaty is inadequate. The additional legal protection provided under an investment protection agreement can be of great significance in these circumstances.

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In most countries, autonomous tax policy is a sensitive subject. This finds expression in B.I.T.s. In general, states are wary of third-party actions that may impose undesired limitations on taxation. This concern extends to B.I.T.s²⁸ and often is manifested in a number of B.I.T.s through the inclusion of a carve-out provision. The carve-out removes taxation from the scope of the B.I.T. However, other B.I.T.s include only a partial exclusion for taxation²⁹. The protocol to the Germany-Mexico B.I.T. states that tax measures that violate provisions of a B.I.T. can be subject to arbitration, with the exception of those provisions relating to national or M.F.N. treatment³⁰.

Taxation as a form of indirect expropriation under B.I.T.s

The right of a state to impose tax is a fundamental attribute of sovereignty. Consequently, international law provides that taxation constitutes an important exception to the rule that expropriation is not allowed without adequate compensation. By its nature, taxation involves the taking of the taxpayer's money, resulting in a form of expropriation. Nonetheless, tax exclusion clauses in B.I.T.s generally prevent effective actions against the state imposing tax.

Nonetheless, international law recognizes that taxation by sovereign states can amount to indirect expropriation in specific circumstances. In the case of *Yukos*³¹, the court ruled that the tax measures imposed by the host state on a resident of the investor state could amount to expropriation for purposes of the relevant investment protection treaty 'if the ostensible collection of taxes is determined to be part of a set of measures designed to effect a dispossession outside the normative constraints and practices of the taxing authorities'.

The definition of 'expropriation' in investment protection agreements usually follows the definition found under international law³². Expropriation³³ can occur both directly and indirectly³⁴. Direct expropriation occurs if the investment is nationalised or otherwise directly confiscated by means of a legal transfer of ownership or a direct physical takeover³⁵.

Indirect expropriation occurs when a state interferes in the use of an investment or in the benefits received from that investment, even if the investment has not been physically seized and the legal ownership has not been affected. A governmental measure can also qualify as indirect expropriation if the investment's market value decreased as a result thereof³⁶ or if the economic benefit that could reasonably be expected was denied³⁷. The effect of such government action is equal to that of expropriation. In broad terms, direct expropriations are rarely found, while indirect expropriations are more common³⁸.

Taxation³⁹ represents a partial breach of property rights. As such, most forms of taxation could be contested by invoking an investment protection agreement, although this could not reasonably be expected to be the intention of such an agreement⁴⁰. As a general rule, taxation does not qualify as expropriation under international law⁴¹. Under international law, a state cannot be held liable for loss of ownership as a result of a *bona fide* tax that is generally accepted as a legal expression of the executive power of a government⁴².

Exceptional circumstances

This does not mean that taxation cannot fall under the scope of the definition of expropriation. In certain circumstances, taxation can constitute expropriation under international law⁴³ as a result of which a tax dispute between a tax authority and an investor can be resolved by arbitration⁴⁴. In *Link Trading v. Moldova* (2002), the arbitration panel ruled that taxation can be considered an expropriation if the nature of the tax involves 'abusive taking'.

According to the panel, a tax is considered 'abusive taking' if it is unreasonable, arbitrary, discriminatory, or contrary to existing agreements⁴⁵. In *Encana v. Ecuador* (2006), where a refusal to refund Ecuadorian V.A.T. was in dispute, the panel concluded that taxation falls under the scope of the definition of expropriation if it can be qualified as 'extraordinary, punitive in amount or arbitrary in its incidence'⁴⁶.

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As a result of the current paucity of case law in regard to tax disputes, it can be concluded that two types of taxation can be identified under an investment protection agreement. Taxation that results in an indirect expropriation must be distinguished from taxation that, while having a substantial negative impact on the market value of the investment, nevertheless must be regarded as legitimate and, therefore, does not qualify as an indirect expropriation under an investment protection agreement⁴⁷.

Assessment framework

Certain elements can be extracted from case law and the literature that, taken together, can create an assessment framework for distinguishing *bona fide* tax measures from taxation that qualifies as expropriation:

- The government measures must lead to a substantial decrease in value.
- The decrease in value interferes with the reasonable expectations underlying the investment.
- The government measure deviates from internationally accepted norms (characteristics test)⁴⁸.

This assessment framework was confirmed in *Archer Daniels Midland v. Mexico (2008)*, where the panel ruled that factors beyond a substantial decrease in value or paralyzing government interference could be taken into account in determining whether the tax constituted an expropriation:

...including whether the measure was proportionate or necessary for a legitimate purpose; whether it discriminated in law or in practice; whether it was not adopted in accordance with due process of law; or whether it interfered with the investor's legitimate expectations when the investment was made⁴⁹.

In the *Revere Brass and Copper (1978)* case⁵⁰, the arbitration panel ruled that mining tax and royalties, imposed in violation of a concluded advance tax ruling, qualified as expropriation. The ruling formed part of a concession

given to a subsidiary for the extraction of bauxite in Jamaica. The newly elected government ignored the ruling and increased the tax burden by introducing a new mining tax. Revere considered the negative impact on profitability excessive and ended its subsidiary's activities. The arbitration panel recognized that Revere's subsidiary still had full ownership and could have continued with its activities but regarded the matter as an expropriation under international law nonetheless because Revere could no longer make an economically effective use of the business. The profitability of the investment was severely impaired by the tax.

Substantial financial damages

While it is difficult to determine the scope and extent of damage arising from a tax measure for it to qualify as expropriation, general agreement exists that the bar is set very high⁵¹. The United Nations Conference on Trade and Development (U.N.C.T.A.D.) concluded that the damage must include 'a significant depreciation' in value⁵². Moreover, if a measure is extremely discriminatory or absurd, the extent of financial damage need not be the same as for a more common measure⁵³. In *Occidental v. Ecuador (2004)*⁵⁴ the panel dealt with a refusal by the Ecuadorian tax authorities to refund V.A.T., contrary to earlier agreements with the taxpayer. The taxpayer invoked the expropriation clause of the relevant B.I.T. According to the panel, the refusal did not qualify as expropriation since it did not deprive the taxpayer of the economic benefits that were reasonably to be expected or inflict substantial damages on the investment. The right to a V.A.T. refund was not a substantial part of the investment⁵⁵. The previously cited *Archer Daniels* case is one of the few rulings that attempt to define the standard to be applied when measuring damages. The panel concluded that the damage criterion is met if the taxpayer is deprived of all or the majority of the benefits generated by the investment. Not only must the

scope of the tax relevant but also the duration of the tax. A permanent loss of value will carry more weight than a temporary loss of value⁵⁶.

Other provisions providing legal protection against tax measures

Equal, national treatment under non-discriminatory provisions

The *Archer Daniels* case previously discussed involved a 20% tax imposed by Mexico on soft drinks containing a corn syrup sweetener. The tax did not apply to soft drinks sweetened with sugar cane. The reason for this measure appeared to have been the protection of the Mexican sugar cane market. ADM was a U.S. manufacturer of corn syrup. It saw a sharp decline in the value of its Mexican investments as a result of the measure. ADM challenged the tax under the North American Free Trade Agreement (N.A.F.T.A.), a multilateral investment protection agreement. One of the grounds for its complaint was that the tax qualified as expropriation⁵⁷.

The arbitration panel applied the assessment framework described above and concluded that the impact of the tax on ADM's investments was not sufficient to constitute expropriation. However, the arbitration panel considered the tax a violation of N.A.F.T.A. because the non-discrimination provision guarantees the domestic and equal treatment of foreign investments. The arbitration panel ruled that the effect of the tax was such that U.S. manufacturers and distributors of corn syrup in Mexico received less favourable treatment than Mexican manufacturers of sugar cane. As a result, the tax violated the investment protection agreement.

Fair and equitable treatment

The *Occidental v. Ecuador* case⁵⁸, in respect of which a decision was given under the U.S.-Ecuador B.I.T. (1993) is similar to the *Archer Daniels* case. Initially, the arbitration panel rejected a claim based on the expropriation provision, because revoking a right to a V.A.T. refund did not qualify as expropriation. However, after further consideration, the revocation

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of the refund was considered to be an unauthorized violation of the investment protection agreement. The arbitration panel considered that the right to fair and equitable treatment⁵⁹ had been violated. The right to a V.A.T.

refund was part of an agreement with the Ecuadorian tax authorities, which interpreted national legislation (the ruling). The arbitration panel emphasized that a contracting state to a B.I.T. must provide investors from the other contracting state with a stable and predictable legal infrastructure. That obligation is a consequence of the right to fair and equitable treatment that is mandated by the B.I.T. Whether the contracting state acted in bad faith was irrelevant. Based on the underlying facts, the panel concluded that the domestic V.A.T. legislation and the subsequent interpretation in a tax ruling materially contributed to Occidental's decision to invest in Ecuador. The panel concluded that 'the tax law was changed without providing any clarity about its meaning and extent, and the practice and regulations were also inconsistent with such changes'⁶⁰. As such, the panel ruled that Ecuador failed in its obligation to provide a stable and predictable legal system. The revoked refund resulted in a violation of the existing B.I.T.⁶¹.

CONCLUSIONS

The scope of substantive rights laid down in an investment protection agreement in the context of taxation is difficult to define, partly due to the scarcity of guidance in the case law. Nonetheless, it follows from the above that a B.I.T. can provide legal protection against those forms of taxation that may constitute a violation of its provisions. Particularly, the provisions on expropriation, non-discrimination and the right to fair and equitable treatment set limits on a contracting state's right to impose taxation.

Where taxation results in a substantial decrease of the value of an investment, it may be a form of expropriation that can be redressed under a B.I.T. if it detrimentally affects the reasonable expectations of the investor that formed the basis for its investment.

However, access to a B.I.T. is allowed only if the imposition of the tax deviates from internationally accepted legal standards. The most obvious example of an internationally accepted legal standard is a tax that violates the principle of non-discrimination. The tendency of arbitration panel decisions is that when the violation of a generally accepted legal principles is flagrant, the disputed government action on the investment need not be as great in order for a claim by an affected investor to be upheld.

