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Swiss Tax Case Report – October 2022

Another Case of Denial of Swiss Withholding Tax Relief by the Swiss Supreme Court

With a judgment rendered on 13 September 2022 (case 2C_359/2022), the Swiss Federal Supreme Court confirmed the ruling of the Federal Administrative Court of 10 March 2022 (case A-4347/2019), according to which a Swiss company A, beneficiary of a substantial dividend received from another Swiss company B, was to be denied any relief of the 35% federal withholding tax (WHT) deducted from the dividend, due to tax avoidance.

Company A had purchased the shares of company B from a Canadian national, UK resident individual, C, shortly before the dividend was declared and paid. On the day of the sale of the shares of company B to company A, company B had sold its main asset (an item of real estate) to a third party, thereby realizing a substantial book gain, which enabled the subsequent dividend distribution to company A.

The Swiss courts concurred with the view of the Federal Tax Administration (FTA), which had qualified the transactions as a "proxy liquidation" of company B on behalf of the foreign resident seller of the shares. The Supreme Court confirmed that, not only had the refund of dividend WHT to be denied to the Swiss resident purchaser of the shares and legal beneficiary of the dividend based on the tax avoidance reservation contained in art. 21 para. 2 of the Federal WHT Act, but in addition, there was no room for the (indirect) application of the UK-Switzerland income tax treaty either, which, if applied by reference to the UK resident seller of the Swiss shares, might have reduced the residual burden of Swiss WHT to 15%.

Facts of the case

Swiss company B, originally held by UK resident individual C (the facts description of the lower court indicates that C held the B shares via a "corporate structure" in Liechtenstein) owned a piece of real estate, having a book value of about CHF 5.1 million, as its principal asset. In the year 2013 Swiss company A purchased all shares of company B for a cash price of CHF 6.3 million plus an undertaking to take over from C an account payable towards company B of almost CHF 1 million. On the same day, company A procured to sell the real estate held by company B to a third party for CHF 18.2 million. Company B recorded a net gain of some CHF 12.6 million from the transaction. About

two years later, the general meeting of company B resolved to distribute a dividend of almost CHF 10 million to company A. The dividend was duly reported to the FTA, along with a request to settle the 35% WHT liability by mere notification in lieu of tax payment with subsequent tax refund to the dividend beneficiary.

In 2016 the FTA informed company A that the request to settle the WHT tax obligation by mere notification was rejected on grounds that the WHT was not refundable due to tax avoidance (art. 21 para. 2 WHT Act). Following that information, company A settled the WHT obligation of almost CHF 3.5 million, plus some late payment interest of almost CHF 100,000 towards the FTA. Subsequently company A filed a request for refund of the WHT paid, which was again rejected by the FTA on grounds of tax avoidance in the meaning of art. 21 para. 2 WHT Act (final decision of 18 October 2027).

An objection by company A against that decision was formally turned down by the FTA on 26 June 2019. The FTA held in substance that the fact pattern of the case amounted to a tax avoidance. The FTA determined that the sale of the real estate by company B, followed by the distribution of all available liquid funds to company A which had purchased company B on the date of the sale of the real estate amounted to a *de facto* liquidation of company B. remained without success. The short sequence of the events (sale of the real estate, sale of the company shares, cash distribution to the buyer of the company shares) clearly pointed to a nexus between the transactions and created an assumption of tax avoidance, which company A was unable to rebut. The transactions put in place were aimed at allowing the factual liquidation of company B under the ownership of company A, thereby saving the foreign resident seller of company B from having to bear the burden of the Swiss WHT on the liquidating dividend; the transactions thus amounted to an abusive "proxy liquidation", fulfilling the criteria of tax avoidance in the WHT refund context.

