

# NEWSLETTER

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# SCHELLENBERG WITTMER

Attorneys-at-Law

## Tax Aspects of the Bilateral Agreements II

**The Bilateral Agreements II between Switzerland and the EU will enter into force in the very near future. The Agreements, in particular the Agreement on the taxation of savings income, will effect important tax changes. These changes will have an overall major, positive impact on the attractiveness of Switzerland for multinational groups.**

### 1 Overview

The Bilateral Agreements II between Switzerland and the EU contain eight Agreements which cover processed agricultural products, statistics, pensions, the environment, media, taxation of savings, fight against fraud and finally, the Schengen / Dublin Agreement. The first of these Agreements to come into effect will be the Agreement regarding the taxation of savings income which enters into force as of 1 July 2005. The entry into force of the other Agreements is regulated separately. The Agreement on cooperation in the fields of justice, police, asylum and migration (Schengen / Dublin) will be the subject of a referendum (people's vote) scheduled to take place on 5 June 2005.

From a tax standpoint, the Agreement on the taxation of savings income is of particular interest. The Agreement contains three elements:

- I Firstly, Switzerland has agreed to levy a withholding tax on interest payments from a paying agent located in Switzerland to individuals being tax domiciled in EU member states.
- I Secondly, the Agreement abolishes the tax at source on dividends, interest and royalties between affiliated companies of Switzerland and EU member states.
- I Thirdly, Switzerland undertakes to negotiate the terms pursuant to which it will render administrative assistance

for tax fraud or the like in double tax treaty cases with member states, as set forth in a Memorandum of Understanding.

In addition to the Agreement on the taxation of savings income, tax provisions are found in the Agreements regarding fight against fraud, pensions and Schengen / Dublin. The Pension Agreement provides, in pertinent part, that pension income of former EU officials domiciled in Switzerland is exempted from Swiss income taxation, provided that certain conditions are met. The Agreement on fight against fraud as well as Schengen / Dublin, contains international administrative and legal assistance provisions applicable for tax offences.

### 2 Agreement on Taxation of Savings

#### 2.1 Withholding Tax on Interest Payments

Switzerland undertakes to introduce a withholding tax on interest payments from a non-Swiss source made by a paying agent located in Switzerland to an individual domiciled in an EU member state. Switzerland thereby supports the EU member states in taxing individuals resident in their states and essentially provides execution assistance to the foreign tax authorities. The tax withheld will be 15% in the first three years, rise to 20% in the following three years and to 35% in subsequent years. Switzerland will retain 25% of the withholding tax revenue and will pass on the remainder, on an anonymous basis, to the EU member state in which the individual is tax resident. Provided that such individual declares the interest income properly, he can claim for a refund of the withholding tax. Outside the scope of the Agreement are interest payments paid by a lender domiciled in Switzerland, as well as interest payments paid to legal entities and individuals domiciled in any country not being a member of the EU.



The interest deduction must be made by the paying agents. Swiss banks or asset managers, natural or legal persons living or working in Switzerland, partnerships or branches of foreign companies usually or occasionally managing third party assets within the scope of their business operation and in whose name they pay or receive interest, will all meet the definition of a paying agent. In contrast, interest being paid on a non-commercial basis is not covered by the Agreement. In instances where interest is paid through several intermediaries, only the last intermediary paying the interest directly to the individual is deemed a paying agent for the purpose of the Agreement.

An individual entitled to an interest payment which is subject to the withholding tax can elect for an interest notification replacing the tax deduction. Upon such an express instruction, the paying agent will make a notification of the interest payment to the tax administration of the country in which the individual is domiciled. By such an election, the individual voluntarily waives the applicability of Swiss banking secrecy law.

Switzerland further undertakes to provide administrative assistance upon the request of EU member states in cases of tax fraud or the like, concerning interest payments falling within the scope of the application of the Agreement. After the Agreement has been signed, Switzerland and EU member states will negotiate and determine the conditions regarding the extension of such administrative assistance for tax fraud or the like to the scope of bilateral double tax treaties. It is understood, however, that Switzerland will only provide administrative assistance in cases of tax fraud or the like, and not in tax evasion cases.