Future cases and arbitration guidance will be required to determine the circumstances in which a violation of specific international tax principles can be considered a deviation from internationally accepted legal standards. In matters relating to taxation, it may be expected that an arbitration panel will apply a high standard before a claim will be upheld under a B.I.T. regarding the imposition of tax. The unanticipated imposition of tax by the host country must have a significant impact on the value of the investment and must be at odds with the reasonable expectations of the investor at the time the investment was made. If both these conditions are met, it is conceivable that a panel may conclude that such taxation qualifies as indirect expropriation.

For tax advisers who customarily look for relief under the terms of an income tax treaty, the most interesting aspect of arbitration under a B.I.T. is that the investor is a direct party to the arbitration. Indeed, the investor can instigate arbitration proceedings in addition to participating in the proceedings. The generous legal protection offered by an investment protection agreement stands in stark contrast to arbitration under a tax treaty, but it is still in the formative stages.

Arbitration under a tax treaty or an investment protection agreement does not necessarily have to be mutually exclusive. The competent authority in the state of residence can be requested to start a M.A.P. under the relevant tax treaty, while at the same time commencing proceedings under the existing investment protection agreement. Note that access

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to a B.I.T. may require that all avenues for domestic legal recourse have been exhausted previously. In this respect, the spectre of arbitration under an investment protection agreement can keep pressure on the mutual consultation procedure under the tax treaty.



¹ O.E.C.D. Income and Capital Model Convention and Commentary, Paris, 21 November 2017.

² U.N. Model Double Taxation Convention Between Developed and Developing Countries, U.N., as updated on 19 May 2017. This model treaty distinguishes itself from the O.E.C.D. Model Treaty by a stronger emphasis on the position of the source state.

³ See article 25, fifth paragraph, of the O.E.C.D. Model Convention.

⁴ E.U. Council Directive on Tax Dispute Resolution Mechanisms in the European Union on 10 October 2017.

⁵ In the following, the term 'investment protection agreement' refers to a B.I.T. and a multilateral investment agreement offering similar investment protection.

⁶ J.W. Salacuse, BIT by BIT: The Growth of Bilateral Investment Treaties and Their Impact on Foreign Investment in Developing Countries, 24 Int'l L. pp. 655-675 (1990).

⁷ E.g., A. Newcombe & L. Paradell, Law and Practice of Investment Treaties (Kluwer Law International 2009).

⁸ I.d.

⁹ See S. Franck, *Foreign Direct Investment, Investment Treaty Arbitration*, and the Rule of Law, McGeorge Global Bus. and Dev. L. Journal 19, p. 337 (2007).

¹⁰ K.J. Vandeveld, *Bilateral Investment Treaties: History, Policy, and Interpretation* (Oxford University Press 2010).

¹¹ See S. Franck, *The Legitimacy Crisis in Investment Treaty*

Arbitration: Privatizing Public International Law through Inconsistent Decisions, 73 *Fordham L. Rev.* 4, pp. 152-165 (March 2005).

¹² R. Dolzer & M. Stevens, *Bilateral Investment Treaties*, pp. 81-82 (Kluwer Law International 1995).

¹³ See also Franck, *supra* n. 12.

¹⁴ Franck, *supra* n. 12.

¹⁵ H.L. Buxbaum, *The Private Attorney General in a Global Age: Public Interests in Private International Antitrust Litigation*, 26 *Yale Intl. L. J.* pp. 219-263 (2001).

¹⁶ See also Vandevelde, *supra* n. 11.

¹⁷ Franck, *supra* n. 10.

¹⁸ *Vienna Convention on the Law of Treaties* (23 May 1969), *Treaties IBFD*. See Franck, *supra* n. 12.

¹⁹ Dolzer & Stevens, *supra* n. 13, p. 26.

²⁰ Dolzer & Stevens, *supra* n. 13, p. 27.

²¹ AR: I.C.S.I.D., 14 January 2004, Case No. ARB/01/3, *Enron v. Argentina*, par. 44, and Vandevelde, *supra* n. 11, p. 13.

²² M. Sornarajah, *The International Law on Foreign Investment*, p. 9 (Cambridge University Press 2004).

²³ EC: I.C.S.I.D., 18 August 2008, Case No. ARB/04/19, *Duke Energy v. Ecuador*.

²⁴ E.g., in AL: I.C.S.I.D., 26 April 1999, Case No ARB/94/2, *Tradex Hellas v. Albania* and CZ: U.N.C.I.T.R.A.L., 14 March 2003, IIC 62 (2003), *CME v. Czech Republic*, the court stated that '[it is not required that] the assets or funds be imported from abroad or specifically from [territoriality of the other contracting state] or have been contributed by the investor itself'. See also Vandevelde, *supra* n. 11, p. 148.

²⁵ United Nations Conference on Trade and Development (U.N.C.T.A.D.), *Bilateral investment treaties 1995-2006: Trends in investment rule making*, p. 12 (U.N. 2007).

²⁶ *Id.*, p. 13.

²⁷ Case 284/16 *Slovak Republic v. Achmea*.

²⁸ U.N.C.T.A.D., *supra* n. 29, p. 81.

²⁹ U.N.C.T.A.D., *supra* n. 29 p. 82.

³⁰ U.N.C.T.A.D., *supra* n. 29, p. 83.

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³¹ *Quasar de Valores et al v The Russian Federation*, Award dated 20 July 2012.

³² A.F. Rodriguez, *International Arbitration Claims against Domestic Tax Measures Deemed Expropriatory or Unfair and Inequitable*, Inter-American Development Bank, Occasional Paper-SITI-11, p. 7 (January 2006).

³³ Weston considers 'expropriation' to be ambiguous and unsuitable. He proposes using 'wealth deprivation'. See B. Weston, 'Constructive taking' under *International Law: A Modest Foray into the Problem of 'Creeping Expropriation'*, *Virginia Journal of Intl. L.* 16, pp.103-175 (1975).

³⁴ E.g., U.N.C.T.A.D., *supra* n. 29, p. 44, and O.E.C.D., *Working Papers on International Investment*, No. 2004/4, *Indirect Expropriation and The Right to Regulate*, in *International Investment Law* p. 3 (O.E.C.D. 2004).

³⁵ O.E.C.D., *supra* n. 39, p. 3.

³⁶ MX: I.C.S.I.D., 21 November 2007, Case No. ARB(AF)/04/05, *Archer Daniels Midland v. Mexico*.

³⁷ MX: I.C.S.I.D., 30 August 2000, Case No. ARB(AF)/97/1, *Metalclad Corporation v. Mexico*.

³⁸ C.H. Schreuer, Part 1 — Report: The concept of expropriation under the ECT and under investment protection treaties, *Investment Arbitration and the Energy Charter Treaty*, pp. 108-159 (C. Ribeiro ed., 2006); 2 *Transnat'l Dispute Mgmt.* 3, p. 108 (June 2005).

³⁹ For practical reasons, the definition of 'tax' as applied in investment treaties, is not discussed. In general, it is accepted that a tax measure will include legal provisions, procedures and their legal implementation.

⁴⁰ E.g., T. Walde & A. Kolo, *Investor-State Disputes: The Interface Between Treaty-Based International Investment Protection and Fiscal Sovereignty*, 35 *Intertax* 8/9, pp. 440-447 (2007).

⁴¹ E.g., in MX: U.N.C.I.T.R.A.L., 3 February 2006, LCIA Case No. UN3481, *EnCana v. Ecuador*, the court stated that, 'a tax law is not a taking of property; if it were, a universal state prerogative would be denied by a guarantee against expropriation, which cannot be the case'. In MX: I.C.S.I.D., 16 December 2002, Case No. ARB(AF)/99/1, *Feldman v. Mexico*, 7 I.C.S.I.D. Reports 318 (2003) 42 ILM 625, the tribunal argued that, 'governments must be free to act in the broader public interest through protection of the environment, new or modified tax regime, the granting or withdrawal of government subsidies, reductions or increases in tariff levels, imposition of zoning restrictions and the like.'

⁴² Sec. 712, *Restatement of the Law Third, the Foreign Relations of the U.S.A.* (American Law Institute 1987); *Feldman*, para. 105.

See also A. Kolo, *Tax 'Veto' as a Special Jurisdictional and Substantive Issue in Investor-State Arbitration: Need for Reassessment?*, Symposium, 2009.

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⁴³ Rodriguez, *supra* n. 37, p. 8. See also U.K.: London Court of International Court of Arbitration, 1 July 2004, Administered Case No. UN 3467, *Occidental v. Ecuador*. See also L. B. Sohn & R.R. Baxter, *Draft Convention on the International Responsibility of States for Injuries to Aliens*, 55 A.J.I.L. 545, art. 10(5) (1961) (herein, the Harvard Draft):

An uncompensated taking of property of an alien or a deprivation of the use or enjoyment of property of an alien which results...from the action of the competent authorities of the State in the maintenance of public order, health, or morality...shall not be considered wrongful, provided...it is not a clear and discriminatory violation of the law of the State concerned,...[and] it is not an unreasonable departure from the principles of justice recognized by the principal legal systems of the world.

⁴⁴ Rodriguez, *supra* n. 37, p. 13; see also CA: N.A.F.T.A./U.N.C.I.T.R.A.L., 26 June 2000, *Pope & Talbot Inc. v. the Government of Canada*, Interim Award in which the tribunal concluded that, 'a blanket exception for regulatory measures would create a gaping loophole in international protections against expropriation.'

⁴⁵ MD: U.N.C.I.T.R.A.L., 18 April 2002, *Link v. Moldova*, available at <http://italaw.com/documents/Link-Trading-Moldova.pdf>.

⁴⁶ MX: U.N.C.I.T.R.A.L., 3 February 2006, LCIA Case No. UN3481, *EnCana v. Ecuador*.

⁴⁷ Wälde & Kolo, *supra* n. 45; R.E. Walck, Tax and currency issues in international arbitration, 3 *World Arb. & Med. Rev.* 2, p. 176 (2009).