Considerations of the Federal Administrative Court on Appeal

Company A's appeal against the FTA's final decision to the Federal Administrative Court was turned down as well. The Administrative Court reiterated the three-prong test for tax avoidance: (1) the taxpayer has chosen a legal transaction structure or form that appears to be unusual, inappropriate, unfit to achieve the purported business objective of the transaction (objective element); (2) the formal choice made by the taxpayer appears to be mainly driven by a motive to achieve a substantial tax saving (subjective element, lack of valid non-tax business reasons), and (3) if accepted by the tax authorities, the transactions would actually achieve a substantial tax saving (effective element). Where all three criteria a met, the tax authorities may treat the transactions for

tax purposes, as if a "proper", "straight forward" transaction had been implemented to achieve the purported business objectives.

The Administrative Court reiterated in general terms the jurisprudence of the Federal Supreme Court that a tax avoidance in the meaning of at. 21 para. 2 WHT Act is imminent where a non-Swiss resident person – for whom the burden of the Swiss WHT is generally a final one – sell its shares in a Swiss company, the liquidation of which is imminent, to a Swiss resident individual or legal entity with a view of (indirectly) obtaining the benefit of the relief from Swiss WHT awarded to that Swiss resident acquirer, which would not have been available to the foreign resident seller of the Swiss shares (Supreme Court Ruling 147 II 338, consid. 3.3 and further jurisprudence). In particular, the presumption of a tax avoidance scheme in the meaning of art. 21 para. 2 WHT Act applies to situations where the sale of Swiss shares (or bonds, notes), the return of which is generally subject to federal WHT, by a non-resident to a Swiss resident taxpayer timely coincides with a further "important flow of financial funds and an unusual financing of the acquisition of the shares (or bonds/notes) in question". Such a time coincidence creates a rebuttable presumption of tax avoidance. The taxpayer is left with the opportunity to prove that the time coincidence is not rooted in a motivation to obtain a significant saving of tax.

The Administrative Court rejected the assertion made by company A that the short sequence of relevant events was a mere coincidence. The Court found that company A had already been in contact with the buyer of the company B's real estate prior to the acquisition of company B's shares (a portion of the sale price for the real estate had already been paid in advance) and concluded that Company A's intention from the beginning had been to acquire the shares, to sell the underlying real estate and to cash in the profit from such sale as a (de facto) liquidating dividend, thereby ensuring the relief from the dividend WHT, which would not have been available to C, the foreign seller of the shares. Among other things, the Administrative Court also found that the purchase price for the company B shares agreed upon between company A and seller C reflected a significant discount to the intrinsic value of the shares (in view of the sale price of company B's real estate), which was clearly indicative of the parties' intention to share the benefit of the expected WHT refund among them.

Overall, the Administrative Court concluded that all three elements of tax avoidance were met: The transaction structure chosen by the parties was unusual – the normal process would have involved a purchase of the real estate by company A from company B in order to sell it, followed by a liquidation of company B and distribution of the liquidation surplus to the foreign resident shareholder C, whereby such shareholder would

have carried the burden of the WHT; there were no non-tax business reasons justifying the unusual transaction structure; and the WHT burden would indeed have been avoided, had the tax authorities accepted the structure. Under the "normal" process the WHT burden would have amounted to at least 15%, if the Swiss double taxation treaty with the UK had been applicable, or 35% otherwise. The Administrative Court clarified that it does not matter for the tax avoidance analysis whether the intended tax saving would have benefited the applicant for WHT relief or the (foreign) seller of the Swiss shares.

Main Considerations of the Federal Supreme Court

On appeal by company A, the Federal Supreme Court confirmed the ruling of the Administrative Court. The Supreme Court was bound by the factual findings of the Administrative Court, as the determination of the facts of the case by the lower court (stating in essence that there was an apparent nexus between the sale of company B's main asset without any reinvestment of the proceeds, i.e. its de facto liquidation, and the acquisition of company B's shares by company A with the subsequent substance distribution by company B to company A) was not manifestly wrong, i.e. arbitrary. The appellant had tried to challenge the factual findings of the Administrative Court by substituting them with its own statement and interpretation of the facts. However, that was not an admissible argument in the procedure before the Supreme Court.