The effectiveness of the Agreement is uncertain and controverted because the potential efficiency is substantially restrained by the fact that the withholding tax is only levied upon interest payments to individuals and not on interest payments to legal entities. Additionally, a number of financial products are exempted from the withholding tax, including, but not limited to, bonds issued before 1 March 2001 ("grand-fathered bonds", exempted until 31 December 2010), insurance products and pure derivative finance products. In contrast, however, periodical, as well as lump sum (actual or deemed), interest payments on structured finance instruments are subject to the withholding tax. Fund distributions are also subject to the tax provided the fund has invested at least 15% of its assets directly or indirectly in interest paying products (e.g. notes). Furthermore, if a fund has invested 40% or more, directly or indirectly, in interest paying products, the withholding tax will also be levied upon capital gains on the occasion of a sale. On the other hand, certificates are not subject to the tax, provided that they contain at least 5 underlying securities. If this condition is not met, the mentioned rules for funds will apply to certificates also. Significantly, from a practical standpoint, the paying agent is responsible for the classification of the product as well as for the correct calculation and delivery of the withholding tax.

While Andorra, Monaco, Liechtenstein and San Marino have agreements regarding the taxation of savings income with the EU comparable to Switzerland's, it remains to be seen to what extent the effects of the Agreement will be circumvented by a mere transfer of the paying agent to a country which has not effected an Agreement with the EU. Such a loophole not only exists in the Agreement effected between Switzerland and the EU, but also in the EU-directive on taxation of savings income introducing the exchange of information between the EU member states (with the exception of Belgium, Luxembourg and Austria, which also will introduce a withholding tax). Therefore, apparently the effectiveness of the EU internal Agreement is also questionable.

## **2.2 Abolishment of Withholding Taxes on Dividends, Interest and Royalties**

In exchange for its participation in the EU savings directive, Switzerland successfully negotiated that withholding taxes on dividends, interest and royalties, between affiliated companies of Switzerland and EU member states, will be abolished, when the following conditions are met:

- I Abolishment of withholding taxes on dividends: The parent company must have a direct holding of 25% or more of the capital of such subsidiary for at least two years and both companies must be subject to corporation tax without being exempted (Swiss holding, administrative and domicile companies are not considered as being tax exempt for this purpose).
- I Abolishment of withholding taxes on interest and royalties: Both companies must be affiliated by a direct minimum holding of 25% for at least two years or must both be held by a third company directly having a minimum holding of 25% in the capital of both companies for at least two years and the interest and royalty payments must ordinarily be taxed at the level of the receiving company.

It should also be noted that for all types of payments both companies must be corporate entities and may not be tax resident in a third country. Nevertheless, if an existing double taxation treaty between Switzerland and the EU member state provides for a more favourable treatment, such favourable treatment prevails. For some states, transitional provisions are applicable and a special agreement will apply with regard to Spain.

The abolishment of withholding taxes on cross boarder payments of dividends, interest and royalties is of utmost importance for Switzerland. This advantage is more than just a set-off of the potential disadvantages created by the levying of withholding taxes on savings income. The possibility of tax free dividends, interest and royalty payments to and from affiliated companies being domiciled in EU member states strengthens the Swiss position in the international tax competition arena. Also, when considered in light of the excellent

Swiss double tax treaty network currently in place, Switzerland's attractiveness as a domicile country for European holding companies will increase significantly. Switzerland's current attractiveness as a domicile for service, administrative, license, finance and/or management companies will be strengthened. However, it should not be overlooked that the withholding tax is only abolished as respect to payments made **directly** to affiliated companies. Consequently, since often intragroup payment streams are effected between non-directly related companies, such streams should be re-examined in light of the possible impact of the Agreement.

Of importance in this context although not linked to the Agreement is a recent modification of the Swiss domestic rules concerning withholding tax duties in connection with distributed dividends. As per 1 January 2005, a reporting system or a reduction of the withholding tax at source respectively, following prior application to the Swiss Federal Tax Administration, in cross boarder structures was introduced (prior thereto this possibility only existed for distributions to German and US American parent companies). This new procedure replaces the cumbersome and costly former procedure, wherein the full withholding tax had to be deducted and thereafter refunded upon request to the recipient of the dividend payment. This significant improvement further increases the attractiveness of Switzerland as domicile country for companies. Finally, it should also be noted that Switzerland, unilaterally, does not levy any kind of withholding taxes on royalty payments and only on interest payment in particular cases.

