Multilateral Instrument: Recent trends in Swiss treaty policies

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Key takeaways:

In the context of the ratification of the Multilateral Instrument, Switzerland has reviewed and summarised its practice in international tax law, in particular regarding:

- **Treaty access for investment funds**
- **Swiss domestic law exemptions for income derived from abroad set to continue**
- **Practice trends regarding prevention of treaty abuse**
- **Passive income branches situated in third jurisdictions**
- **No Swiss CFC legislation**
- **No Swiss domestic agent PE legislation**

What is the "Multilateral Instrument"?

The OECD and G20 countries have adopted a package of recommendations to prevent profits from being shifted to low-tax countries where/if there is no value added ("Base Erosion and Profit Shifting", "BEPS" project).

Several of these recommendations provide for changes in the bilateral double taxation treaties ("DTTs") of the participating countries. The Multilateral Instrument ("MLI") was created to avoid having to amend all double taxation treaties individually. By ratifying the MLI, the participating countries can ensure that all of their double taxation treaties are amended at once when ratified (as long as the conditions laid down in the MLI for this are fulfilled).

On 22 March 2019, the Swiss parliament approved ratification of the MLI. Thus, subject to an objecting popular vote (which may be called by 11 July 2019), the Swiss government will place its MLI ratification bill with the OECD.

Which BEPS recommendations are implemented through the Multilateral Instrument?

Specifically, the following topics are dealt with in the area of double taxation treaties:

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Hybrid Mismatches

The chapter “Hybrid Mismatches” deals, in particular, with the tax treatment of transparent entities and dual resident entities.

“Transparent entities” are not treated as tax resident, but are disregarded for tax purposes under the tax law of either of the DTT jurisdictions concerned. The MLI proposes an explicit provision clarifying that no double tax treaty benefits should be granted if the income derived is not treated as income of a person tax resident in any of the DTT jurisdictions concerned.

“Dual resident” entities are companies that are tax resident in more than one country under applicable national tax laws. The MLI proposes that there should no longer be an automatic tie-breaker rule, but that the countries concerned should determine in bilateral procedures in which country the company will be treated as a tax resident.

In addition, the chapter “Hybrid Mismatches” discusses the question whether and under what conditions a country under a double tax treaty grants a tax exemption for income originating in another country.

Treaty Abuse

The granting of double tax treaty benefits may be refused if an abusive arrangement exists. In the chapter “Treaty Abuse,” the MLI formulates criteria for when a design is deemed abusive – “Principal Purpose Test” / “PPT Rule” (or what general conditions must always be fulfilled for treaty benefits to be granted – “Limitation on Benefits” / “LoB” test).

Avoidance of Permanent Establishment Status

The chapter “Avoidance of Permanent Establishment Status” deals with an extension of the cases in which a company can be taxed in another country because of a permanent establishment (“PE”).

In particular, the scope of application of the so-called "agent PE" will be extended, and the concept of exceptions that do not justify PE will be changed.

The MLI also suggests a so-called “anti fragmentation” rule, which allows, when determining a PE’s existence, discrete and separately performed activities (e.g., of different and separate group entities) to be perceived as a single combined activity.

Improving Dispute Resolution; Arbitration

The MLI proposes rules for both the Mutual Agreement Procedure (according to the OECD Model Convention 2017) and for arbitration.

Treaty access for investment funds

The rules proposed in the MLI chapter “Hybrid Mismatches” concerning "transparent entities" may disadvantage Swiss investment funds. Under Swiss domestic tax law, investment funds are generally treated tax transparent. Swiss investment funds therefore do not qualify as "tax resident,” thus excluding them from double tax treaty benefits. By contrast, investment funds from other countries are often tax residents and as such are therefore generally entitled to demand double tax treaty benefits from Switzerland. For this reason, Switzerland would like to retain the position of negotiating a balanced solution in bilateral double taxation treaty negotiations, irrespective of the MLI. Switzerland has therefore made a reservation to the MLI provisions on "transparent entities" eliminating these MLI provisions from applying to Switzerland.

Because of the particularities of investment fund structures, for investment funds/companies which are part of an investment fund structure, treaty relief has often proven to be difficult to get in practice. For investment fund structures built according to industry practices one should now consider referring also to provisions contained in the MLI proposing that a double tax treaty’s purpose is not only to avoid double taxation but also to further develop the economic relationship between the DTT countries (see below "Current practice trends regarding prevention of treaty abuse").

Swiss domestic law exemptions for income derived from abroad set to continue

Double taxation treaties may include regulations that obligate a country to grant a tax exemption for income originating in another country. The MLI chapter “Hybrid Mismatches” now contains regulations that make granting double taxation treaty benefits dependent on taxation already in place in the source country. The aim here is to avoid double non-taxation cases.

