

The Application of Double Tax Conventions to Trusts and Collective Investment Schemes in Switzerland

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**THE APPLICATION OF DOUBLE TAX CONVENTIONS TO TRUSTS AND COLLECTIVE
INVESTMENT SCHEMES IN SWITZERLAND**

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For my parents

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Abstract

Trusts and Collective Investment Schemes (CISs) have become increasingly relevant in recent years. A considerable amount of assets are now administered and managed through CISs and trusts. This has a profound impact on the economic growth and profitability of Switzerland as a financial center. Such development is, in part, the consequence of globalization, and the increased cross-border investments through the use of CISs and trusts. In response to this phenomenon, it is proposed that Switzerland adopt clear legislation so that its position as an international financial center remains attractive and competitive for CISs and trusts.

Despite the increasing significance of cross-border transactions structured under CISs and trusts, there are still a number of uncertainties with respect to critical aspects of the taxation of CISs and trusts. In today's tax-transparent and globalized world, Double Tax Convention (DTC) access for CISs and trusts has become fundamental for all interested parties in order to avoid double and multiple taxation between tax jurisdictions. As of today, however, certain key aspects on how and if CISs and trusts can gain access to DTCs under Swiss and OECD frameworks remain unclear.

However, the competitiveness of Switzerland and the attractiveness of the Swiss marketplace as an internationally-recognized fund and trust center for foreign investors/wealth owners, depends on Switzerland's ability to adapt and respond to these new challenges and the demands of wealth owners.

Therefore, it becomes key to be able to clearly determine and predict when and how CISs and trusts can gain access to DTCs.

The main focus of this study is to analyze the tax treatment of CISs and trusts under DTCs under Swiss and OECD standards "*de lege lata*". Whereas in common law jurisdictions, some of the conditions that CISs and trusts need to fulfill to gain access to DTCs, namely being a "person", "resident", "beneficial ownership" and "attribution of income", might have already been specified with more clarity, the Swiss courts and doctrine have not yet determined when those conditions would be fulfilled. Thus, under Swiss law, ensuring DTC access for CISs and trusts becomes a more difficult and uncertain task. For CISs and trusts, once the other conditions, if applicable, have been fulfilled, the central question for wealth owners becomes whether a given trust or CIS may be considered resident for tax purposes and therefore able to benefit from DTC access. To this end, said issue will be critically analyzed in this book, and the focus will shift to a presentation of the overall conclusions. This study also provides recommendations to ensure DTC access for CISs and trusts "*de lege ferenda*".

In order to provide simplicity and clarity for the reader, a symmetrical structure was followed in this analysis. Interestingly, however, the practical proposals to amend the OECD Model and OECD Commentary presented in this study are mainly asymmetrical. This is due to the fact that the OECD has opted to issue reports and guidelines for certain areas, such as the application of DTCs to CISs, and leave others, such as trusts, out of the scope of its reports. Thus, some areas have already been presented with solutions, while others still remain unexplored.

Résumé

Les trusts et les fonds de placement (ou organismes de placement collectif (OPC)) ont acquis une importance croissante au cours des dernières années. Des montants considérables sont actuellement administrés et gérés par le biais de fonds de placement ou de trusts. Cela a un impact direct sur la croissance et la compétitivité de la place financière suisse. En partie, ce développement est une des conséquences de la globalisation et de l'accroissement des placements transfrontières de capitaux par le biais de fonds de placement et de trusts. En réponse à ce phénomène, il a été proposé que la Suisse adopte une législation claire en la matière afin qu'elle reste attractive et compétitive en tant que centre financier international pour les fonds de placement et les trusts.

Malgré l'importance croissante des transactions transfrontières structurées par le biais de fonds de placement et de trusts, il reste de nombreuses incertitudes quant à certains aspects cruciaux de l'imposition des fonds de placement et des trusts. Dans le contexte actuel de transparence fiscale et de globalisation, l'accès aux Conventions de double imposition (CDI) pour les OPC et les trusts est devenu fondamental pour toutes les parties intéressées, afin d'éviter une double ou multiple imposition fiscale dans plusieurs juridictions. Toutefois, à ce jour, certains aspects essentiels de la question de savoir si et comment les fonds de placement et les trusts peuvent avoir accès aux CDI, en droit suisse et selon les principes de l'OCDE, demeurent incertains.

Cela étant, la compétitivité de la Suisse et l'attrait de la place financière suisse en tant que centre de compétence reconnu au niveau international dans le domaine des fonds de placement et des trusts dépendent de la capacité de la Suisse à s'adapter et à répondre à ces nouveaux défis et aux demandes des investisseurs. Il est par conséquent important de pouvoir prévoir clairement sous quelles conditions et selon quelles modalités les fonds de placement et les trusts peuvent avoir accès aux bénéfices des CDI.

La présente étude vise principalement à analyser "*de lege lata*" le traitement fiscal des fonds de placement et des trusts en droit fiscal national et international, soit sous l'angle des CDI conclues par la Suisse et du standard de l'OCDE. Alors que dans les juridictions de common law certaines conditions devant être satisfaites par les OPC et les trusts pour avoir accès aux bénéfices des CDI (à savoir être une "personne", être "résident", être le "bénéficiaire effectif" et la question de "l'attribution du revenu") peuvent avoir déjà été précisées avec plus de clarté, la pratique suisse en lien avec ces conditions n'a pas encore été fixée. Ainsi, sous l'angle du droit suisse, assurer l'accès aux bénéfices des CDI pour les fonds de placement et les trusts devient plus difficile et incertain. Pour les fonds de placement et les trusts, une fois que les autres conditions applicables sont remplies, la question centrale pour les investisseurs est celle de savoir

si un trust ou un fonds de placement peut être considéré comme étant un "résident" au sens de la CDI et avoir ainsi accès aux bénéfices de la CDI. Cette problématique est analysée de manière critique dans la présente étude, en mettant l'accent sur la présentation de conclusions générales. La présente étude formule également des recommandations "*de lege ferenda*" pour assurer l'accès aux bénéfices des CDI pour les fonds de placement et les trusts.

Dans un souci de simplification et clarté pour le lecteur, l'analyse suit une structure symétrique. Cela étant, les propositions concrètes de modification du Modèle OCDE et du Commentaire OCDE formulées dans notre étude sont principalement asymétriques. Cela est dû au fait que l'OCDE a publié des rapports et des lignes directrices pour certains sujets, tels que l'application des CDI aux fonds de placement, et pas pour d'autres, tels que les trusts.

Key words in English

- Taxation of Collective Investment Schemes under Swiss law
- Taxation of foreign Trusts under Swiss law
- International Double Taxation
- Hybrid Mismatch Arrangements
- Introduction to Double Tax Conventions
- Application of Double Tax Conventions to Hybrid Entities
- Double Tax Convention conditions (person, beneficial ownership, resident, attribution of income)
- OECD Materials (OECD Model and OECD Commentaries)
- OECD Report on the granting of treaty benefits with respect to the income of Collective Investment Vehicles
- OECD Report on Beneficial Ownership
- OECD Partnership Report
- BEPS Action Nr. 2

Key words in French (mots-clés)

- Taxation des fonds de placement en droit suisse
- Taxation des trusts étrangers en droit suisse
- Double imposition internationale
- Dispositifs Hybrides
- Introduction aux conventions de double imposition
- Application des conventions de double imposition aux entités hybrides
- Conditions de la convention de double imposition (personne, bénéficiaire effectif, résident, attribution des revenus)
- Matériels OECD (Modèle OECD et commentaires OECD)
- Rapport de l'OCDE sur l'octroi des bénéfices des conventions fiscales aux revenus d'organismes de placement collectif
- Rapport de l'OCDE sur le bénéficiaire effectif
- Rapport de l'OCDE sur les sociétés de personnes
- BEPS Action Nr. 2