⁴⁸ E.g., *Archer Daniels*; Wälde & Kolo, *supra* n. 45, Harvard Draft Convention, *supra* n. 66 O.E.C.D., *supra* n. 39; *Restatement*, *supra*, n. 47, §712, cmt. (g); Iran-US.. Claims tribunal, 29 December 1989, Award No. 460-880-2, *Too v. Greater Modesto Insurance Assocs., et al.*; and R. Moloo & J. Jacinto, Environmental and Health Regulation: Assessing Liability Under B.I.T.s, 29 *Berkeley J. of Intl. L.* 2, pp. 1-66 (2011).

⁴⁹ *Archer Daniels*, par. 250.

⁵⁰ 24 August 1970, *Revere Copper and Brass Inc and Overseas Private Investment Corporation (1978)*, 56 *ILR* 258, discussed by M. Hunter & A.C. Sinclair, *Ammoil Revisited Reflections on a Story of Changing Circumstances*, in *Investment Law And Arbitration: Leading Cases From The ICSID, NAFTA, Bilateral*

Treaties and Customary International Law p. 360 (T. Weiler ed., Cameron May 2005).

⁵¹ E.g., Kolo, *supra* n. 47; *Archer Daniels*; Rodriguez, *supra* n. 37; and *Feldman*, para 103.

⁵² U.N.C.T.A.D., *Series on Issues in International Investment Agreements: Taking of Property 4 (2000)*. See also R. Higgins, *The Taking of Property by the State: Recent Developments in International Law*, 176 *Recueil des Cours*, pp. 259-324 (1982).

⁵³ Wälde & Kolo, *supra* n. 45.

⁵⁴ *Occidental v. Ecuador*.

⁵⁵ *Occidental v. Ecuador*. See also I.C.S.I.D., 13 September. 2006, Case No. ARB/04/15, *Pope & Talbot and Telenor v. Hungary*.

⁵⁶ *Archer Daniels*, para. 240:

The test on which other Tribunals and doctrine have agreed – and on which the 'Claimants' rely – is the 'effects test'. Judicial practice indicates that the severity of the economic impact is the decisive criterion in deciding whether an indirect expropriation or a measure tantamount to expropriation has taken place. An expropriation occurs if the interference is substantial and deprives the investor of all or most of the benefits of the investment. There is a broad consensus in academic writings that the intensity and duration of the economic deprivation is the crucial factor in identifying an indirect expropriation or equivalent measure.

⁵⁷ ADM invoked article 1102 of the N.A.F.T.A.

⁵⁸ *Occidental v. Ecuador*.

⁵⁹ Art. II(3)(a) of the Treaty between the United States of America and the Republic of Ecuador Concerning the Encouragement and Reciprocal Protection of Investment, with Protocol and a Related Exchange of Letters (27 August 1993): 'Investment shall at all times be accorded fair and equitable treatment, shall enjoy full protection and security and shall in no case be accorded treatment less than that required by international law'.

⁶⁰ *Occidental v. Ecuador*, para 184.

⁶¹ It should be noted that the tribunal in *EnCana v. Ecuador*, para. 173 considered that a contractual obligation was indeed more important than an obligation derived from general legislation and, therefore, applied to the underlying issue a more limited interpretation of the right to fair and equitable treatment: '[i]n the absence of a special commitment from the host state, the foreign investor has neither the right nor any legitimate expectation that the tax regime will not change, perhaps to its disadvantage, during the period of the investment'.



Swiss Corporate Tax Reform – An Overview

By Stephan Neidhardt and Marius Breier
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INTRODUCTION

On 19 May 2019, a revised corporate tax reform was adopted by the Swiss voters in a referendum, the last proposal having been rejected by the Swiss voters in February 2017.

The reform establishes the basis for new rules on Swiss corporate taxation and repeals corporate tax rules that had attracted intense international criticism.

Switzerland will introduce new progressive measures, such as the patent box regime and an additional R&D deduction, which are compatible with international standards and which should allow the country to defend its traditional premium ranking as a global business location.

This article gives an overview of the new regulations and measures provided by the corporate tax reform that will enter into force on 1 January 2020.

REPEAL OF SPECIAL CANTONAL TAX REGIMES

Switzerland has been increasingly criticised for its special cantonal tax regimes — the main criticism being that the regimes were designed to attract companies with ‘mobile’ international activities and enabled them to shift profits without being subject to taxation where the profits were actually generated. As the criticism grew, the European Union went so far as to put Switzerland on a ‘grey list’ of countries with harmful tax regimes, while the O.E.C.D. and the E.U. called for their abolishment.

Countering the mounting international pressure, the corporate tax reform will repeal all of these special cantonal tax regimes, namely the holding, mixed, domiciliary and principal company regimes as well as the finance branch regime upon the implementation of the reform on 1 January 2020, allowing Switzerland to comply with the international standards of the OECD, EU and G20.

STEP-UP AS A TRANSITIONAL MEASURE

To mitigate the effects of abolishing the preferential cantonal tax regimes, companies that currently benefit from special tax statuses under these regimes may apply a step-up as a transitional measure.

The step-up, which is only applicable on the cantonal and communal level, contributes to the taxation of hidden reserves and goodwill under the tax regime where they were created and thus avoids over-taxation. Under the regulations provided by the corporate tax reform, two step-up models will be applicable: These are, on the one hand, the 'current law step-up', which exists under present law and, on the other hand, the 'new law step-up'.

According to the current law step-up, companies currently benefitting from a special cantonal tax regime may decide to disclose their hidden reserves and goodwill in a tax-neutral manner upon the abolishment of the cantonal tax regime and depreciate the disclosed hidden reserves and goodwill over the following years, thus reducing the corporate income tax burden.

The new law step-up enables companies currently subject to a special cantonal tax regime to apply a lower tax rate (special tax rate) for corporate income tax purposes for a period of five years following the abolition of the special cantonal tax regimes on 1 January 2020. The special tax rate can be applied within this period provided that the profits do not exceed the amount of hidden reserves and goodwill that will be determined by the competent cantonal tax authorities at the end of 2019.

Companies currently benefitting from special tax status should carefully weigh up both options for the step-up. The question of whether the current law step-up or the new law step-up will lead to lower overall taxation must be considered on a case-by-case basis.

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PATENT BOX

As part of the reform, a patent box will be introduced on the cantonal or communal levels. Under this measure, net gains on patents and similar rights will be up to 90% exempt from taxation. The cantons will decide on the specific exemption when incorporating the patent box into their cantonal legislation.

The patent box can be applied for corporate income that is allocable to patents, protection certificates, topographies, documents protected under the Therapeutic Products Act, reports protected under the Plant Protection Products Ordinance, and corresponding foreign rights. Copyrighted software is not included, unless it is embedded in a patented product or protected by a patent abroad.

The net gains on patents and similar qualifying rights are calculated using the so-called residual method. Under the residual method, the starting point is the total profit of the company. All profits not related to patents or similar rights are deducted from the total profit and are subject to ordinary taxation.

In order to determine the remaining net profit in the patent box, the so-called Nexus quotient must be calculated in line with the O.E.C.D. considerations. The Nexus quotient is the ratio between the qualifying research and development (R&D) expenses (potentially multiplied by 130%) and the total R&D expenses. The qualifying R&D expenses include expenses for R&D conducted by the company itself in Switzerland, R&D conducted by third parties resident in Switzerland or abroad, as well as R&D conducted by group companies resident in Switzerland. The exemption is only applicable to the patent box profit to the extent of this ratio.

Furthermore, it should be mentioned that upon entry into the patent box, all expenses related to the qualifying I.P. which were deducted for tax purposes over the last ten years prior to the patent box entry must be singled out. Such expenses were deducted under the ordinary tax status, whereas the related

income will benefit from the reduced taxation in the patent box.

The cantons will adopt different approaches to deal with these expenses. In some cantons, for instance, R&D expenses incurred prior to the entry of the patent box will be added to the ordinarily-taxed profit by means of a taxed hidden reserve. This allows for a future depreciation of the taxed hidden reserve in the tax balance sheet, whereby the respective depreciation expense will be included in the patent box.

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Regarding the detailed calculation of the basis for the R&D super-deduction, one must distinguish between 'internal' R&D costs for R&D activities performed by the company itself and 'external' R&D costs for R&D activities conducted by third parties on behalf of the company.

Regarding the 'internal' R&D costs, the basis for the super-deduction is calculated as the R&D-related staff costs (including salaries and social security contributions) of the company plus a lump-sum mark-up on staff costs of 35% (representing a lump-sum amount for other 'internal' R&D costs of the company).

Regarding the 'external' R&D costs, the basis for the super-deduction is calculated as 80% of the expenses for R&D activities performed by third parties resident in Switzerland. R&D expenses invoiced by third parties resident outside of Switzerland do not qualify for the R&D super-deduction.

The total amount of the 'internal' and 'external' R&D expenses eligible for the super-deduction is subsequently multiplied by a factor not exceeding 150%. The specific factor for the R&D super-deduction is determined by the cantons.

The following table depicts a sample calculation for a R&D super-deduction with a factor of 50%:

ADDITIONAL R&D DEDUCTION (R&D SUPER-DEDUCTION)

In order to promote R&D and dampen the effects of the abolition of the preferential cantonal tax regimes, an R&D 'super-deduction' will be introduced.

The additional R&D deduction is restricted to cantonal and communal taxes only and is dependent on voluntary transposition of the measure into cantonal law. The term 'R&D activities' was very broadly defined by the legislator and is based on common O.E.C.D. standards. Therefore, companies may benefit from this super-deduction for basic research, scientific application, and knowledge-based R&D.

Internal R&D costs	R&D-related staff costs	Premium	Qualifying R&D Expenses	Net profit according to financial statement
	741	x 135%	= 1,000	
External R&D costs	Invoice of domestic contractors	Permitted quota		
	625	x 80%	= 500	3,000
	Total Qualifying R&D Expenses		=1,500	
	Super-deduction 1,500 x 50%; "R&D deduction"			-750
	Taxable profit			2,250

NOTIONAL INTEREST DEDUCTION (N.I.D.)

An optional N.I.D. for cantons with a specific minimum tax rate (high-tax cantons) will be introduced. This allows for the introduction of a substitute measure to replace the existing privileged taxation regime for finance branches and finance companies. Furthermore, it reduces the discrepancies between the tax treatment of debt and equity financing, especially as it will only be applicable to excess equity that could be substituted by debt.