The Supreme Court held that company A, a Swiss tax resident that had duly accounted for the dividend in question, was indeed the beneficial owner of the shares in Company B, which gave rise to the dividend distribution. Therefore, the only question at stake was the presence or not of a tax avoidance scheme, as the tax avoidance would remove the claimant's entitlement to any WHT refund.

The Supreme Court tested again the three cumulative criteria (objective, subjective and effective elements) of the tax avoidance, based on the factual findings of the Administrative Court. The Supreme court referred to its existing jurisprudence concerning situations of "proxy liquidation" of a Swiss company, i.e. situations where a non-Swiss resident taxpayer (for whom the burden of Swiss WHT is principally supposed to be a final tax burden, unlike for Swiss resident tax-compliant taxpayers) .sells its Swiss shares to a Swiss resident taxpayer in view of a liquidation of the company, in order to (indirectly) obtain the benefit of a WHT refund. The Court reiterated that the Administrative Court had determined that the sale of company B's shares to company A and the sale of company B's main asset, allowing for the subsequent dividend distribution to company A, had occurred on the same day and were apparently connected with each other. The

Curt supported the Administrative Court's conclusion that the sale of the real estate had been "programmed" in advance in order to facilitate company B's liquidation right after the purchase of its shares by company A. This fulfilled the objective element of the tax avoidance. In terms of the subjective element, the Supreme Court reiterated that the bilaterally agreed share sale price was clearly below the intrinsic value, which effectively would have allowed the buyer and the seller of the shares to split the benefit of the saved WHT between them. No other reasons for the specific structuring of the transaction were apparent. As regards the effective element, the Supreme Court confirmed the lower court's stamen, according to which a "normal" process would have involved a purchase of company B's real estate by company A and a subsequent liquidation of company B, whereby the UK resident shareholder C would have suffered the WHT on the liquidation surplus, which would have amounted to at least 15%, considering the UK-Switzerland income tax treaty, art. 10 ciph. 2 letter b, or to 35% otherwise (interestingly, neither the Supreme Court nor the Administrative Court made any reference to the fact mentioned at an earlier stage in the process, that C had held his shares in company B indirectly, through a corporate entity based in Liechtenstein). In any case, a substantial tax (WHT) saving would have been achieved, had the tax authorities accepted the transactions. Therefore, the effective criterion of tax avoidance was likewise fulfilled.

The Supreme Court finally addressed the subsidiary argument raised by the claimant, according to which the denial (if any) of the WHT refund to the claimant (company A) on grounds of tax avoidance should be limited to the residual WHT burden of 15%, which would have applied to the UK (London) resident seller C of the company B shares, had they not effectively implemented the transaction structure being challenged by the Swiss authorities. The Supreme Court dismissed that argument in quite unambiguous words. It referred to its existing jurisprudence, according to which no partial refund of WHT can be claimed in situations of tax avoidance. The Court considered literally that "… the fact that the fiscus would have secured a tax (WHT) revenue of only 15%, rather than (the full) 35%, if the transactions had been structured in a proper fashion, does not matter at all. The interested parties have precisely implemented a fact pattern which excludes the application of the double tax treaty. As mentioned […], the primary objective of the WHT is to prevent fiscal fraud. The moment one is confronted with a tax avoidance, no refund shall be granted at all, in accordance with art. 21 para. 2 WHT Act [references to judgments from the years 1981 and 2009]."

Comments

The conclusion of tax avoidance by the Swiss courts under the facts pattern at hand is rather unsurprising as such. More remarkable are the comments of the Supreme Court on the subsidiary position taken by the taxpayer, that the denial of WHT refund should be limited to the residual rate of 15%, which would have applied under the tax treaty with the home jurisdiction of the seller of the Swiss shares. The Supreme Court dismissed that position in no uncertain terms with a very brief reasoning: According to the Supreme Court, the (hypothetical) tax position the foreign seller of the Swiss shares would have been in, had the parties implemented a "proper" transaction structure, is totally irrelevant in situations where the Swiss authorities determine a tax avoidance scheme pursuant to art. 21 para. 2 of the Swiss WHT Act. In such situations, the Supreme Court simply holds the parties to the "abusive" transaction scheme they have actually put in place, in order to effectively exclude any (hypothetical/potential) tax treaty benefits that might lead to a reduction of the full WHT burden of 35%.