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Abbreviations

1962 Abuse Decree	Swiss Federal Decree of 14 December 1962 on Measures against the Improper Use of DTCs Concluded by the Swiss Confederation (RS 672.202)
AMLA	Anti-Money Laundering Act
Art.	Article
ASA	Archiv für Schweizerisches Abgaberecht (Archives de Droit Fiscal Suisse), Bern, Switzerland (periodical)
AStG	Aussensteuergesetz, Germany (foreign taxes act)
ATF	Swiss Official Collection of Federal Tribunal Judgments
BGE	Entscheidung des Schweizerischen Bundesgerichts (Federal Tribunal Judgment)
BIFD	Bulletin for International Fiscal Documentation, Amsterdam, IBFD (periodical)
BTR	British Tax Review, UK (periodical)
CC	Swiss Civil Code of 10 December 1907 (RS 210)
CDFI	Cahier de Droit Fiscal International, The Hague (periodical)
CFA	OECD Committee on Fiscal Affairs
CISA	Swiss Federal Act on Collective Investment Schemes of June 23, 2006 (RS 951.31)
CISO	Ordinance on Collective Investment Schemes of November 22, 2006 (RS 951.311)
CO	Swiss Code of Obligations of 30 March 1911 (RS 220)
Cst.	Federal Constitution of the Swiss Confederation of 18 April 1999 (RS 101)
DTC	Double Taxation Convention for the Avoidance of Double Taxation with Respect of Taxes on Income (and on Capital for few countries)
ESchG	Cantonal Law on Inheritance and Gift Taxes of the Canton of Zurich of 28 September 1986

Abbreviations

ET	European Taxation, Amsterdam, IBFD (periodical)
FC	Federal Constitution of the Swiss Confederation of 18 April 1999 (RS 101)
FF	Swiss Federal Official Gazette
FTA	Swiss Federal Tax Administration, Bern
Hague Convention	The Hague Convention of 1 July 1985 on the Law Applicable to Trusts and their Recognition (RS 0.221.371)
HC	The Hague Convention of 1 July 1985 on the Law Applicable to Trusts and their Recognition (RS 0.221.371)
IBFD	International Bureau for Fiscal Documentation, Amsterdam
IFA	International Fiscal Association
IFL	Swiss Federal Law on Investment Funds of 18 March 1994 (RS 951.31)
Intertax	International Tax Review, the Netherlands (periodical)
IRS	Internal Revenue Service, US
JAAC	Case law of the administrative authorities of the Swiss Confederation
JdT	Journal des Tribunaux, Lausanne, Switzerland (periodical)
LDFT	Swiss Federal Direct Tax Law of 14 December 1990 (RS 642.11)
LHDT	Swiss Federal Law of 14 December 1990 on the Harmonization of Direct Taxes of Cantons and Municipalities (RS 642.14)
LP	Limited Partnership for Collective Investment
MC	Model Convention
MOU	Memorandum of Understanding
Nordic Conv.	Nordic Convention on Income and Capital entered into by Denmark, Finland, Iceland, Norway, Sweden and The Faroe Islands concluded in 1983 and replaced in 1987, 1989 and 1996.
Nr.	Number
OECD	Organization for Economic Cooperation and Development

Abbreviations

OECD MODEL	OECD Model Tax Convention on Income and on Capital (revised version of 1992)
OREF	Ordre romand des experts-fiscaux diplômés
p.	page
Para.	Paragraph
PILA	Swiss Federal Private International Law of 18 December 1987 (RS 291)
pp.	pages
RDAF	Revue de Droit Administratif et de Droit Fiscal, Lausanne, Switzerland (periodical)
RDS	Revue de droit suisse (Zeitschrift für Schweizerisches Recht), Basel, Switzerland (periodical)
RECHT	Zeitschrift für juristische Ausbildung und Praxis, (Stämpfli Verlag), Bern, Switzerland (periodical)
REPRAX	Zeitschrift zur Rechtsetzung und Praxis im Gesellschafts- und Handelsregisterrecht. (Droit des sociétés et droit du registre du commerce: revue de la législation et de la pratique.), Schulthess Verlag, Zürich, Switzerland (periodical)
Rev. Rul.	Revenue Ruling, US
RO	Official Collection of Federal Laws
RS	Systematic Collection of Federal Laws
RSDIE	Revue suisse de droit international et de droit européen, Zurich, Switzerland (periodical)
SBA	Swiss Federal Banking Law of 1 March 2012 (RS 952.0)
Sec.	Section
SICAF	Investment Company with Fixed Capital (Société d'Investissement à Capital Fixe)
SICAV	Investment Company with Variable Capital (Société d'Investissement à Capital Variable)
ST	Der Schweizer Treuhänder (L'Expert-Comptable Suisse), Zurich, Switzerland (periodical)
StE	Der Steuerentscheid, Basel, Switzerland (periodical)
STL	Stamp Tax Law of 27 June 1973 (RS 641.10)

Abbreviations

STO	Stamp Tax Ordinance of 3 December 1973 (RS 641.101)
StR	Steuer-Revue, Muri/Bern, Switzerland (periodical)
SWI	Steuer und Wirtschaft International, Austria (periodical)
SZIER	Schweizerische Zeitschrift für internationales und europäisches Recht (Swiss Review of International and European Law), Schulthess Verlag, Zürich, Switzerland (periodical)
Tax Notes Int'l	Tax Notes International, US (periodical)
UK	United Kingdom
US	United States of America
v.	Versus
VCLT	Vienna Convention of 23 May 1969 on The Law of Treaties (RS 0.111)
WTL	Swiss Federal Withholding Tax Law of 13 October 1965 (RS 642.21)
WTO	Swiss Federal Withholding Tax Ordinance of 19 December 1966 (RS 642.211)
ZBJV	Zeitschrift des bernischen Juristenvereins, Bern (periodical)
ZR	Blätter für Zürcherische Rechtssprechung

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Part 1

Overview

Part 1 - Overview

1 Introduction

*It is not the strongest of the species that survive,
nor the most intelligent, but the ones most responsive
to change (Charles Darwin, 1809 - 1882)*

1.1 Subject of the Study

In today's globalized world, wealth owners and their advisers are faced with a new set of fundamental challenges. The ongoing disputes regarding bank secrecy in Switzerland and other jurisdictions have led to a competitive landscape in which new parameters play a vital role to determine if a certain jurisdiction is attractive for investment purposes, and in which tax law is becoming increasingly important. This study will analyze the tax treatment of hybrid entities¹ such as Collective Investment Schemes (CISs) and trusts under both Swiss domestic tax law, and international tax law. This study will focus on the international tax aspects, and in particular, on the issue of Double Tax Convention (DTC) access for CISs and trusts. By way of analogy to Darwin, only the most responsive financial centers - those who can more easily adapt to change - are likely to survive in this new landscape. The competitiveness of Switzerland, and the attractiveness of the Swiss marketplace as an internationally-recognized fund and trust center, depends on its ability to adapt and respond to these new challenges of a tax-transparent world, as well as to the demands of today's wealth owners. In a world that is becoming

¹ This is an undefined term in tax law which generally refers to persons other than individuals and companies such as partnerships, non-corporate CISs (following the definition in the OECD Commentary) and trusts (following the definition in the Hague Convention), which are either (i) fiscally-transparent entities ("*flow-through*"), (ii) partially or completely tax-exempt entities ("*tax-exempt*") bearing the risk of mismatches due to differences which could arise under the domestic tax laws of the residence and source states such as qualification conflicts, which may then lead to different treatment under, and differential application of, DTCs.

more and more tax-transparent and in light of the increasing relevance of on-shore financial services, the lack of access to DTCs by CISs and trusts could become a competitive disadvantage for the Swiss Financial Market.