However, the specific requirements for the application of the N.I.D. are currently only met by the cantons of Zurich and Aargau. Further, only the canton of Zurich intends to actually implement this measure.

The N.I.D. will be applicable on the equity which exceeds the average equity required for business operations in the long term.

This excess equity is calculated by deducting the core capital from the effectively available equity (N.I.D. only applies if there is a surplus). The core capital is calculated by multiplying the assets by a given capital adequacy ratio.

The applicable interest rate will be based on the yield of ten-year Swiss Federal bonds. To the extent that excess equity is proportionally attributable to all kinds of receivables from related parties, a higher arm's length interest rate may be applied (so-called margin taxation).

OVERALL RELIEF LIMITATION

The measures provided by the reform may be applied in combination. However, all cantons must implement a so-called overall relief limitation.

This relief limitation stipulates that, on the whole, the patent box exemption, R&D super-deduction, N.I.D.

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expenses, and depreciations in connection with the aforementioned current law step-up may reduce the corporate income of a company (corporate income before consideration of tax losses carried forward and without consideration of the measures themselves) by no more than 70%. The cantons may opt for a lower rate than 70% when incorporating the relief limitation into their cantonal legislation.

It is yet to be defined exactly how the relief limitation will be calculated, especially in the event that tax losses are carried forward on the level of the company. The relief limitation could, for example, be calculated as follows under the assumption of a relief limitation of 70%:

Profit after taxes (without any measures)	CHF	100,000
Additional R&D deduction	CHF	25,000
Patent box deduction	CHF	35,000
Step-up depreciation	CHF	20,000
Total deductions	CHF	80,000
Maximum amount of deductions due to relief limitation (70% of profit after taxes without any measures)	CHF	70,000
Deduction surplus (to be added back due to 70% relief limitation)	CHF	10,000
Taxable profit (30% of profit after taxes without any measures)	CHF	30,000

CAPITAL TAX RELIEF

The cantons may introduce a reduced capital tax rate relating to equity capital invested in corporate equity



interests, patents, and similar rights, as well as intra-group loans.

This constitutes an appropriate substitute for the abolished reduced capital tax rate for companies currently benefitting from one of the special cantonal tax regimes.

The canton of Zurich, for instance, intends to introduce a 90% deduction on equity attributable to participations, loans to subsidiaries and patents.

EXTENSION OF THE LUMP-SUM FOREIGN TAX CREDIT

The lump-sum foreign tax credit prevents international double taxation. Its application will be extended to Swiss permanent establishments of foreign companies.

INCREASE AND HARMONIZATION OF TAXATION OF DIVIDENDS FROM QUALIFYING PARTICIPATIONS

The corporate tax reform leads to an increase and harmonization of the taxation of dividends arising from qualifying participations (ownership of 10% or more of the company's capital) on the level of individuals resident in Switzerland receiving the qualifying dividends.

Currently, on the Federal level, the tax base for such qualifying dividends amounts to 60% of the gross dividend amount if the qualifying participation is held as a private asset and 50% if the qualifying participation is held as a business asset. Said amounts are increased to a standard rate of 70% on the Federal level.

On the cantonal level, the tax base for qualifying dividends varies from canton to canton. The corporate tax reform, however, implements a minimum tax base for qualifying dividends on the cantonal level of 50%. Therefore, the cantons may still set their own rates for the taxation of qualifying

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dividends provided that said rates are not lower than 50%.

Moreover, it should be noted that some cantons currently operate a partial tax rate system rather than the aforementioned partial taxation system. This means that a lower tax rate rather than a lower tax base is applied for qualifying dividend payments. The corporate tax reform, however, will harmonize the taxation of qualifying dividends by stipulating the application of the partial taxation system both on the Federal and cantonal or communal levels.

CAPITAL CONTRIBUTION PRINCIPLE RESTRICTIONS

The capital contribution principle will be restricted for companies listed on Swiss stock ex-changes. A 'Repayment Rule' and a 'Partial Liquidation Rule' will be implemented, taking into account the principle of proportionality.

Under Swiss law, dividends paid from retained earnings are subject to Swiss withholding tax at source as well as income tax on the level of individuals resident in Switzerland receiving the dividends. If, however, the dividends are paid from capital contribution reserves, the dividend payments trigger neither Swiss withholding tax nor income tax.

Due to the newly introduced Repayment Rule, companies listed on Swiss stock exchanges may only repay capital contribution reserves (without triggering withholding and income tax implications) if they pay at least an equal amount of dividends from their retained earnings (triggering withholding and income tax implications) provided that such retained earnings are available. The Repayment Rule will also apply to the issuance of bonus shares and an increase of nominal value. However, intra-group dividends will not be covered by this new rule.

In accordance with the Repayment Rule, the Partial Liquidation Rule stipulates that in the case of a share buyback programme with a liquidation of the shares



bought back, the company buying back the shares is obliged to charge at least half of the repurchase price against the capital contribution reserves. Swiss listed companies often distribute their retained earnings by means of a share buyback programme. This is due to the fact that, as a general rule, only Swiss institutional investors participate in such programmes as sellers. The Swiss institutional investors do not face any negative tax implications as they are entitled to a full refund of Swiss withholding tax and are not subject to individual income tax.

Without the additional Partial Liquidation Rule, Swiss listed companies could circumvent the Repayment Rule by distributing all their retained earnings by means of a share buyback programme. In a subsequent ordinary dividend distribution, they could distribute their capital contribution reserves without taking the Repayment Rule into account since there are no retained earnings left on the level of the listed company by the time the ordinary dividend distribution occurs.

Last, but not least, it should be noted that it could be beneficial for listed companies to convert existing capital contribution reserves into share capital. Such a conversion should not lead to any negative tax consequences, at least until such time as the Repayment Rule and the Partial Liquidation Rule enter into force on 1 January 2020.

This would allow listed companies to counter the new Repayment Rule and Partial Liquidation Rule by repaying such share capital to its shareholders in the future since a repayment of share capital, as opposed to a repayment of capital contribution reserves, is not affected by these new rules.

NEW RULES ON TRANSPOSITION

A 'Transposition' is a fact pattern pursuant to which an individual converts future taxable dividend

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payments into tax-free capital gains by selling a privately held participation to another privately held corporation that is personally controlled by the individual.

Under the current Swiss tax regulations, such a transaction leads to a requalification of the tax-free capital gain as taxable dividend income to the extent that the consideration received exceeds the sum of the nominal value and the capital contribution reserves if the percentage of the participation transferred is at least 5%.

In accordance with the new regulations provided by the corporate tax reform, this threshold of 5% for the participation transferred will be abolished. This means that even a sale of less than 5% to a personally controlled corporation can lead to a conversion of the tax-free capital gain into taxable dividend income.

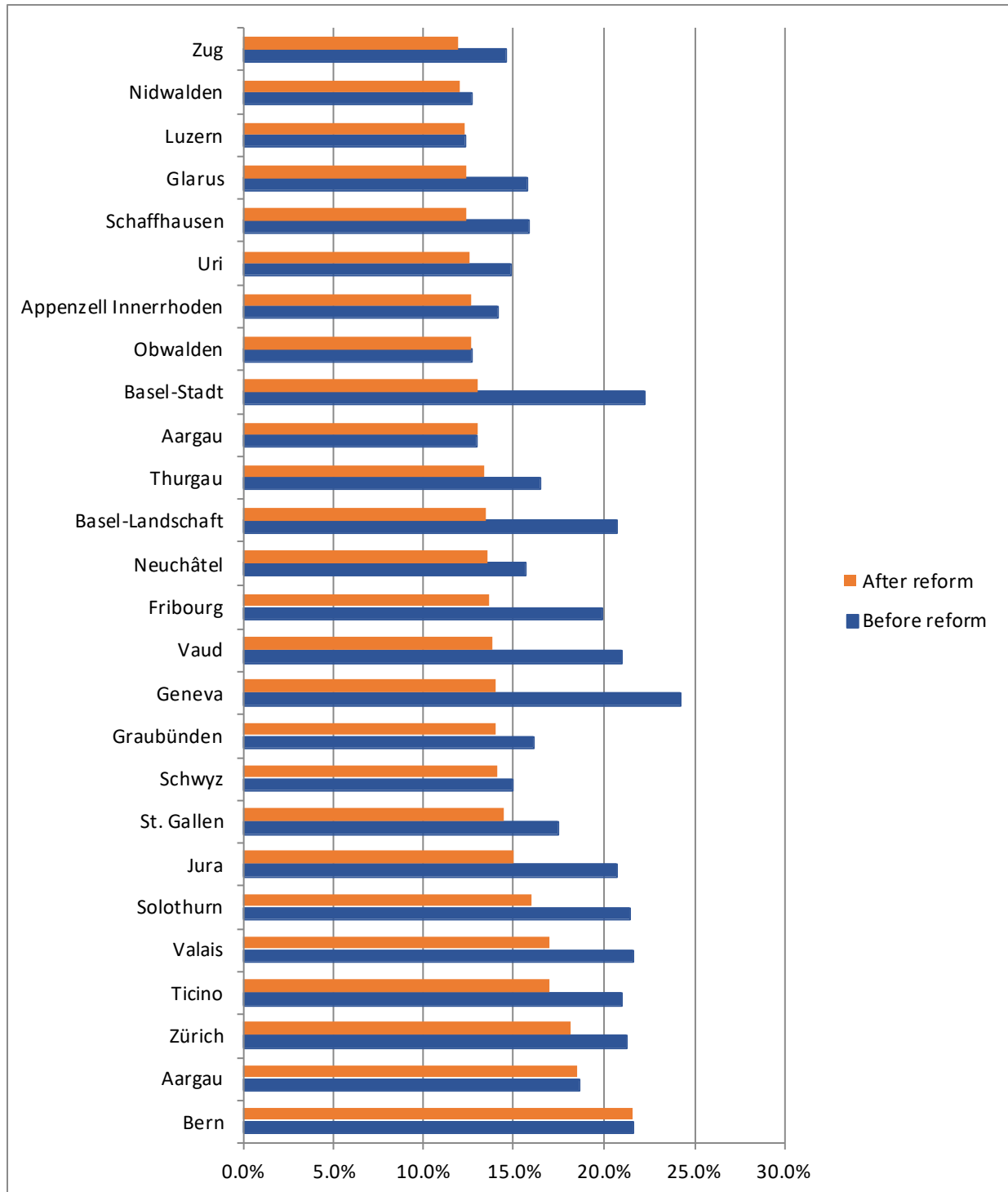
CANTONAL TAX RATE REDUCTIONS

Even though not formally part of the corporate tax reform, most cantons will lower their cantonal corporate income tax rates as part of its local implementation.