### 2.3 Memorandum of Understanding

In a Memorandum of Understanding, an integral part of the Bilateral Agreements II, Switzerland undertakes to negotiate the introduction of administrative assistance upon the request by EU member states in cases of tax fraud or the like in the scope of bilateral double tax treaties. Hitherto, Switzerland only provided administrative assistance where necessary to execute a double tax treaty itself, and not to assist in the execution of the domestic law of another country. However, the Swiss commitment is not entirely new: Switzerland will merely grant the same treatment to EU member states as has been granted to the USA for several decades in the Swiss-US double tax treaty. Essentially, it has been agreed that administrative assistance will be granted in those cases in which the seeking country has established tax fraud or the like. Administrative assistance will not be granted in tax evasion cases. The meaning of the expression "and the like" will be negotiated bilaterally between the Federal Tax Administration and each EU member state. The term will encompass those offences not defined in Swiss statutes but which have the same degree of unlawfulness as tax fraud, as defined in Swiss statutes. Negotiation on these issues has already commenced.

## 3 Cooperation Agreements Schengen/Dublin

The Schengen Agreement and the Dublin Agreement are closely connected to the extent that they can only enter into force conjointly. The Dublin Agreement contains no tax elements and pertains solely to the management of asylum issues. The Schengen Agreement, on the other hand, regulates legal assistance with regard to tax offences. These provisions were central in the negotiations due to their possible impact upon Swiss Bank Secrecy laws.

With respect to direct taxes, such as income taxes of individuals and corporate income taxes for legal entities, the Schengen Agreement will have no impact on Switzerland. As currently, legal assistance will be granted for tax fraud only.

With regard to indirect taxes, the situation is different: Schengen generally improves mutual legal assistance in criminal matters. Under certain conditions, legal assistance will newly be provided in cases of tax evasion with the consequence of the application of constraining measures such as interrogation of witnesses, confiscations or account inspections (in such cases banking secrecy does not prevail).

The legal principle of speciality ensures that information transferred to a foreign state in connection with legal assistance, may not be used for any purpose other than that stated in the request for legal assistance. Accordingly, information gathered in connection with indirect taxes may not be used for the purpose of direct taxes.

Furthermore, the Schengen Agreement grants Switzerland an unlimited exception in the event the legal assistance provisions, as between EU member states, are extended to tax evasion cases regarding direct taxes or the Agreement is otherwise later modified. Therefore, Switzerland is also protected in the future from having to provide legal assistance regarding direct taxes and banking secrecy is prospectively contractually protected.

## 4 Fight against Fraud Agreement

The Fight against fraud Agreement will simplify and accelerate international cooperation between the Swiss and European customs' tax and judicial authorities in their fight against fraudulent activities. In contrast to the Schengen Agreement, the Fight against fraud Agreement, in addition to legal assistance also introduces administrative assistance between administrative authorities. However, as with the Schengen Agreement, it only covers indirect taxes (customs duties, value added tax, consume taxes on alcohol, tobacco, oil etc.). Similarly, as with the Schengen Agreement, the Fight against fraud Agreement covers not only tax fraud, but tax evasion of indirect taxes, provided that the offence is also punishable in the state being requested to provide the assistance and further that the amount of the offence exceeds EUR 25'000 or is related to an unlawful import of goods exceeding a value of



EUR 100'000. This Agreement also contains the principle of speciality, pursuant to which information obtained may not be used in other proceedings, particularly in proceedings on direct taxes.

## 5 Outlook and Call for Action

The entry into force of the Bilateral Agreement II raises both opportunities and risks for Switzerland. The abolishment of withholding taxes on cross boarder payments of dividends, interest and royalties to affiliated companies is particularly positive. In combination with the introduction of the reporting procedure for the withholding tax on dividends to parent companies, new opportunities have thus been created for multinational companies with relations to Switzerland. The attractiveness of Switzerland as a venue for holding companies and group internal special purpose companies as finance companies, IT companies or management companies will increase significantly. Multinational Groups should therefore examine their current structures in light of the new planning opportunities presented by the Bilateral Agreement II.

On the other hand, potential paying agents must ensure that their internal systems are capable of calculating and transferring the correct tax amount to the Tax Administration. The implementation of the EU savings directive requires a significant amount of know-how, as the characterisation of the various financial products, as well as the calculation of the withholding tax, is complex and demanding.

## Contacts

The content of this Newsletter does not constitute legal or tax advice and may not be relied upon as such. Should you seek advice with regard to your specific circumstances, please contact your Schellenberg Wittmer liaison or any of the following persons:

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