The use of CISs and trusts as investment vehicles has increased exponentially, and Switzerland is not a stranger to this development. Legal and regulatory changes and the forces of globalization have led to an increase in cross-border investments through hybrid entities or, in today's OECD language "*hybrid mismatch arrangements*"², such as CISs and trusts. Considerable assets are now administered and managed in Switzerland through these structures, and such investments have a profound impact on the growth and profitability of the Swiss financial center. Due to their flexibility and manifold applications, CISs and trusts create many advantages for wealth owners. The attractiveness of investing in a CIS inheres in the possibility to hold a diversified and professionally managed portfolio of securities, enabling actors to invest in a variety of companies and marketplaces around the world without the need to possess or gain specific knowledge of those businesses and industries. As for trusts, wealth owners can give up ownership of assets whilst ensuring that their value is employed for a particular purpose or use, or is held for the benefit of a certain person or class of persons.

Despite the increasing significance of cross-border structures using CISs and trusts, there are still a number of uncertainties with regards to critical aspects of Swiss tax law, such as the conditions for CISs and trusts to gain access to Swiss DTCs. A key aspect in a tax transparent world is to ensure protection from double taxation for the growing number of cross-border business structures using CISs and trusts. Thus, the particular analysis of each of the requirements to gain DTC access, e.g. person, resident, attribution of income and beneficial ownership, is vital.

Indeed, the attractiveness and competitiveness of a financial center that fails to offer such protection from double taxation is likely to be severely impaired. To this end, financial centers as well as tax authorities must understand the unwritten economic principle that the overall tax burden influences the movement of capital and, as a consequence, wealth owners' investment decisions³.

² OECD, Final Report on BEPS Action 2.

³ MUTEN, Taxes Influence the Movement of Private Capital, p. 743 et seq.

This book deals precisely with these issues and questions. In order to ensure simplicity and clarity for the reader, the author followed a symmetrical structure in the analysis of hybrid entities such as CISs and trusts. Interestingly, however, the practical proposals to amend the OECD Model and OECD Commentary presented in this study are mainly asymmetrical. This is due to the fact that the OECD has opted to regulate certain areas, such as the tax treatment of CISs, and leave others, such as trusts, unregulated.

1.2 Research Objective and Scope of the Study

1.2.1 General Introduction

The objective of this study is to examine the application of DTCs to CISs and trusts. In order to do so, references and comparisons with other countries' legal systems will be made where appropriate. The analysis is organized as follows.

First, the treatment of CISs and trusts under the current Swiss tax provisions will be analyzed. This analysis will be limited to issues relating to the direct taxation of income. Matters relating to indirect and wealth taxes will not be addressed. One important issue in this respect, however, concerns inheritance and gift taxes within trust structures. Therefore, some minor references will be made to inheritance as well as gift taxes, although the various cantonal practices will not be analyzed in detail.

Second, this study will focus on the treatment of CISs and trusts under DTCs "*de lege lata*". Specific consideration will be given to the general conditions for the application of DTCs to CISs and trusts in light of OECD materials. The specific requirements to access a DTC for person, resident, attribution of income and beneficial owner will be explored.

This analysis is particularly complicated, since Switzerland has an extensive network of more than seventy income tax treaties. This analysis is also challenging since the Swiss Federal Supreme Court and the Swiss Federal Administrative Court have not yet addressed the application of DTCs to hybrid entities in detail such as CISs and trusts.

This analysis will address a number of materials that the OECD has released to provide some clarity to the issue on which the OECD position as to whether CISs and trusts can gain access to DTCs.

A number of relevant OECD works will be dealt with in this book. First, the report titled “*Application of the OECD Model Tax Convention to Partnerships*”, analyzing the application of the OECD Model Convention to Partnerships, which was released on January 20, 1999 by the OECD Committee on Fiscal Affairs, is analyzed. This report was the result of a working group formed in 1993 by the OECD Committee to examine the application of the Model Tax Convention to non-corporate entities such as trusts and partnerships.

The report provides examples of cases in which the OECD identified issues regarding the entitlement of partnerships to access DTCs. It focuses on asymmetrical situations in which one jurisdiction allocates income to a partnership, whereas another jurisdiction does not consider partnerships to be taxable entities, resulting in the income being allocated to the partners. The report addressed the difficulties that arose from the varying degrees of tax transparency in different jurisdictions, ranging from fully-transparent to fiscally-opaque cases.

It is worth noting that this report focused exclusively on partnerships and, thus, contains the general principles in relation to the DTC entitlement only to partnerships⁴. These general principles have common features but, however, have to be further developed and discussed by the OECD Member States before applying them to other non-corporate entities such as trusts and CISs. In this regard, this Chapter also answers the question of whether the findings of the Partnership Report can be applied to other hybrid entities such as CISs and trusts⁵.

In 2006, a similar study to the one regarding partnerships was undertaken in relation to collective investment schemes. On May 31, 2010, the OECD issued the CFA or CIV Report on the “*Granting of Treaty Benefits with respect to the Income of Collective Investment Vehicles*”⁶. This report was inserted into the 2010 version of the OECD Commentary and shed some light on the application of DTCs to CISs. The report, however, did not encompass the case of trusts. The CFA Report’s more relevant conclusions refer to

⁴ OECD, Partnership Report, para. 1.

⁵ See Chapter 6.1.3

⁶ See the Report of the OECD’s Committee on Fiscal Affairs (“CFA”), The Granting of Treaty Benefits with respect to the Income of Collective Investment Vehicles, in: OECD Report, 31 May 2010.

treaty entitlement of CISs according to the provisions of the OECD Model, and the question of whether a CIS may be considered a *resident person* and the *beneficial owner* of income. The CFA Report also proposes model provisions to be used by contracting states as a basis when drafting DTCs.

Other materials that will be analyzed and which provided clarification on the fulfillment of “*beneficial ownership*” requirement are the OECD Discussion Draft on Clarification of the Meaning of “*Beneficial Owner*” in the OECD Model Tax Convention” of 29 April 2011⁷ and the Revised Discussion Draft on Clarification of the Meaning of “*Beneficial Owner*” of 19 October 2012⁸. Both documents aimed at providing some clarity to the more controversial question of the beneficial ownership requirement for trusts and other entities. Finally, the changes of the Revised Discussion Draft were included in the OECD’s latest Commentary, published on 15 July 2014

Later on, on March 19, 2014, the OECD released two Public Discussion Drafts as part of its Base Erosion and Profit Shifting (“BEPS”) Action Plan. This document will also be explored. The Public Discussion Draft BEPS Action nr. 2, Neutralize the Effect of Hybrid Mismatch Arrangements, was aimed at inserting rules to neutralize the effect of hybrid mismatch arrangements and also sets out recommendations for further changes to the OECD Model to clarify the treatment of hybrid entities.

In this sense, the first document (BEPS Action Nr. 2: Neutralize the Effects of Hybrid Mismatch Arrangements, Recommendations for Domestic Laws) provides recommendations for domestic rules to be adopted by countries in order to neutralize the differences in the taxation treatment of hybrid mismatch arrangements (hybrid entities and hybrid instruments). The second document is the BEPS Action Nr. 2: Neutralize the Effects of Hybrid Mismatch Arrangements, Treaty Issues. Of particular interest to this study is the second topic on “*ensuring that transparent entities are not used to obtain the benefits of treaties unduly*”, which discusses the effect of those rules on the

⁷ See the Report of the OECD’s Committee on Fiscal Affairs (“CFA ”), Clarification of the Meaning of “Beneficial Owner” in the OECD Model Tax Convention, in: Public Discussion Draft, 29 April 2011.

⁸ See the Report of the OECD’s Committee on Fiscal Affairs (“CFA ”), Clarification of the Meaning of “Beneficial Owner” in the OECD Model Tax Convention, in: Public Revised Discussion Draft, 19 October 2012.

OECD Model Tax Convention and proposes changes to the Convention as pertains to the treatment of hybrid entities. This second document complements the first one, and suggests changes such as an express provision in the OECD Model Tax Convention, which would ensure that hybrid entities which are wholly or partly fiscally-transparent (*“flow-through”*) are not unduly used to obtain treaty benefits.

It should be pointed out that the analysis contained in this book is current as per December 31, 2015. Considering the relevance of the issues discussed, it is certain and expected that new developments will be made almost on a daily basis that might affect some of the conclusions and recommendations outlined here.