Although the objective of the Supreme Court's argument is clear, its underlying logic – and fairness - could be questioned. The jurisprudence of the Swiss Supreme Court also states that in case of tax avoidance, the tax authorities shall deviate from the legal transaction structure effectively implemented by the taxpayer in favor of a hypothetical, more "appropriate" transaction in view of its purported business objectives, in order to determine and apply the proper tax consequences. Following that approach, it does not really make sense to refuse to apply the tax consequences (including tax benefits in particular) resulting from the transaction that has been actually implemented on the one hand (because that structure is considered to be "abusive") one the one hand, but then, on the other hand, also to refuse to fully apply the tax consequences (at least as far as potential tax benefits are concerned) to the hypothetical transaction structure, which the tax authorities consider to be more "appropriate" in terms of the tax avoidance analysis. The now re-confirmed practice of the Federal Supreme Court appears to be driven by a wish to simply punish any (Swiss) taxpayer found to have engaged in a "tax avoidance in the context of Swiss WHT refunds.

That raises the question of what would happen to a foreign taxpayer resident in a tax treaty jurisdiction, who engages in transactions aimed at reducing the residual rate of Swiss WHT by transferring/selling the Swiss shares (or bonds/notes) to a resident of another tax treaty jurisdiction, the treaty of which offers a lower residual rate of WHT. Switzerland knows a long-standing tax practice usually referred to as the "old reserves" doctrine. Under that approach, the Federal Tax Administration may deny the application of the rules of the "better" tax treaty (lower residual WHT rate), which would otherwise

be applicable to the acquirer of the Swiss shares, to the retained earnings and reserves of the Swiss company as at the date of the transfer of its shares, whenever those earnings and reserves will be actually distributed to the new shareholder; instead, the reduction of Swiss WHT pertaining to the "old reserves" would continue to be governed by the previously applicable tax treaty. Although the "old reserves" practice is apparently also inspired by an anti-tax avoidance concept, it can in my opinion not be based on the anti-tax avoidance rule of art. 21 para. 2 of the Swiss WHT Act, as the basis for any refunds of Swiss WHT to non-resident beneficiaries cannot be found it the national WHT Act, but exclusively in the Swiss international double tax treaties. Therefore, in my opinion, the Swiss authorities would have to rely on the international notion of abuse of (tax) treaty rights to enforce their "old reserves" doctrine in a tax treaty context.

The "proxy liquidation" scenario would also be thinkable in a tax treaty context. The seller of the Swiss shares might even be resident in a non-treaty jurisdiction, while the acquirer would be resident in a treaty country, whereby the relevant tax treaty might provide for a residual WHT rate of 15% or even less (0% in a "best" case). It is rather easy to imagine that the Swiss courts, when being confronted with a sufficiently clear case of "proxy liquidation", whereby the buyer of the Swiss company shares would reside in a "favorable" tax treaty country, would apply similar "tax avoidance" criteria to deny the buyer the tax treaty benefits, although they would presumably have to rely on the notion of "abuse of tax treaty rights", rather than the Swiss domestic notion of tax avoidance. Where the seller of the Swiss shares likewise resides in an (albeit less favorable) tax treaty jurisdiction, the question would be again, whether the hypothetical tax treaty relief pursuant to the treaty with the seller's country of residence would be taken into consideration, or whether the parties would simply be "held to" the new shareholding structure, as is the case pursuant to the Federal Supreme Court's doctrine under the domestic tax avoidance provision, thereby denying any WHT refund. For the time being, this question remains open.