In this respect, it should be noted that those cantons already applying relatively low corporate income tax rates will only reduce the tax rates marginally, if at all, whereas some higher tax cantons such as Basel-Stadt or Geneva will reduce their corporate income tax rates substantially.

The canton of Zurich intends to leave the applicable corporate income tax rate almost unchanged (while the applicable effective tax rate in the city of Zurich will be reduced from 21.2% to 18.2%) and focus on fully exploiting the opportunities created by the substitute measures under the reform instead (e.g., the patent box, R&D super-deduction, or N.I.D.).

CANTONAL CORPORATE INCOME TAX RATE



OVERVIEW

The following table provides an overview of the implementation of the corporate tax reform in the different cantons (only cantons printed **boldly** have already finally resolved their cantonal implementation of the corporate tax reform).

Canton	Special rates for realisation of hidden reserves (new law step-up)	Full tax-free (current law) step-up of hidden reserves	Patent box relief	R&D super-deduction	N.I.D.	Overall relief limitation	Capital tax relief (cantonal different measures and conditions apply)	Minimum taxation of qualifying dividends (private/business assets)	Ordinary corporate income tax rates (in cantonal capital) before/after reform
Aargau	2.5%	Yes	90%	50%	No	70%	Yes	50%/50%	18.6%/18.6%
Appenzell Ausserrhoden	1.3% / 2.6%	Yes	50%	50%	No	50%	Yes	60%/60%	13.0%/13.0%
Appenzell Innerrhoden	2.0%	No	30%	-	No	50%	Yes	50%/50%	14.2%/12.7%
Basel-Landschaft	2.2% / 2.6%	Yes	90%	20%	No	50%	Yes	60%/60%	20.7%/13.5%
Basel-Stadt	3.0%	Yes	90%	-	No	40%	Yes	80%/80%	22.2%/13.0%
Berne	0.5%	Yes	90%	50%	No	70%	Yes	50%/50%	21.6%/21.6%
Fribourg	no special rate	No	90%	50%	No	20%	Yes	70%/70%	19.9%/13.7%
Geneva	13.3%	No	10%	50%	No	9%	No	70%/60%	24.2%/14.0%
Glarus	1.5%	Yes	10%	-	No	10%	Yes	70%/70%	15.7%/12.4%
Graubünden	0.5%	Yes	70%	50%	No	55%	Yes	50%/50%	16.1%/14.0%
Jura	0.5%	Yes	90%	50%	No	70%	Yes	70%/70%	20.7%/15.0%
Lucerne	0.4%	Yes	10%	-	No	70%	Yes	60%/50%	12.3%/12.3%
Neuchâtel	not yet defined	No	20%	50%	No	40%	Yes	60%/60%	15.6%/13.6%
Nidwalden	1.2% - 1.8%	Yes	90%	-	No	70%	No	50%/50%	12.7%/12.0%
Obwalden	not yet defined	Yes	90%	50%	No	70%	Yes	50%/50%	12.7%/12.7%
Schaffhausen	0.8%	Yes	90%	-	No	70%	Yes	60%/60%	15.7%/12.4%
Schwyz	0.4%	Yes	90%	50%	No	70%	Yes	50%/50%	15.0%/14.1%
Solothurn	1.0%	Yes	90%	50%	No	70%	Yes	70%/70%	21.4%/16.0%
St. Gallen	0.5%	Yes	50%	40%	No	40%	Yes	70%/70%	17.4%/14.5%
Thurgau	0.5%	Yes	40%	-	No	50%	Yes	70%/70%	16.4%/13.4%
Ticino	3-4%	Yes	90%	50%	No	30%	Yes	70%/70%	21.0%/17.0%
Uri	1.2%	Yes	30%	-	No	50%	No	60%/60%	14.9%/12.6%
Valais	not yet defined	No	90%	50%	No	50%	Yes	60%/50%	21.6%/17.0%
Vaud	11.4%	No	90%	50%	No	70%	Yes	70%/70%	21.0%/13.8%
Zug	0.8-1.6%	Yes	90%	50%	No	70%	Yes	50%/50%	14.6%/11.9%
Zurich	0.5%	Yes	90%	50%	Yes	70%	Yes	50%/50%	21.2%/18.2%



IMPLEMENTATION

The corporate tax reform will enter into force on 1 January 2020 on the Federal level. The provisions made by Federal law regarding cantonal tax regulations must still be translated into the cantonal tax laws of each canton.

As things stand at present, the respective cantonal implementations have already been resolved in nine cantons (Basel-Stadt, Fribourg, Geneva, Glarus, Luzern, Schwyz, St. Gallen, Vaud, and Zurich). The other cantons are at different stages of the legislative processes. However, most cantons plan to decide on the implementation laws (including the reduction of the corporate income tax rates) before the end of 2019 and implement them jointly with the Federal reform on 1 January 2020.

CONCLUSION

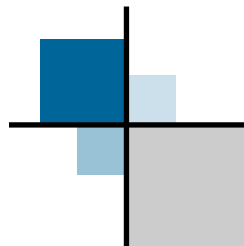
The popular vote on 19 May 2019 marked the end of a long-enduring political and legislative process.

Switzerland will finally repeal the corporate tax rules that had attracted such intense criticism from other countries (some of this criticism dating back as far as to the pre-B.E.P.S. era).

The revised corporate tax reform implements transitional measures and new progressive instruments, such as the patent box and R&D superdeduction, aimed at ensuring that the abolition of the special cantonal tax regimes will be compensated. Furthermore, in the wake of its implementation on 1 January 2020, most cantons will reduce — some significantly — their corporate income tax rates.

Therefore, the corporate tax reform ought to secure and increase Switzerland's overall competitiveness as a business location with a view to innovation, value creation, and job preservation.

To ensure a smooth and tax-efficient transition to the post-tax reform environment, companies should analyse their structures and the impact of the new rules — especially the transitional rules — over the course of 2019 and take appropriate action.





Main Features of Polish Income Taxation

By Marek Bytof

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GENERAL REMARKS

The Polish income tax landscape is deeply impacted by Poland's membership in the O.E.C.D. and the E.U. The standards, rules, and laws of both organisations apply in Poland. To that end, Poland has signed the Multilateral Instrument (M.L.I.) which has revised many, but not all, of the 80 double tax treaties in force in a manner consistent with the O.E.C.D.'s B.E.P.S. Project. These include treaties with Australia, Austria, France, Israel, Japan, Slovakia, Slovenia, and the U.K. On the other hand, several treaties will not be modified by the M.L.I. Included in this category are tax treaties with the Netherlands, Germany, and the United States. Beyond the M.L.I., B.E.P.S. standards have been transposed into the local tax environment, and the ongoing process of implementing E.U. legislation is underway, recently focussing on anti-tax avoidance directives such as A.T.A.D. and DAC6.

BASIC INTERNAL TAX CONCEPTS

Internally, Polish tax law contains two separate sets of income tax rules. One covers the income of individuals and another covers the income of legal entities and partnerships that are limited by shares (Corporate Partnerships). Other partnerships are fiscally transparent.

The personal and corporate income tax regimes contain similar constructive assumptions.

Residence

All taxpayers, whether individuals or entities, are subject to tax on a worldwide basis if they meet a residency test.

Individuals are regarded as Polish tax residents if they are present in Poland for more than 183 days per year or if their centre of vital interests is located in Poland, as detailed in the case law. On the other hand, all legal entities (and Corporate Partnerships) are regarded as local tax residents if their registered seat or place of management is in Poland.

Tax rates

For individuals, a rate of 18% is applicable to income up to a threshold that

equates to approximately €19,600. Income in excess of that amount is subject to tax at a rate of 32%. There are relatively low levels of direct deductions for an individual when computing taxable income. These are so-called free-of-tax amounts. Self-employed individuals may choose to be taxed at a 19% flat rate with no threshold. A new, effective from August 2019, revision to Polish tax law will provide an exemption from tax for individuals up to the age of 26 years. In addition, for certain activities, lump sum rates are also available, with the rates ranging from 2% to 20%.

For corporations and Corporate Partnerships, the regular income tax rate is 19%. A reduced 9% rate is available for small corporations and Corporate Partnerships. Entities with pre-tax income not exceeding the equivalent to €1,200,000 per year benefit from the exemption. Withholding tax on dividends is 19%. Note that exemptions provided by double tax treaties or the E.U. Parent-Subsidiary Directive are not taken into account in determining whether the ceiling on the 9% rate is exceeded.

Dividend payments

Corporate taxpayers that distribute dividends of up to approximately €460,000 must ensure they are not involved in fully artificial structures, created mainly for the purpose of tax avoidance. Taxpayers paying out dividends over the threshold must deduct refundable withholding tax, imposed at the rate of 19%. A shareholder entitled to tax-free treatment under a treaty or the E.U. Parent-Subsidiary Directive may apply for a full refund of the withheld tax.

An option exists for intercompany dividends to be paid without any withholding tax. However, the benefit is allowed only where a prior ruling is obtained from the tax administration, known as the K.A.S. To benefit from the non-deduction, the taxpayer must give a formalised declaration to the tax administration stating the facts and circumstances and explaining why the exemption from withholding tax is applicable. However, the system is complex and withholding tax on dividends in excess of the equivalent of approximately €460,000 is suspended through the end of 2019.

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Losses

For individuals, corporations, and Corporate Partnerships, losses may be carried forward for up to five years. During the carryover period, not more than 50% of the losses may be deducted in any single year during the carryover period.

RULES TO COMBAT AGGRESSIVE TAX PLANNING

In recent years, the Polish tax system has been reshaped to counteract aggressive tax planning via wholly artificial domestic and international structures.

General Anti-Avoidance Rule

On 15 July 2016, the new General Anti-Avoidance Rule (G.A.A.R.) came into force.