As Switzerland is a member of the OECD, the OECD materials quoted above are especially relevant and somewhat binding. This study will therefore focus on proposals to insert specific provisions into the OECD Commentary – which are currently included in the 2014 version of the OECD Commentary. Also, this study will focus on the interpretation of these provisions, which will provide practitioners with an understanding of the application of DTCs to CISs and by analogy, to trusts (since the CFA Report and the new provisions in the 2014 version of the OECD Commentary only formally cover CISs).

The main research method will be the comparative method. However, comparison will not be used as an interpretative aid towards clarifying domestic laws, but rather, to gather examples of the possible ways of treating CISs and trusts for tax purposes under national and international (DTC) laws, and to help identify appropriate measures to eliminate the confusion surrounding the application of DTCs to CISs and trusts at an international level.

1.2.2 Research Questions

Five key research questions will be addressed in this study.

The focal points of this study were selected based on the lack of clear provisions within the OECD Model for the application of DTCs to hybrid entities such as trusts and CISs as well as their economic significance for a financial center such as Switzerland. The main topics that will be addressed in this study may be summarized as follows:

- Taxation of Swiss CISs under Swiss law (Chapter 2);
- Taxation of Trusts under Swiss law (Chapter 3);
- Tax Treatment of CISs under DTCs (Chapter 6);
- Tax Treatment of Trusts under DTCs (Chapter 6);
- Identification and Evaluation of Possible Conceptual Solutions regarding the Tax Treatment of CISs and Trusts under DTCs (Chapter 8).

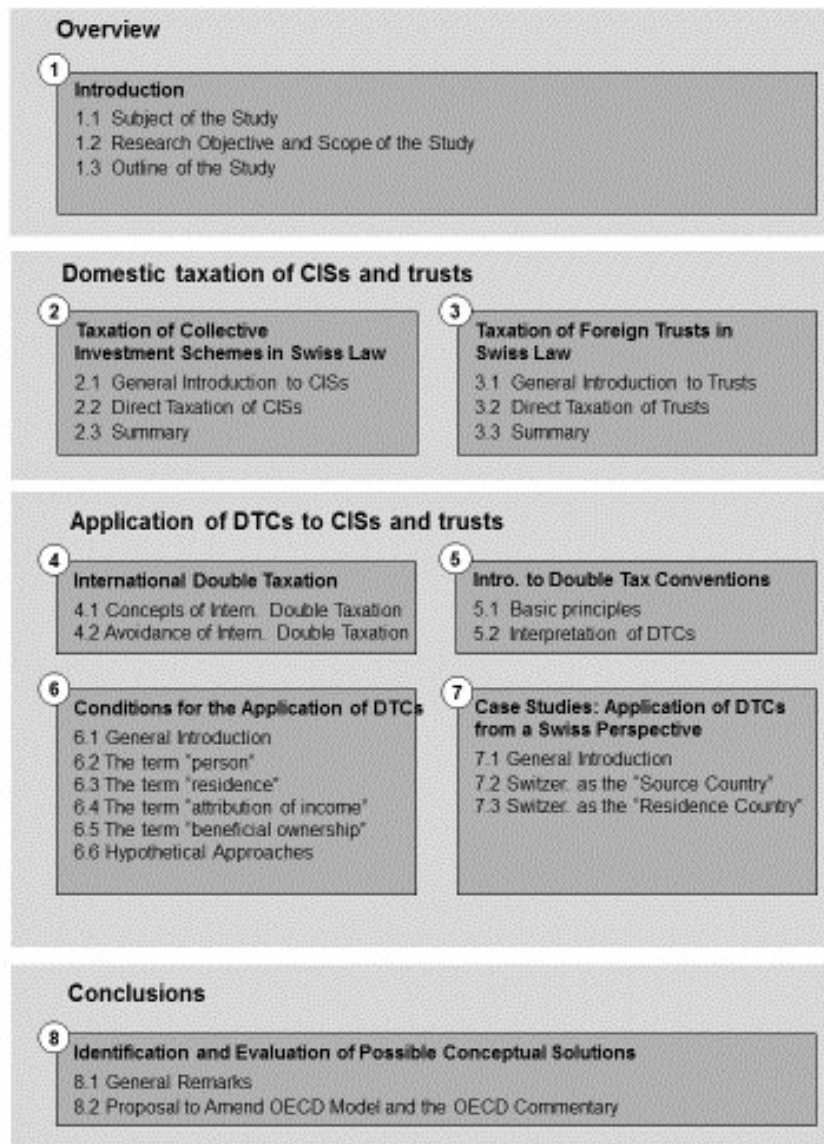
It should be noted, however, the central question refers to two issues, namely, the systematic analysis of the application of DTCs to CISs and trusts “*de lege lata*”; and the overall conclusions and recommendations forming a new approach under the OECD Model and its Commentaries as to the treatment of CISs and trusts within DTCs, “*de lege ferenda*”. In order to ensure simplicity and clarity for the reader, a symmetrical structure was followed in the analysis of hybrid entities such as CISs and trusts. Interestingly, however, the practical proposals to amend the OECD Model and OECD Commentary presented in this study are mainly asymmetrical. This is due to the fact that the OECD has opted to regulate certain areas, such as the tax treatment of CISs, and leave others, such as trusts, mainly unregulated.

1.3 Outline of the Study

This study comprises eight chapters. The **first chapter** provides an overview of the subject (Chapter 1.1) and delimits the scope and objectives of the study, outlining the research questions and scope in more detail (Chapter 1.2) and briefly, its structure (Chapter 1.3). The **second chapter** addresses the domestic tax treatment of Swiss CISs. This chapter contains an introduction to CISs, with reference to some general economic principles, and certain aspects of the framework applicable to CISs in selected jurisdictions (Chapter 2.1). The scope of the tax analysis is defined in (Chapter 2.2). This is followed by the examination of the tax treatment of Swiss CISs (Chapter 2.3). The chapter concludes with a brief overview of the taxation of Swiss CISs in Switzerland (Chapter 2.4). **Chapter three** focuses on the tax treatment of foreign trusts in Switzerland. A general introduction to trusts is provided with a brief analysis of the trust concept in general (Chapter 3.1). The previ-

ous chapter's structure is mirrored as to the scope of the tax analysis (Chapter 3.2), before a detailed examination of the tax treatment of trusts (Chapter 3.3). The chapter concludes with a brief summary of the taxation of trusts in Switzerland (Chapter 3.4). **Chapter four** addresses the issues of double taxation and double non-taxation of CISs and trusts by first, explaining the concepts of international double taxation and double non-taxation and the circumstances giving rise to them (Chapter 4.1) and the methods by which such issues may be eliminated (Chapter 4.2). **Chapter five** will introduce the reader to the world of DTCs (Chapter 5.1). Particular attention is being paid to the interpretation of DTCs. This will be particularly important in determining the application of DTCs to CISs and trusts (Chapter 5.2). In **chapter six**, the core of this study, a full examination of the application of DTCs to CISs and trusts will be presented, by a systematic analysis with reference to "*de lege lata*". The chapter opens with an introduction (Chapter 6.1) followed by an in-depth analysis of the terms "*person*" under Art. 3 OECD Model (Chapter 6.2), and "*residence*" under Art. 4 para. 1 OECD Model (Chapter 6.3). The "*tie-breaker*" provisions for dual-resident individuals (Chapter 6.3.7) will be examined, followed by an analysis of the terms "*attribution of income*" (Chapter 6.4), and the "*beneficial ownership*" requirement (Chapter 6.5). Finally, various hypothetical approaches to secure DTC access are discussed with reference to the CFA Report and the provisions inserted by the 2010 version of the OECD Commentary (Chapter 6.6). In **chapter seven**, the author analyzes different case scenarios in order to illustrate the application of DTCs to CISs and trusts from a Swiss perspective, with Switzerland acting as either the source country or the residence country. The chapter will also outline possible solutions to situations in which the source and residence country treat the CIS or trust equally or differently from a tax perspective. In **chapter eight**, the focus shifts to overall conclusions and recommendations, as well as conceptual solutions regarding the tax treatment of CISs and trusts under DTCs "*de lege ferenda*". The structure of the study is illustrated in the figure below.

