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OECD-BEPS measures in Swiss double tax treaties – impact of the principal purpose test

The OECD published in October 2015 an action plan comprising 15 measures to fight base erosion and profit shifting (BEPS) of companies in the international tax environment. In the meantime, more than 100 countries have signed this initiative – the so-called inclusive framework means it's not only limited to OECD/G20 member states anymore.

Multilateral instrument

Action 15 addresses how the measures can effectively be implemented between the different states. This shall be done via a multilateral instrument, ie the multilateral convention to implement tax treaty related measures to prevent BEPS (MLI) signed in June 2017. It currently covers more than 75 countries. Switzerland, as an OECD member state, has also signed the MLI and initiated the legislative process to implement it (in the Federal Resolution regarding the ratification of the MLI – Federal Resolution – MLI). The MLI comes with various options, and also allows states not to implement certain provisions.

Switzerland has – like many other countries – taken the approach to generally cover only the mandatory minimum BEPS standards when implementing the MLI. Contrary to the majority of countries, Switzerland follows the amending view, ie. requires that the existing double tax treaties will be amended with the new wording. Thus, an agreement both on the content of the MLI provisions and this procedural view has currently been found with 14 countries, including Luxembourg, Italy and Austria. Further, Switzerland will also continue its bilateral treaty negotiations, like currently with the UK, where it reflects its positions under the MLI (Federal Resolution regarding amendment protocol to the Swiss-UK double-tax treaty; together with the MLI and the Federal Resolution – MLI, the legislative dispatch).

Principal purpose test to avoid treaty abuse

One of the main material changes will be the introduction of the principal purpose test (PPT) to avoid treaty abuse, as outlined in BEPS Action 6. This will be important for multinational groups but also the financial services industry and (private equity) funds. Switzerland will apply this minimum standard and has made a reservation to the application of other specific anti-abuse rules (dividend transfer transactions, rules regarding capital gains, permanent establishments in third jurisdictions and the saving clause to secure the right to tax Swiss residents). According to the PPT, benefits under a double tax treaty shall generally not be granted if it is reasonable to conclude that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit. Other than current rules that focused on obtaining withholding tax treaty relief, the PPT covers all benefits under a double tax treaty.

Switzerland has already reflected this principal purpose approach in recent tax treaties with respect to dividend withholding tax, where obtaining the treaty benefit was *the* (not one) principal purpose. According to the legislative dispatch, this should generally not result in changes to the current practice, since the PPT also includes an exception ('*unless the granting of the benefit would be in accordance with the object and purpose of the treaty*'). However, it is important to note that Switzerland will – in addition to the PPT – also apply a beneficial ownership test to assess whether the 35% Swiss domestic withholding tax on dividends may be reduced under a tax treaty. Beneficial ownership generally requires the entitlement of the owner to the proceeds and the power to dispose of the income. In past – and often highly disputed – court decisions in Switzerland, the beneficial ownership test has been applied rather extensively, and withholding tax reduction or refund claims were in most cases denied because of missing beneficial ownership rather than treaty abuse. Thus, this will likely not change with the PPT: it will be important not only to document non-treaty-benefit reasons for a certain structure, eg the shareholding in a Swiss company, but also to justify the beneficial ownership. Criteria for the latter are according to the Swiss Federal Court eg whether the recipient bears the risk to receive the dividend at all and whether there is an inter-dependency between the receipt of the dividend and the obligation to pass it on, ie the receipt of the income depends on the obligation to transfer it and the obligation to transfer the income depends on the receipt of the income.

It remains to be seen how the different tax authorities will implement the PPT in practice. Although the MLI intends to establish a level playing field with certain mandatory minimum standards, the wording and interpretation guidelines of the PPT are quite broad and leave room for interpretation. Further, the interaction of the PPT with general and specific anti-abuse rules can be different from country to country. Switzerland's general anti-abuse rule requires based on case law that the sole reason for a certain transaction is the intended tax saving, which would be narrower than the PPT. In practice, both tests will likely be rather similar from the tax authorities' perspective.

Application to Swiss-EU intragroup transactions

The former EU-Swiss interest savings agreement which included similar provisions like the EU Parent Subsidiary Directive regarding the full withholding tax reduction in intra-group scenarios for dividend, interest and royalty is now covered by article 9 of the EU-Swiss agreement on the automatic exchange of financial information for tax purposes. This article includes a general anti-abuse provision which – based on the legislative dispatch – should reflect the PPT once implemented in the respective double tax treaties.

Timeline

The consultation phase for the Swiss

legislative dispatch ended in April. With respect to mandatory rules, only limited comments were made. The legislative dispatch should be discussed in parliament in autumn 2018 and could be ratified in 2019. The amendments of these double tax treaties would be effective three months after the notification (to the beginning of the next month) and by the beginning of the following calendar year for withholding tax purposes (not before January 1 2020).

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