Based on an O.E.C.D. concepts, the G.A.A.R. authorizes the K.A.S. to determine a taxpayer's position without taking into account any artificial or contrived arrangements intended to gain artificial tax advantages that are contrary to the object and purpose of tax law. Under the G.A.A.R., the tax consequences are determined according to the transactions that would have been performed if the taxpayer had acted appropriately. In broad terms, appropriate activity connotes that the taxpayer does not act in an artificial manner and has commercial grounds for entering the transactions. Stated somewhat differently, it means that a transaction was entered into not simply to obtain a tax advantage. If a transaction is disregarded under the G.A.A.R. rules, additional tax may be imposed, and because it is paid late, interest will be due in connection with the initial underpayment. As a consequence of any such reclassification, the taxpayer may be charged late-payment interest on tax deficiencies arising from the application of the G.A.A.R.

Absence of cases

It has been three years since the G.A.A.R. entered into force. During this period, no cases have been published providing guidance on the practical application of the rule. As a result, the Polish G.A.A.R., which uses ill-defined terms such as 'artificial',

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'contrived', 'tax advantage', and 'commercial grounds', provides more uncertainty than it resolves. Even a fair entrepreneur who pays taxes and fulfils all requirements cannot be sure that the tax authorities will not question his or her activities in the future and impose additional taxes and interest.

To illustrate, the practical understanding of the term 'tax advantage' is not clear. Theoretically, the term covers each of the following:

- a failure to determine the tax liability,
- a delay in determining the tax liability,
- a reduction of the amount of tax,
- an overestimation of losses, and
- obtaining an excessive tax refund.

All of these are referred to as tax advantages in the Polish G.A.A.R. laws, yet they may not arise for an abusive intent as to the amount of Polish tax due and payable from a transaction. In many cases, the tax advantage may simply result from different understandings of one or more relevant business-related facts. In illustration, an individual may choose to take advantage of the 8.5% lump sum tax rate on rental income. It is clear that the individual has elected lump sum tax to avoid paying greater tax. There is no commercial purpose but tax reduction. Yet it is clear to most sane persons that the ability to choose to pay a lower tax was precisely what the Polish parliament intended when the relevant tax provision was enacted into law.

Regrettably, little comfort can be derived from a legal definition of the 'artificial manner of obtaining tax advantages' as no limits or qualifications are placed on its applications. A rational person might look to the following factors as a prerequisite for applying the G.A.A.R. to a particular transaction:

- unjustified division of the transaction,
- unjustified economic involvement by third parties,
- lack of economic and business justification for entering a business transaction,
- appearance of elements leading to the same or

similar position to the one existing before an activity took place,

- appearance of elements which annul or offset each other, and
- the extent to which an entity would not reasonably choose such mode of action

These abusive situations generally can be demonstrated within day-to-day business operations. An exemption until the end of December 2019 provides that the G.A.A.R. will not be applied to transactions that do not exceed the equivalent of approximately €23,000 per year.

Material on Ministry of Finance website

Some clarifying material is published on the Ministry of Finance website. Mostly, the material consists of tax warnings, published only in Polish, which are not legally binding but show the general views of the K.A.S.

At present, the tax warnings refer to wholly artificial arrangements involving private investment funds or shelf companies. These broadly follow decisions issued on 26 February 2019 by the Court of Justice of the E.U. in the so-called Danish Cases.

Protective opinions

In these circumstances, the 'protecting opinion' has been introduced as a way of obtaining legal protection for planned operations that may be subject to the G.A.A.R. A request is submitted to the K.A.S. and is quite similar to a request for a tax ruling. The request should explain the factual background, planned operations, business and economic justification, tax implications, and the taxpayer's own view as to the reasons why the G.A.A.R. is not applicable. The fee charged by the K.A.S. is the equivalent of approximately €4,500, which is a relatively high amount for start-up companies. As a result, not many protecting opinions have been issued as taxpayers are not keen to pay the fee. Nonetheless, the protecting opinion is the only solution for entrepreneurs who wish to be sure that business activities will not be contested under G.A.A.R.

Mandatory Disclosure Rules

Aggressive scope

The Mandatory Disclosure Rules (M.D.R.) constitute another instrument aimed at combating artificial structuring. On the 26 October 2018, the Polish parliament adopted an act transposing the Council of the European Union Directive 2018/822 of 25 May 2018. This is an amendment to Directive 2011/16/E.U. with respect to mandatory automatic exchange of information in the field of taxation in relation to reportable cross-border arrangements (DAC6). It entered into force in the Polish tax system on 25 June 2018.

The Polish parliament chose a very aggressive approach in transposing DAC6. First, implementation was significantly accelerated. The measures entered into force on 1 January 2019, instead of 1 July 2020 as specified in DAC6. In addition, the M.D.R. applies retroactively and is effective from 25 June 2018. Second, the Polish M.D.R. legislation is much wider in scope compared to DAC6. It embraces expanded coverage of reportable tax arrangements that includes wholly domestic tax arrangements and V.A.T. Thus, it goes beyond the cross-border scope of DAC6.

Persons covered

There are two categories of persons covered by the M.D.R. rules: users and promoters. A user is a natural or legal person, or an organisational unit that does not have legal personality:

- to whom the arrangement is made available,
- in whose enterprise the arrangement is being implemented, or
- who is prepared for the implementation or who has taken a step to implement the arrangement.

A promoter is an adviser obliged to disclose the scheme. A promoter may be:

- a natural,
- a legal person,
- an organisational unit that does not have legal personality,
- a tax adviser,
- an attorney at law, or

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- an employee of a bank or another financial institution.

As a catchall, a promoter may be another person who performs services, is not listed above, but who has similar qualifications to those listed above.

Hallmarks of tax avoidance

The Polish M.D.R. sets out 24 hallmarks that indicate a potential risk of tax avoidance. DAC6 provides 15 hallmarks. Only 11 of the 24 hallmarks require the existence or suspicion of a tax benefit. The others must be reported even if no tax plan or benefit is involved. Where the M.D.R. applies, reporting is required within 30 days from the date of sharing the scheme or implementing the advice.

Triggers for mandatory reporting within the 30-day time limit include:

- The promoter or user undertakes to abide by a confidentiality clause beyond the standard professional confidentiality rules within a profession.
- The fee is fixed by reference to the amount of the tax advantage derived from the arrangement.
- The documentation or form of the arrangement is significantly harmonised so that it is identical or nearly identical with documents in comparable schemes offered to other taxpayers.
- The scheme results in a change in the classification of income or tax rules applicable to the transaction, resulting in a lower tax rate, tax relief, or tax exemption.
- There has been a circular flow of cash as part of the scheme.
- Cross-border payments have been made to an associated enterprise based in a low-tax country, reducing Polish taxes.
- The user has undertaken to co-operate with the promoter who designs the arrangement.

Tax scheme numbers, penalties, and guidance

After submission of the report, a 'tax scheme number' is issued. The Ministry of Finance has stated that, from

the beginning of 2019 until 10 July 2019, promoters have submitted 3,341 reports while only 272 tax scheme numbers were granted. This shows how complicated and unclear the process may be and that the pace of the tax authorities is slow.

Failure to report or other non-compliance may result in the imposition of fines of up to the equivalent of approximately €2,333,300 for a promoter and up to the equivalent of approximately €5,040,000 for a user.

The biggest concern in the Polish implementation of the M.D.R. regulations is their application. Open questions exist as to which persons have the status of a promoter, which arrangements should be reported, and whether an intermediary has a duty to investigate arrangements that are not originated by the taxpayer.

The Polish Ministry of Finance has issued official guidelines containing 100 pages of practical tips on the proper way to comply with the M.D.R. regulations. The guidelines have a significant impact as they give legal protection to those who follow ministerial recommendations. Unfortunately, the guidelines are available in Polish only. They can be downloaded from the Ministry's website.

Exit tax for corporations and individuals

The exit tax is perhaps the most controversial of the new anti-avoidance measures adopted by the Polish parliament. The exit tax was introduced in internal tax laws on 1 January 2019, following the E.U. A.T.A.D. provisions. However, the local approach is significantly broader than the original E.U. concept. While the scope of the E.U. directive is limited to entities subject to corporate income tax, the Polish version also covers individuals. This has led to doubts as to whether the exit tax regulations are in accordance with E.U. law.

The regular rate of exit tax on entities subject to corporate tax is 19%. The rate for individuals is 19% or 3% depending on whether they are entitled to deduct costs (higher rate applies) or they not entitled to deduct costs (lower rate applies). Individuals are not chargeable if the fair market value of their assets does not exceed the equivalent of approximately €920,000.

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For individuals, the exit tax arises only on financial assets and assets connected with business activities. Substantial questions exist in quantifying real estate assets for exit tax purposes. No guidance

exists in determining when ownership of real estate assets is connected with the conduct of a business. If activities in managing the asset are relatively few and the ownership is passive, is it nonetheless a business? When is real estate merely an investment activity that produces an annual return in the form of rents? Official clarification has been promised by the Ministry of Finance. It is expected that whenever issued, guidance will be provided.

Controlled Foreign Company legislation

Controlled Foreign Company (C.F.C.) rules have been in effect in Poland from January 2015. From January 2019, the C.F.C. rules have been expanded to cover Controlled Foreign Entities (C.F.E.) and Controlled Foreign Arrangements (C.F.A.). Hence, the C.F.C. rules cover not only companies but also trusts, foundations, groups of companies, and any legal relationship having fiduciary features.

The applicable tax rate is 19% of the taxable base. Many different types of passive income fall within the C.F.C. rules, including income derived from dividends, shares, debts, royalties, and rents. If a company (or arrangement) derives at least 33% of its income from passive assets and a Polish resident taxpayer owns directly or indirectly an equity interest representing at least 50% of the voting rights within the entity, the entity is a C.F.C. In addition, all structures located in a harmful jurisdiction or a jurisdiction that does not have a comprehensive tax treaty with Poland in effect are also regarded as C.F.C.s, no matter the nature of their income.