Figure 1.1: Structure of the Study



Source: Own figure

Part 2
**Domestic Taxation of Collective
Investment Schemes and Trusts**

Part 2 - Domestic Taxation of Collective Investment Schemes and Trusts

2 Swiss Collective Investment Schemes under Swiss Law

Men will find that they can prepare with mutual aid far more easily what they need, and avoid far more easily the perils which beset them on all sides, by united forces.
(Baruch Spinoza, 1632 - 1677)

2.1 General Introduction to the Concept of Collective Investment Schemes

2.1.1 Introduction

Historic sources show that Collective Investment Schemes (CISs) (*“Kollektive Kapitalanlagen”*; *“organismes de placement collectif”*)⁹ have existed for a very long time¹⁰. Their origins go back as far as 1774¹¹, when an Amsterdam stockbroker called Abraham van Ketwich established the oldest known investment fund, known as *“Concordia Res Parvae Crescunt”* - the Latin expression for *“Eendragt maakt Magt”*¹². Translated, it means nothing more than *“unity makes the strength”*¹³. Switzerland was also one of the pioneer countries. On 5 March 1849, three private banks in Geneva established the first Swiss fund, which was called *“Omnium, Société Civile Genevoise*

⁹ In the past, the term *“investment fund”* was commonly used. Now, and in the present study, the term *“collective investment scheme”* is used as defined in Chapter 2 and 2.2, which encompasses all of the various legal forms that such funds may take.

¹⁰ BONGAARTS/ED, General report on the taxation of investment funds, p. 25.

¹¹ ROUWENHORST, Mutual Funds, p. 10.

¹² ROUWENHORST, Mutual Funds, p. 10; BERGHUIS, thesis, p. 47.

¹³ In this vein also: KOSTERS/MOOIJ, National report on investment funds, p. 635.

d'Emploi de Fonds"¹⁴. It was not until the end of the 19th century that the triumphal march of Anglo-Saxon "Investment Trusts" began. 1868 marked the founding of the London-based "Foreign and Colonial Government Trust", the mutual fund set-up in the Anglo-Saxon countries¹⁵ such as Great Britain, Scotland¹⁶ and the United States. Their goal was "to give the investor of moderate means the same advantages as the large capitalist in diminishing the risk of investing in foreign and colonial Government stocks, by spreading the investment over a number of different stocks"¹⁷. The creation of such CISs was a direct consequence of the financial crisis at that time. The objective of CISs was to protect investors "against the risks of a badly regulated market"¹⁸.

More recently, developments in the European Communities - in particular the issuance of two new directives concerning investment funds (the European Product Directive: UCITS-Directive 2001/108/EC¹⁹ of 21 January 2002 and the European Fund Services Directive: UCITS Management Directive 2001/107/EC²⁰ of 21 January 2002²¹) - have required Swiss legislators to modernize the law. Adaptation of the Swiss legislation was in any case necessary to prevent the fund business, which is crucial to Switzerland, from migrating to other countries. As of 1 January 2007, the Swiss federal law governing investment funds (IFA) of 18 March 1994 was adapted to conform with the revised EU directives, giving rise to the Federal Act on Collective

¹⁴ LIEFMANN, *Beteiligungs- und Finanzierungsgesellschaften*, p. 128, 137; CASSIS, *History of international financial centers*, p. 129; SCHERER/BURGY, *National report on the taxation of investment funds*, p. 795.

¹⁵ HURLEY, *National report on investment funds*, p. 819; ROUWENHORST, *Mutual Funds*, p. 16; KREMER, *Organismes de Placement Collectif*, p. 16.

¹⁶ In Scotland, for example, the objective was to invest in farm mortgages. In this vein: MERRIMAN, *Unit Trusts*, p. 1-10.

¹⁷ Extracted from the Prospectus of the Foreign and Colonial Government Trust from 1868. Among others: LAUX, *Investmentfonds-Philosophie*, p. 19; DEN OTTER, *Investmentfonds*, p. 30; COX, *Investmentgesellschaft*, p. 586.

¹⁸ BONGAARTS/ED, *General report on the taxation of investment funds*, p. 25.

¹⁹ Technical Explanations CISA, p. 6402 et seq.; WINZELER, *Basler Kommentar, Kollektivanlagengesetz*, nr. 20 ad. Art. 1.

²⁰ Technical Explanations CISA, p. 6402 et seq.; WINZELER, *Basler Kommentar, Kollektivanlagengesetz*, nr. 21 ad. Art. 1.

²¹ REICH, *Vom AFG zum KAG*, p. 9 et seq.

Investment Schemes (CISA) (*“Bundesgesetz über die kollektiven Kapitalanlagen”*; *“Loi fédérale sur les placements collectifs de capitaux”*)²². In the same step, the legislator broadened its scope of application to form comprehensive legislation on CISs²³, with the main goal of increasing the attractiveness and competitiveness of the Swiss marketplace as a fund center, namely through the creation of three new legal forms of CISs. Two corporate vehicles were established: the Investment Company with Variable Capital (SICAV), based on the relevant provisions of the popular Luxembourg SICAV-legislation²⁴, and the Investment Company with Fixed Capital (SICAF)²⁵, regulated until now – if at all – by Swiss stock exchange law. The third legal form created is the Limited Partnership for Collective Investment (LP)²⁶, a new non-corporate investment vehicle for risk capital, following a slightly modified form of Art. 594 CO et seq. Instead of creating a new legal structure *“ab ovo”*, the legislator preferred to adapt an existing legal form.

These revisions entailed significant changes. With the entry into force of the CISA, several tax laws had to be modified²⁷. The changes concerned included amendments to the Federal Acts of 14 December 1990 on the Federal Direct Tax (LDFT)²⁸, the Federal Act of 14 December 1990 on the Harmonization of Cantonal and Communal Direct Taxes (LDHT)²⁹, the Federal Act of 13 October 1965 on the Withholding Tax Law (WHTL)³⁰, the Federal Act of 27 June 1973 on the Stamp Tax Law (STL)³¹ and the Federal Act of 1 January 1995 on the Value Added Tax Law (VATL)³². However, as will be

²² Swiss Federal Act on Collective Investment Schemes of 23 June 2006 (CISA) published in Systematic Collection of Federal Laws: SR 951.31. The CISA has recently been revised and the new provisions entered into force on 1 March 2013. This revision triggered no relevant consequences in relation to the tax regulation of CISs in Switzerland.

²³ Technical Explanations CISA, p. 6396, 6401 et seq.

²⁴ Technical Explanations CISA, p. 6420.

²⁵ Technical Explanations CISA, p. 6396.

²⁶ Technical Explanations CISA, p. 6413.

²⁷ Technical Explanations CISA, p. 6491 et seq.

²⁸ Art. 10 para. 2; 20 para. 1 (e); 49 para. 2; 56 (j); 66 para. 3; 72; 129 para. 3 LDFT.

²⁹ Art. 7 para 3; 13 para. 3; 20 para. 1; 23 para. 1 (i); 26 para. 3; 45 (d) LDHT.

³⁰ Art. 4 para 1 (c); 4 para. 2; 5 para. 1 (b); 9 para. 3; 10 para. 2; 11 para. 2; 15 para. 1 (a) and (b); 26; 27 WTL.

³¹ Art. 1 para. 1b lit. 5; 13 para. 2a (3); Art. 14 para. 1a and b; 17a STL.

³² Art. 18 lit. 19 (f) VATL.

demonstrated in this study, further changes will inevitably result, chiefly with regards to Swiss withholding tax, in order for Switzerland to retain an attractive tax landscape for foreign investors investing in Swiss CISs.