Unlike many other countries, Switzerland already grants exemptions for income derived from abroad under its unilateral domestic tax law. This unilateral tax exemption applies to permanent establishments as well as to real property outside of Switzerland. In these cases, the tax exemption is granted without a double taxation treaty. These Swiss unilateral regulations are set to continue into the future.

Current practice trends regarding prevention of treaty abuse

The MLI chapter “Treaty Abuse” first states that a double taxation treaty should not create any opportunities to obtain tax benefits through "tax evasion or avoidance.”

In addition, a proposed provision states that the double tax treaty’s purpose is not only to avoid double taxation but also to further develop the economic relationship between the DTT countries. Switzerland intends to include this provision in its double taxation treaties covered by the MLI. Thus, as a legislative matter, this purpose of promoting economic relations should, in our view, also be taken into account when it comes to determining whether/under what conditions a structure is - or is not – "abusive". This approach corresponds to current developments in international tax law:

For instance, in the context of the Canadian General Anti-Avoidance Rule (“GAAR"), in a double tax treaty case, the Tax Court of Canada has deemed it reasonable to assume that the treaty negotiators desired treaty relief to be granted according to industry practices because the treaty provisions were intended to attract foreign direct investments (Alta Energy Luxembourg S.A.R.L. v. The Queen, 2018 TCC 152). For investment fund structures, see above "Treaty access for investment funds."

In its double taxation treaties, Switzerland includes the Principal Purpose Test (PPT Rule) proposed in the MLI chapter "Treaty Abuse" in its "simplified" form (i.e., the simplest version/basic version). In addition, the MLI proposes a regulation, stating that, even if an abusive arrangement exists, tax benefits can still be granted as long as tax benefits would also have been granted in a non-abusive arrangement. In various countries, however, this scenario does not correspond to practice: with any abusive arrangement, tax benefits are generally denied. Regarding the Swiss tax authorities, this practice has not always been handled consistently. From a more general point of view, however, where tax benefits would also have been granted in an alternative arrangement, the question arises: what constitutes an abusive arrangement?

In the Swiss parliamentary procedure concerning MLI ratification approval, it has now been stated that, from Switzerland's point of view, it is conceivable to grant tax benefits even in the case of treaty abuse as long as tax benefits would also have been granted in a non-abusive arrangement. Thus, Switzerland has decided not to adopt the MLI regulation in general. Instead, bilateral negotiations should be reserved to achieve a balanced solution.

Passive income branches situated in third jurisdictions

Permanent establishments are not "tax resident" in terms of double tax treaty law. However, the double taxation treaty applicable to the country where the permanent establishment’s head office is located can also be applied to the income of that permanent establishment.

The MLI chapter “Treaty Abuse” now proposes a regulation stipulating that these double taxation treaty benefits should not be granted if the local tax burden of the permanent establishment is below a certain minimum threshold and if the permanent establishment's income is not derived from the active conduct of a business. This regulation might cover, for example, finance branches in offshore jurisdictions.

As mentioned above, Switzerland already grants exemptions for income derived from permanent establishments situated outside Switzerland according to its unilateral domestic tax law. From Switzerland's point of view, therefore, low taxation alone justifies neither the assumption of an abusive behavior nor the refusal of double taxation treaty benefits. Switzerland has subsequently made a reservation to these MLI provisions so that they will not apply to Switzerland.

No Swiss CFC legislation

The MLI chapter “Treaty Abuse” proposes regulations that make clear that a country may apply its Controlled Foreign Company ("CFC") rules irrespective of the provisions of a double taxation treaty. In the EU, the "Anti-Tax Avoidance Directive" goes so far as to oblige EU countries to introduce CFC legislation. Unlike many other countries, Switzerland (not being a member of the EU) has no CFC legislation.

No Swiss domestic agent PE legislation

Unlike many other countries, Swiss domestic tax law generally does not provide for the concept of agent PEs. This means that in inbound situations (non-Swiss business "operating" in Switzerland), Switzerland normally does not levy tax even if there is a case of an agent PE in the sense of a double taxation treaty. Neither does Switzerland intend to introduce the concept of an agent PE into its tax legislation.

From Switzerland's point of view, the definition of agent PE is therefore mainly relevant in outbound situations (Swiss business "operating" outside of Switzerland) and leads to an extension of the tax liability of Swiss companies abroad. An automatic adoption of the extension of the agent PE concept, proposed in the MLI chapter “Avoidance of Permanent Establishment Status,” would therefore impact the balance of the Swiss double taxation treaties concerned. For this reason, Switzerland has decided not to adopt the MLI regulation regarding the agent PE in general. Instead, the definition of the agent PE should be reserved for bilateral double taxation treaty negotiations.

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