The company (or arrangement) will not be regarded as a C.F.C. if it carries out actual business activities. A combination of objective circumstances should be used to determine whether the business is real or devoid of any economic and commercial purpose. Under the law, the company must have sufficient substance to objectively prove its business activity. Substance means office space, qualified personal, proper equipment, *etc.*

Contrary to G.A.A.R. or M.D.R. regulations, tax rulings may be obtained from the K.A.S. regarding the scope of the C.F.C. rules on a foreign entity. At present, no disputes or case law exists under the C.F.C. rules, and no Polish taxpayers are known to be under investigation regarding the status of entities owned outside of Poland.

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- patents
- extensions of patent protection
- extensions of patent protection for medicinal products and plant protection products
- registered medicinal and veterinary products admitted to trading
- software

CONSTITUTION FOR BUSINESS

While the foregoing discussion illustrates the proliferation of anti-avoidance rules enacted in recent years, many tax planning opportunities continue to exist. For example, the Polish parliament recently approved a governmental package of laws called the Constitution for Business. Some have referred to it as the most significant reform of Polish commercial law since the end of the communist regime. Among the new business friendly acts are:

- Entrepreneurs Law Act intended to promote co-operation between the state's
- administration and entrepreneurs
- Act on Ombudsman for Small and Medium-sized Entrepreneurs intended to provide helpful advice to small and medium-sized businesses, eliminating risk, and reducing costs
- Act on the rules for participation of foreign entrepreneurs and other foreign persons in trade
- on the territory of the Republic of Poland, intended to prevent surprise application of laws

INTELLECTUAL PROPERTY BOX REGIME

One specific tax related act that that is intended to provide tax benefits is the Intellectual Property (I.P.) Box Regime. The purpose of this measure is to provide a new business-friendly environment for innovative activities. The main feature of the Polish I.P. Box Regime is a preferential 5% tax rate applied to qualified income obtained from certain I.P. rights created, developed, or acquired and improved by a taxpayer. The qualifying I.P. rights include among other the following items:

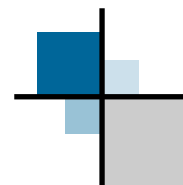
Qualified income covers fees and royalties derived under license agreements covering qualifying I.P. rights and income from direct sale of such rights.

The Polish I.P. Box Regime meets O.E.C.D. standards. Taxpayers planning to benefit from the regime must fulfil additional documentation requirements. These include a requirement to maintain accounting records that allow for the identification of each qualifying I.P. right and the determination of revenues, tax deductible costs, and income or loss attributable to that right. Nonetheless, the Polish I.P. Box regulations are broader and more flexible than those that exist in certain other jurisdictions.

The Ministry of Finance recently issued guidelines stating that the new I.P. Box Regime may be combined with pre-existing relief for research and development (R&D) activities. Bearing in mind that R&D relief makes it possible for a 100% or, in some situations, 150% deduction, the regime is quite advantageous.

CONCLUSION

In sum, investing in Poland comes with both pitfalls and rewards. Poland is zealously committed to compliance and transparency, at times going beyond the efforts of its O.E.C.D. and E.U. counterparts. This fervour is expected to decrease the likelihood that Polish measures will be challenged by the European Commission. At the same time, the government has adopted measures that appeal to investors, particularly with the recent introduction of the Constitution for Business and the I.P. Box Regime.





Swiss Exchange of Information in Tax Matters – Sea Change in a Landlocked Country

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IN THE BEGINNING...

The refusal to exchange information with other jurisdictions in tax matters came close to being considered part of the definition of Swiss identity. That has changed.

Up until 2009, Switzerland would, as a general rule, exchange tax information with other jurisdictions only in cases of alleged tax fraud. The distinction between tax evasion (or avoidance in some jurisdictions) and tax fraud played a central role in this context. Somewhat idiosyncratically, the Swiss would not regard an incomplete tax return (e.g., one not listing a Swiss bank account) as a falsified document, but merely as a false 'declaration'. This distinction, coupled with Swiss banking confidentiality provisions reinforced by criminal sanctions, allowed for safe shielding of assets held with Swiss banks from tax authorities.

It should not be forgotten that this was not a unilateral, or even 'hostile', act on the part of the Swiss. The above distinction was reflected in the vast majority of Swiss double tax treaties (D.T.T.s) at the time. In other words, the approximately 60 jurisdictions with whom Switzerland entered into D.T.T.s were well aware of and agreed to the Swiss distinction between tax fraud and tax evasion and the consequences for information exchange. That said, D.T.T.s such as those with the U.S., the U.K., and Germany already included more rigorous standards for quite some time.

In 2009, things took a sharp turn when the Swiss government committed to adopting the O.E.C.D. standard of information exchange. To start with, this was restricted to the exchange of information on request according to Article 26 of the O.E.C.D. Model Convention. With the introduction of F.A.T.C.A., the U.S. prepared the ground for the automatic exchange of information, which was later followed by the even more remarkable concept of spontaneous information exchange.

This article gives an overview of the status quo and expected developments in Switzerland. Currently, Switzerland participates in information exchanges on (i) an automatic basis; (ii) a spontaneous basis; (iii) grounds of a D.T.T. upon request; and (iv) the basis of the B.E.P.S.

Project, the so-called Country-by-Country-Reporting (CbCR). Notably, Switzerland has also amended the information exchange clause in its D.T.T. with the U.S.

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Finally, very recent case law has pushed the boundaries of what used to distinguish an unlawful 'fishing expedition' from a legitimate request under the D.T.T., in this instance with France.

INFORMATION EXCHANGE ON REQUEST – FISHING EXPEDITIONS?

Switzerland now receives a large number of information exchange requests each year, both in relation to individuals and corporations (in 2016: 66,553 requests; in 2017: 18,164 requests). Often, if the request relates to individuals, Swiss bank accounts will be involved, whereas requests in relation to corporations tend to seek information about transfer pricing, substance, and/or tax regimes.

Even though the information exchanged on receipt of a request on D.T.T. grounds has a longstanding history in Switzerland and most D.T.T. provisions on information exchange have been ratified, Swiss case law demonstrates that a number of questions are yet to be resolved. Political considerations must also be included in the equation.

Latest case law developments

As a general rule, information will be exchanged on the basis of a D.T.T. or tax information exchange agreement (T.I.E.A.) request (provided the information is foreseeably relevant for carrying out the provisions of a D.T.T. or T.I.E.A.) to the tax administration of a requesting state or for the enforcement of domestic tax laws. The term 'foreseeably relevant' is neither defined in the O.E.C.D. Model Convention nor in the D.T.T.s themselves. The O.E.C.D. commentary states that 'the standard of foreseeable relevance' is intended to provide for exchange of information in tax matters to the 'widest possible extent'. However, so-called fishing expeditions are forbidden, and the foreseeable relevance of an information exchange must be examined on a case-by-case basis.

In a recent judgment, the Federal Supreme Court approved an information exchange request from the French tax authorities in relation to 40,000 UBS accounts, and other matters, after the Federal Administrative Court had rejected

the original request by arguing that it amounted to a fishing expedition.

In summary, the French Authorities received, from the German authorities, lists of UBS bank accounts potentially held by French residents. The German authorities had received the information in the course of an investigation. For each account, the French authorities requested the name, date of birth, and address of (i) the account holder; (ii) the beneficial owner according to Form A; and (iii) each person who represents either (i) or (ii). In other words, the information which according to the firmly established traditional view was essential for an information request to be valid was missing.

To show that the relevant account holders were unlikely to be compliant with French tax law, the French authorities essentially provided arguments based on statistics (e.g., 91% of accounts disclosed in the course of voluntary disclosure procedures were Swiss bank accounts). The Federal Administrative Court (rightly) concluded that statistical reasons are not sufficient to assume acts of tax avoidance and, therefore, rejected the request.

Why and how the Federal Supreme Court could reach its conclusion that this very broad request could be valid remains unclear. The written decision setting out the judges' motivations has not yet been published.

Information exchange on the basis of stolen data

Various data leaks, in particular from former bank employees who stole client data, caused an increase of information requests based on such stolen data (e.g., the HSBC and UBS cases).

Based on Swiss legislation (i.e., the Federal Act on International Administrative Assistance in Tax Matters), requests for information exchange are not considered if the request violates the principle of

good faith, particularly if it is based on information obtained through a criminal offence under Swiss law. This was often the subject of controversial discussions.

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In March 2017, the Federal Administrative Court ruled that information exchange requests shall not be granted in the event the requesting party has acquired stolen data for information exchange purposes. The court held that such action violates the principle of good faith. In this case too, the tax authorities appealed, and the Federal Supreme Court granted the information request on the basis that the underlying crime had not been committed in Switzerland and was, therefore, not subject to Swiss law. Consequently, the principle of good faith is not applicable.

Approximately one year later, in August 2018, the Federal Supreme Court further eroded the principle of good faith in relation to information requests. Namely, it held that information requests shall be rejected if the requesting party initially confirmed that stolen data would not be used for the purpose of an information request.

In summary, information requests on the basis of stolen data are granted if the criminal action is not subject to Swiss law or if the requesting party warranted not to request information on the basis of stolen data.

SPONTANEOUS EXCHANGE OF INFORMATION (RULING EXCHANGE)

In addition to exchanges upon request, Switzerland has implemented the spontaneous exchange of information.

The term 'spontaneous' means that the tax authority discovering the information sends the information to another country's tax authority on its own volition. It is neither automatic nor requested. Spontaneous exchange is one of three types of information exchange introduced under the O.E.C.D. Convention on Mutual Administrative Assistance in Tax Matters (C.M.A.A.T.).

Switzerland introduced the spontaneous exchange of tax rulings from 1 January 2017, on the basis of the C.M.A.A.T. Qualifying tax rulings that were confirmed after 1 January 2010 and are still applicable on 1 January 2018 are subject to spontaneous exchange by the tax authorities.

Swiss tax authorities will not exchange all types of tax rulings on a spontaneous basis. Those subject to spontaneous exchange are listed in B.E.P.S. Action 5 and specified for Swiss purposes in domestic legislation.

Even though Article 7 of the C.M.A.A.T. may also cover rulings relating to individuals, the Swiss provisions, as currently drafted, affect Swiss corporations only.