2.1.2 Economic Significance

In Switzerland, investments held through CISs have substantially grown over the past decade and have become increasingly important³³. Since industry needs capital³⁴, the investment sector has proven to be one of the most dynamic post-war fields, and this trend will probably continue to expand worldwide³⁵.

As of the end of 2008, the Swiss fund industry encompassed 6,423 funds (1,299 entities created under Swiss law³⁶ and 5,124 entities created under foreign law, dominated by 3,833 funds under Luxembourg law and 606 funds under Irish law)³⁷, with enormous investments being held³⁸. This discrepancy between the number of Swiss funds and the number of foreign funds is due to the unfavorable Swiss withholding tax regulations³⁹.

³³ Technical Explanations CISA, p. 6406.

³⁴ In the beginning of the 19th century, the industry already required capital from investment vehicles. In this vein: ROBERTS, Investment Fund, p. 3 et seq.

³⁵ EFAMA, European Investment Funds, p. 48 et seq; KAPALLE, Basler Kommentar, Kollektivanlagengesetz, nr. 1205 ad. Art. 1; OECD, Report on governance systems, p. 17; BONGAARTS/ED, General report on the taxation of investment funds, p. 25-26; DELWAIDE, Investment Funds, p. 326; GREMILLION, Mutual Fund Industry, ad. Foreword, p. 1; HESS, thesis, p. 1; MÜLLER, Investmentgesellschaft, p. 9. AMONN, General report on the fiscal treatment of international investment trusts and mutual funds, p. 58, only refers explicitly to CISs organized in a trust form or, in other words, to investment trusts.

³⁶ Information retrieved from http://www.finma.ch/d/finma/publikationen/Documents/EBK-JB08_d.pdf on 3 November 2009.

³⁷ Information retrieved from http://www.finma.ch/d/finma/publikationen/Documents/EBK-JB08_d.pdf on 3 November 2009.

³⁸ Due to the financial crisis, in the first quarter of 2009, approximately 3,821 investment funds have been dissolved worldwide. See in this vein: Das Fonds-Sterben - zwischen Legende und Wahrheit, in: Neue Zürcher Zeitung (12 and 13 September 2009). Information retrieved from www.nzz.ch on September 20, 2009.

³⁹ See Chapter 2.3.6.

2.1.3 Definition of Collective Investment Schemes

The nomenclature regarding “*Collective Investment Schemes*” or “*Investment Funds*” has been inconsistent across jurisdictions due to the various legal or organizational forms these may take⁴⁰. The present study will refer solely to the term “*Collective Investment Schemes*” (“*kollektive Kapitalanlagen*”; *placements collectifs de capitaux*”), which encompasses all of the various possible legal forms.

In accordance with the Swiss Federal Act on Collective Investment Schemes of 23 June 2006 (CISA)⁴¹ and its Ordinance of 22 November 2006 (CISO)⁴², which both entered into force on 1 January 2007, the foregoing term refers, in this present study, only to fiscally-transparent entities (“*flow-through*”) such as Contractual Funds (FCP) (“*Vertragliche Anlagefonds*”; “*fonds de placement contractuels*”)⁴³, Investment Companies with Variable Capital (SICAV) (“*Investmentgesellschaft mit variablem Kapital*”; “*société d’investissement à capital variable*”)⁴⁴, and Limited Partnerships for Collective Investments (LP) (“*Kommanditgesellschaft für kollektive Kapitalanlagen*”; “*société en commandite de placement collectifs*”)⁴⁵ which, however, do not include real estate investments⁴⁶.

⁴⁰ BONGAARTS/ED, General report on the taxation of investment funds, p. 23.

⁴¹ Swiss Federal Act on Collective Investment Schemes of 23 June 2006 (CISA) published in Systematic Collection of Federal Laws: SR 951.31. The CISA has been recently revised and the new provisions entered into force on 1 March 2013. This revision triggered no relevant consequences in relation to the tax regulation of CISs in Switzerland.

⁴² Swiss Federal Ordinance on Collective Investment Schemes of 22 November 2006 (CISO) published in Systematic Collection of Federal Laws: SR 951.311.

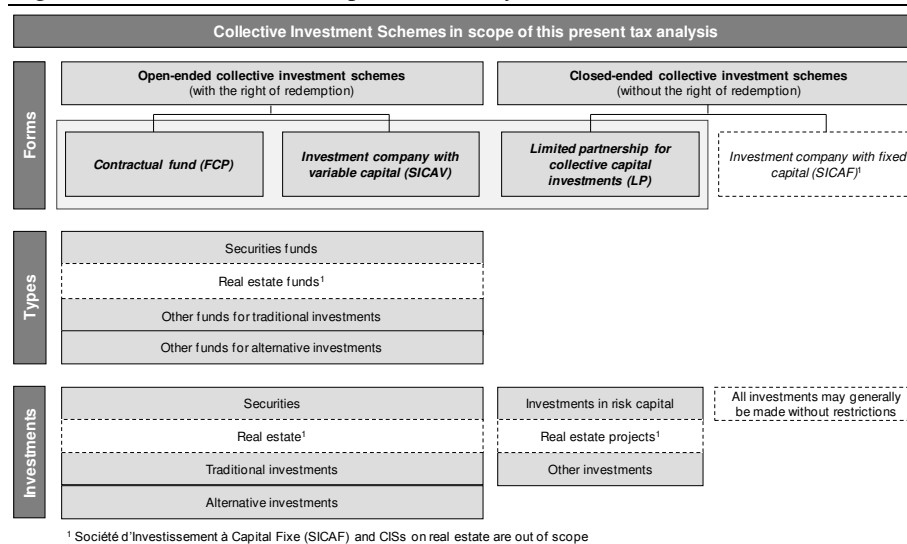
⁴³ Art. 25-35 CISA.

⁴⁴ Art. 36-52 CISA.

⁴⁵ Art. 98-109 CISA.

⁴⁶ PFISTER, Rückerstattung der Verrechnungssteuer an inländische Investoren transparenter ausländischer kollektiver Kapitalanlagen, p. 20-21.

Figure 2.1: CISs within the Scope of this Study



Source: Own figure based on KÜHNE/SCHUNK/KELLER, Collective Investment Schemes

To fully understand the mechanics and rationale behind CISs, they will first be analyzed from an economic perspective⁴⁷, and then from a purely legal perspective⁴⁸, before the examination in detail of their taxation under Swiss domestic tax law⁴⁹.

2.1.3.1 Definition from an Economic Perspective

CISs are financial intermediaries which have been one of the main avenues for small and medium portfolio investors to take advantage of direct investments. Some of the main benefits for portfolio investors include the possibility to invest funds by pooling assets together with other investors and the “sharing of risk management on a cost-effective basis and access to investment expertise”⁵⁰. The ability to diversify one’s investments across different

⁴⁷ See Chapter 2.1.3.1.

⁴⁸ See Chapter 2.1.3.2.

⁴⁹ See Chapter 2.3.

⁵⁰ BONGAARTS/ED, General report on the taxation of investment funds, p. 27.

asset classes⁵¹ and geographic areas is an essential component of today's investment world⁵². Such diversification enables investors to reduce the risks inherent in holding a small number of investments⁵³ and improves their risk-return ratio⁵⁴. Among Swiss-domiciled CISs at the end of 2008, around sixty percent of committed assets were invested outside of Switzerland⁵⁵. In addition, investors benefit from the market experience and highly specialized business management expertise of skilled professionals⁵⁶, cost effectiveness⁵⁷, expanded access to capital⁵⁸, access to markets which may otherwise be closed or too technical to enter⁵⁹ and institutional safety from the regulation and supervision imposed on CISs⁶⁰. In addition, investments in CISs are held in the form of financial instruments which can easily be bought and sold and are generally more liquid than an individual portfolio investing in direct investments⁶¹. A report issued by the US Congress⁶² clearly summarizes the

⁵¹ Including, for example, cash, bonds, stocks, real estate, foreign currency, natural resources, precious metals and other investment categories. See CFA Report, nr. 9, 13.