Under the Swiss provisions, the following types of rulings are subject to exchange:

- **Unilateral transfer pricing rulings.** These include, for example, transfer pricing rulings granted by the Swiss tax authorities without the involvement of other concerned states.
- **Rulings relating to preferential corporate tax regimes.** For example, rulings about holding, mixed, or domiciliary company regimes; principal companies; I.P. boxes; or finance branches are subject to exchange. As those regimes will be abolished by the end of this year, rulings in relation to the patent box which will be introduced in the following year are likely to be subject to the spontaneous exchange of information.
- **Rulings reducing taxable profit without reflection in the financial statement.** Such rulings are rare as the Swiss tax liability of a company is tightly connected to its financial statement. In future, an excess deduction for research and development will be available for qualifying companies. Such type of ruling is likely to become more relevant.
- **Rulings on permanent establishments (P.E.s).** For example, rulings about the recognition of a P.E.

or profit allocation to a P.E. are subject to exchange.

- **Rulings on conduit structures.** Rulings on hybrid structures, for example, are subject to exchange. This category typically applies to circumstances where the structure leads to double non-taxation or under-taxation.

For tax rulings confirmed after 1 January 2018, the taxpayer is requested to complete the O.E.C.D. template within 60 days following the confirmation of the tax ruling. The template is then subject to spontaneous exchange.

In the event the receiving jurisdiction wishes to obtain additional information about the taxpayers, an information exchange, upon request, is required.

AUTOMATIC EXCHANGE OF CBCRS

The latest form of information exchange which was introduced by Switzerland is under the Multilateral Competent Authority Agreement on the Exchange of Country-by-Country Reports. The aim was to comply with the minimum standards for international exchange of CbCRs set out in B.E.P.S. Action 13. The Swiss Parliament enacted corresponding domestic legislation at the end of 2017.

The B.E.P.S. initiative provides for multinational enterprises (M.N.E.) with a consolidated revenue exceeding €750 million (C.H.F. 900 million as per Swiss legislation) to provide tax authorities with information on an annual basis. The information contains the M.N.E.'s worldwide allocation of income, economic activity, taxes (income and withholding tax on received income) paid, number of employees, capital, and retained earnings. The information must be provided in a template with the aim of creating transparency in transfer pricing matters. CbCR aims to increase transparency and allows tax authorities to review the M.N.E.'s tax compliance, in particular the M.N.E.'s transfer pricing policies.

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CbCR reports are not disclosed to the public but annually exchanged with the tax authorities in jurisdictions in which the M.N.E. has entities. M.N.E.s were required to prepare a CbCR for the financial year started in 2018 and are to be exchanged in early 2020. Jurisdictions with which Switzerland will exchange CbCRs include the E.U. countries, Russia, China, and India (further countries listed¹).

DAC6 – EUROPEAN LEGISLATION: WHY SHOULD THE SWISS CARE?

In June 2018, an amendment to the E.U. Council Directive on Administrative Cooperation in the Field of Taxation, commonly referred to as DAC6, introduced new mandatory disclosure rules on certain cross-border tax arrangements for qualifying intermediaries and relevant taxpayers.

DAC6 covers cross-border arrangements, i.e., those with participants in either more than one E.U. Member State or a Member State and a third country. Further, for an arrangement to be reportable, it must meet one or more of the defined 'hallmarks': These are certain features deemed to carry an increased risk of tax-avoidance.

Some hallmarks also require satisfaction of a main benefit test, i.e., whether one of the main objectives of the arrangement is to obtain a tax advantage.

Broadly speaking, five hallmark categories were defined: arrangements (i) involving performance fees for the advisor or mass-marketed schemes, (ii) including tax planning features such as the acquisition of loss-making companies or the conversion of income to capital, and (iii) making use of payments to (almost) zero-tax jurisdictions and depreciation deductions claimed in multiple jurisdictions. All three categories (i) to (iii) require, in addition, that one of the main objectives be the obtaining of a tax advantage. Categories (iv) and (v) include arrangements resulting in (not aimed at!) the undermining of the rules on automatic information

exchange and those using the transfer of hard-to-value intangibles in transfer pricing matters, resulting in a reporting obligation regardless of whether a tax advantage was sought.

The reporting obligation generally rests on the 'intermediary' who, under DAC6, is any person that designs, markets, organises, makes available for implementation, or manages the implementation of a reportable cross-border arrangement. The reporting obligation shifts to the taxpayer in the absence of an intermediary, where the intermediary is exempt by professional privilege, or where the intermediary is located outside of the E.U.

The reportable information is extensive and includes the identification of the involved taxpayers and intermediaries, details of the relevant hallmark(s), a summary of the arrangement, and the value of the arrangement.

And yet, if it is E.U. legislation, why should the Swiss care?

Although – being part of E.U. legislation – the rules do not directly apply in Switzerland, they may affect Swiss 'intermediaries' with operations in E.U. jurisdictions. Therefore, even purely Swiss intermediaries serving E.U. clients will be well advised to consider the impact of DAC6.

Typical examples will include the following scenarios: (i) Swiss bank with branches in one or more E.U. countries; (ii) Swiss consultancy firm registered with an E.U.-based professional services association; or (iii) any E.U.-incorporated entity with its place of effective management in Switzerland, even though the entity is considered tax-resident in Switzerland. In all these cases, Swiss entities are considered E.U. intermediaries and under the obligation to report certain cross-border arrangements to the respective E.U. tax authorities.

Practically speaking, any intermediary that serves E.U. clients should be familiar with the mandatory disclosure rules imposed by the E.U.

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NEW DOUBLE TAX AGREEMENTS – IN PARTICULAR, WITH THE U.S.

Whereas Switzerland had already amended its D.T.T.s with close to 60 jurisdictions to allow for information on request in line with O.E.C.D. standards, there was uncertainty, most notably with regard to the U.S.

The current D.T.T. between Switzerland and the U.S. dates back to 1996. A protocol (the Protocol) aimed at amending the D.T.T. was signed in 2009 and was approved by the Swiss legislator in 2010. Until 2019, the Protocol remained blocked in the U.S. Senate, due to the resistance of Senator Rand Paul, who essentially disagrees with the notion of exchange of tax information altogether. The Protocol was finally approved by the U.S. Senate in July and came into effect on September 20, 2019.

The Protocol's core element is the amendment of Article 26 of the D.T.T., which is now in line with O.E.C.D. standards. Importantly, although the Protocol is unlikely to enter into force before 2020, it allows for requests for information to be made as far back as 2009. Once the Protocol is implemented, the D.T.T. between Switzerland and the U.S. will no longer distinguish between tax fraud (and the 'fraud and the like' concept which had been part of the D.T.T. for some time) and tax evasion (avoidance). That said, since the introduction of F.A.T.C.A., that distinction has been largely theoretical with regard to information flowing from Switzerland to the U.S.

Also, the Protocol explicitly excludes requests for information amounting to 'fishing expeditions' and requests for information 'unlikely to be relevant to the tax affairs of a given taxpayer'. Again, the F.A.T.C.A. agreement had previously introduced group requests in 2014, and in the light of most recent case law (cf. the 'UBS case' described above), it will be interesting to see what impact the Protocol's ban on fishing expeditions will have.

SUMMARY AND CONCLUSIONS

In Switzerland, the movement towards transparency in financial matters began in the late 1970's with the introduction of the Swiss banks' Code of Conduct on the exercise of due diligence. Not only in Switzerland did it take time for these measures to be translated into the realm of tax information exchange. The development of the concept of 'beneficial ownership', originally developed for regulatory and anti-money laundering (A.M.L.) purposes, enabled the exchange of tax information as we know it today.

The past years brought about a convergence, more precisely perhaps a dilution, of previously separate categories. Beneficial ownership used to be distinct for A.M.L., regulatory, and tax purposes. This separation is no more. Information originally disclosed for A.M.L., and even regulatory, purposes is used in tax matters as a matter of course, often without consideration to the appropriateness of such 'cross-pollination'.

This article traced the development of exchange of tax information in Switzerland. Its D.T.T. started out by including the 'small' information exchange provision which, as all parties to those agreements full well knew, essentially constituted mere window dressing. At the time, there was generally no intention between the D.T.T. partners to exchange tax information between jurisdictions. That said, the U.S., the U.K., and Germany were among those with whom, since the 1960's, Switzerland agreed to exchanging information on a broader basis, e.g., in cases of 'tax fraud and like'.

The big shift occurred in 2009 when the Swiss government announced the adoption of the O.E.C.D. standard, at the time meaning the exchange of information upon request. Since then, things have moved swiftly. The F.A.T.C.A. agreement with the U.S. was put in place, in effect providing for one-way delivery of information to the U.S., and was followed by Swiss participation in the worldwide automatic exchange of information, T.I.E.A.s, CbCR, and spontaneous exchange of tax rulings. Following these developments, Switzerland is now at the fore of international cooperation in tax matters.

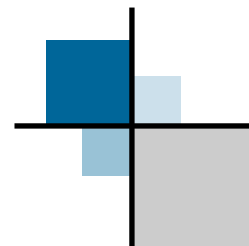
Swiss Exchange of Information in Tax Matters - Sea Change in a Landlocked Country

Arguably, one may even identify overshooting tendencies in that Swiss Supreme Court case law has allowed tax information to be exchanged, approving requests made based on stolen bank data or, most recently, fishing expeditions

which previously were anathema in the field of international tax cooperation.

There is, of course, much to be said for transparency to contribute to the prevention of tax evasion. Still, one cannot help to note that, in particular, the automatic information exchange is an indiscriminate one-size-fits-all approach. It may result, for example, in the exchange of data that is irrelevant for the recipient. There is, for example, little justification for jurisdictions without a wealth tax to receive its taxpayers' bank account balance when there is no corresponding provision under their own domestic legislation. Lastly, and even worse, there is a considerable risk of data being exchanged with jurisdictions that do not guarantee the safety of its taxpayers.

The introduction of information exchange laws was in many cases driven by unbridled legislative enthusiasm, often leaving aside data protection considerations. It is by now a matter of intense debate whether the current level of (automatic) information exchange is compatible with data protection and even humanitarian considerations. The world is a more transparent one and much has been achieved. Nonetheless, transparency may not be a goal in itself. The debate must be kept alive.



¹ "Country-by-country reports" State Secretariat for International Finance SIF, last modified 10 September 2019.

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