⁵² In this vein: GRILLI, Treaty entitlement of investment funds, p. 871.

⁵³ CFA Report, nr. 9; FABOZZI/MODIGLIANI, Capital Markets, p. 113-114; BONGAARTS/ED, General report on the taxation of investment funds, p. 33-34, 36; ZOLT, Taxation of Investment Funds, 1998, p. 970; HESS, thesis, p. 1; STADLER, thesis, p. 11 et seq.; BÜRЛИ-BORNER, thesis, p. 11; AMONN, General report on the fiscal treatment of international investment trusts and mutual funds, p. 58.

⁵⁴ Among others: SPREMANN, Portfolio, p. 28-29.

⁵⁵ This information has been retrieved from the Monthly Statistical Bulletin from the Swiss National Bank of October 2008 on 14 March 2009 from http://www.snb.ch/ext/stats/statmon/pdf/deen/D6_3_Anlagefonds.pdf.

⁵⁶ CFA Report, nr. 9; VIITALA, thesis, p. 17; HAGOPIAN, Investment Funds, p. 81-84; HESS, thesis, p. 1.

⁵⁷ CFA Report, nr. 7, 9 and 12.

⁵⁸ HAGOPIAN, Investment Funds, p. 81-84; ZOLT, Taxation of Investment Funds, 1998, p. 985.

⁵⁹ CFA Report, nr. 8; BÜRЛИ-BORNER, thesis, p. 11; STADLER, thesis, p. 8.

⁶⁰ A good overview regarding the different regulatory systems which may be applicable to investment funds is set forth in an international guide issued by IBFD: IBFD, International guide to the taxation and regulation of mutual investment funds and their investors.

⁶¹ In this vein: GRILLI, Treaty entitlement of investment funds, p. 871.

⁶² This information has been retrieved from an overview and analysis of the Joint Economic Committee United States Congress of February 2002 on 4 January 2010 from <http://www.house.gov/jec/mutual.pdf>.

advantages of CISs or, in the American term, mutual funds: “*The variety of mutual fund types has grown, offering average Americans opportunities to invest money and diversify assets. Mutual fund costs have fallen, driven down by economies of scale and advances in computers and communications. Mutual fund investors have benefited from falling costs, which competition has passed along to them.*”

2.1.3.2 *Definition from a Legal Perspective*

The legal definition encompassed in Art. 7 CISA refers exclusively to Swiss CISs⁶³, but is based on common terminology which is mainly used across Europe. In most French speaking countries, one speaks of “*organisme de placement collectif*” while in English speaking countries, reference is made to “*collective investment schemes*”⁶⁴. The central idea of the CISA, in accordance with the principle “*same business, same risks, same rules*”, is that all CISs are to be covered by the scope of the CISA, regardless of whether they are open-ended⁶⁵ or closed-ended⁶⁶ and regardless of whether there is a contractual or company-based relationship between the investors and the collective investment scheme⁶⁷. The use of general and neutral wording in Art. 7 para. 1 CISA⁶⁸ is justified by these differences regarding the contractual parties, the legal qualification, as well as the contents of various types of CISs.

⁶³ Art. 7 in conjunction with Art. 2 CISA. The definition of foreign CISs can be found in Art. 119 CISA. In comparison to Art. 44 IFA, this provision was broadened and adapted to the criteria of Art. 7 CISA. See thereto: Technical Explanations CISA, p. 6436, 6478; BIZZOZERO/ZUFFEREY, Fonds de placement, p. 28.

⁶⁴ Technical Explanations CISA, p. 6416.

⁶⁵ Art. 8 CISA. Open-ended CISs, in which investors are entitled to have their interest returned at net inventory value, can be organized in the form of a contractual investment fund or Investment Company with Variable Capital (SICAV).

⁶⁶ Art. 9 CISA. Closed-ended CISs, in which investors are not entitled to have their interest returned at net inventory value, can be organized in the form of a limited partnership for collective investment.

⁶⁷ Technical Explanations CISA, p. 6413.

⁶⁸ Technical Explanations CISA, p. 6416.

Figure 2.2: Definition

Art. 7 Definition

¹ Collective investment schemes are assets raised from investors for the purpose of collective investments, and which are managed for the account of such investors. The investment requirements of the investors are met on an equal basis.

Source: Art. 7 para. 1 CISA⁶⁹

Although a detailed survey of this Article would be outside the scope of a fiscal study, a brief analysis of its five elements will facilitate an understanding of the mechanism of CISs. Assets (*“Vermögen”*; *“apports”*)⁷⁰ are contributed by investors to CISs and administered for their account⁷¹ on the principle of external fund management (*“Fremdverwaltung”*; *“administration par des tiers”*)⁷². The concept of collective investment schemes comprises two further elements: an investment scheme (*“Kapitalanlage”*;

⁶⁹ The English translation of the Swiss Federal Act on Collective Investment Schemes of 23 June 2006 (CISA) has been retrieved on 28 January 2009 from http://www.kpmg.ch/docs/20060623_Federal_Act_on_Collective_Investment_Schemes_E.pdf.

⁷⁰ Art. 7 para. 1 CISA; Technical Explanations CISA, p. 6419; HASENBÖHLER/KÜHNE/LENGAUER/AMSTUTZ/IMWINKELRIED/DÖMER, *Recht der kollektiven Kapitalanlagen*, p. 23 et seq.; HESS/SCHERRER, *Kollektivanlagengesetz*, p. 369; RAYROUX/DU PASQUIER, *Basler Kommentar, Kollektivanlagengesetz*, p. 412-413.

⁷¹ In the case of CISs, the management of assets contributed by investors is assigned to third parties responsible for making decisions regarding the sale and purchase of investments. The element of *“external management”* holds independent from the legal form of the CIS from the investors’ viewpoint. The latter have no instruction authority. The fund assets are externally managed by the fund administration (FCP), by bodies of the concerned company (SICAV, LP), or by a third party.

⁷² Art. 7 para. 1 CISA; Technical Explanations CISA, p. 6418; HASENBÖHLER/KÜHNE/LENGAUER/AMSTUTZ/IMWINKELRIED/DÖMER, *Recht der kollektiven Kapitalanlagen*, p. 27 et seq.; RAYROUX/DU PASQUIER, *Basler Kommentar, Kollektivanlagengesetz*, p. 416-417.

“*placement de capital*”) ⁷³ as well as collective investment (“*Kollektivanlage*”; “*placement collectif*”) ⁷⁴. The latter is also described as a joint investment ⁷⁵ in which investment requirements are equally satisfied by each of the investors (“*gleichmässige Befriedigung der Anlagebedürfnisse*”; “*satisfaction des besoins des investisseurs à des conditions égales*”) ⁷⁶. These elements were already incorporated in the legal definition of an investment fund in the IFA of 1966 as well as that of 1998, and align with the longstanding case law of the Swiss Federal Supreme Court ⁷⁷. In comparison with the previous definition in Art. 2 IFA, some elements have disappeared such as “*public advertising*”, “*the principle of risk sharing*” and “*limitation to a contractual legal form*” ⁷⁸.

⁷³ Art. 7 para. 1 CISA; Technical Explanations CISA, p. 6417; Swiss Federal Supreme Court Judgment of 4 May 1990, p. 79 (BGE 116 Ib 73); BÜRLI-BORNER, thesis, p. 33 et seq.; RAYROUX/DU PASQUIER, Basler Kommentar, Kollektivanlagengesetz, p. 413-414.

⁷⁴ Art. 7 para. 1 CISA; Technical Explanations CISA, p. 6417; Swiss Federal Supreme Court Judgment of 4 May 1990 (BGE 116 Ib 73); RAYROUX/DU PASQUIER, Basler Kommentar, Kollektivanlagengesetz, p. 415-416.

⁷⁵ On the level of the statute - see Art. 7 III CISA – the “*collectivity*”, or the “*joint investment*” was not regulated in terms of a minimum number of investors. The “*Federal Council*” states, however, in Art. 5 para. 3 CISO, that in a limited partnership for collective investment there must be, one year after the launch, at least five limited partners involved. It is certain that, for example, a so-called “*Einanlegerfonds*” (a fund with less than five investors) of a contractual investment fund or SICAV could not be approved by the supervisory authority due to the absence of collectivity. See in detail: Technical Explanations CISA, p. 6417 in connection with Swiss Federal Supreme Court Judgment of 4 May 1990, p. 79 (BGE 116 Ib 73).

⁷⁶ Art. 7 para. 1 CISA; Technical Explanations CISA, p. 6417; RAYROUX/DU PASQUIER, Basler Kommentar, Kollektivanlagengesetz, 416; Swiss Federal Supreme Court Judgment of 4 May 1990, p. 79 (BGE 116 Ib 73); Swiss Federal Supreme Court Judgment of 7 February 1984, p. 86 (BGE 110 II 74); Swiss Federal Supreme Court Judgment of 23 December 1981, p. 364 (BGE 107 Ib 358); Swiss Federal Supreme Court Judgment of 19 September 1975, p. 424 (BGE 101 Ib 422).

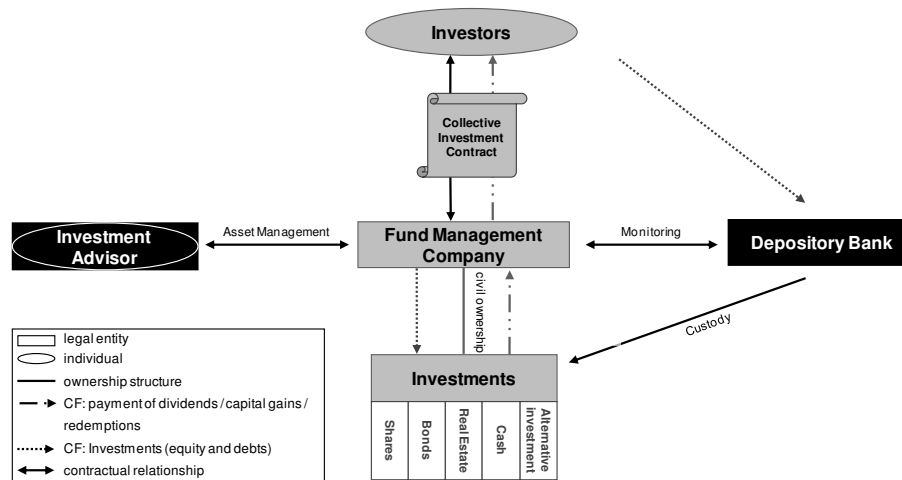
⁷⁷ Swiss Federal Supreme Court Judgment of 4 May 1990 (BGE 116 Ib 73); Swiss Federal Supreme Court Judgment of 23 December 1981 (BGE 107 Ib 358); Swiss Federal Supreme Court Judgment of 7 February 1984 (BGE 110 II 74); Swiss Federal Supreme Court Judgment of 11 February 1972 (BGE 98 Ib 42); Swiss Federal Supreme Court Judgment of 9 June 1997 (“*Imperial*”) = EBK-Bull. 33/1997, 60.

⁷⁸ Art. 3 para. 1 IFA.

2.1.4 Possible Structure of Collective Investment Schemes

In Switzerland, the most common structure of a CIS is the contractual form. In order to better understand, a FCP may be schematized with its relevant parties as follows:

Figure 2.3: Structure of a Contractual Fund (FCP)



Source: Own figure

2.1.5 The Legal Framework Applicable to Collective Investment Schemes in Selected Jurisdictions

The economic mechanism of CISs, which is to enable investors to participate in a pool of professionally managed assets for designated investments, is practically the same among all countries, including Switzerland, the United Kingdom, Luxembourg, Austria, Singapore, Hong Kong, Liechtenstein and Canada. However, the legal forms which these CISs take varies among countries⁷⁹ and some of these forms should be briefly analyzed, since characteri-

⁷⁹ RENK, General report on fiscal problems with investment trusts, p. XLV.

zation as a CIS is the “*natural starting point when discussing the tax treatment of the investment fund*”⁸⁰. Furthermore, “*it is obvious that such varied legal forms (...) are also taxed differently*”⁸¹.

In Swiss law the legal form of the CIS generally determines its tax status. The same principle will be of importance when examining whether a Swiss CIS is able to access DTC benefits. In this regard it is noteworthy that the SICAV enjoys equal tax treatment to the FCP and LP due to the fact that it is a body corporate and, as a consequence, is equipped with legal personality⁸². This can be explained by reference to the “*sine qua non*” condition of the CISA⁸³: “*same business, same risk, same rules*”⁸⁴, the application of which should have been key to the successful and widespread use of Swiss CISs⁸⁵. However, as we have seen, Swiss CISs are not often used due to the applicable tax rules⁸⁶. From an international perspective four different legal forms⁸⁷ - the contractual form, the corporate form, the trust and the partnership forms - have to be taken into consideration when analyzing CISs. Depending on the country’s fund legislation, there may be only one permitted form or several forms permitted in parallel, although most countries allow for more than one.

⁸⁰ VIITALA, thesis, p. 51.

⁸¹ AMONN, General report on the fiscal treatment of international investment trusts and mutual funds, p. 60. In this vein also: OESTERHELT/WINZAP, kollektive Kapitalanlagen, Part III, p. 121. OESTERHELT, Basler Kommentar, Kollektivanlagengesetz, nr. 195a ad. Vor Art. 1.

⁸² Technical Explanations CISA, p. 6420. It must clearly be stated that partnerships such as the Swiss and English Limited Partnership do not have legal personality (though the UK Government is consulting on potentially changing this), whereas Scottish Limited Partnerships do have legal personality.

⁸³ Technical Explanations CISA, p. 6026.

⁸⁴ Technical Explanations CISA, p. 6413.

⁸⁵ Technical Explanations CISA, p. 6026.

⁸⁶ PFISTER, Rückerstattung der Verrechnungssteuer an inländische Investoren transparenter ausländischer kollektiver Kapitalanlagen, p. 20 et seq.

⁸⁷ KAPALLE, Basler Kommentar, Kollektivanlagengesetz, nr. 1207-1208 ad. Vor Art. 1; CFA Report, nr. 23; OESTERHELT/WINZAP, kollektive Kapitalanlagen, Part III, p. 121-123; BÜRLI-BORNER, thesis, p. 16-17 only differentiates the contractual and the corporate forms of CISs without mentioning the trust form. However, MÜLLER, Investmentgesellschaft, p. 28 and AMONN, General report on the fiscal treatment of international investment trusts and mutual funds, p. 60 names the trust but not the partnership form. In this vein: IOSCO, Report on Governance Systems, p. 5.

For instance, Liechtenstein has introduced both the contractual and corporate forms. In early 2007, Switzerland also introduced the corporate and partnership forms. Other jurisdictions, such as the United Kingdom and Canada, where CISs have traditionally been structured as trusts, have also introduced the corporate and partnership forms. In Singapore and Hong Kong most CISs remain organized in the form of trusts⁸⁸.

In the following chapters, the analysis will focus on the contractual, corporate and partnership forms of CISs from a Swiss perspective exclusively. Since Switzerland does not provide for trusts in its legal system (and so the Swiss law treatment of trusts is limited to the recognition of foreign trusts⁸⁹ and their effects⁹⁰) the trust form will also be examined under English law.

2.1.5.1 *Contractual Form*

A contractual CIS is usually established by a fund management company, under which the participants, by individual contractual arrangements, participate in and share the property of the fund as co-owners⁹¹. The fund management company legally owns the fund's assets as trustee for the benefit of the investors⁹². The fund management company also owns the legal rights belonging to the CIS, such as voting rights attaching to shares held as fund assets⁹³. A contractual fund constituted under Swiss law does not possess its

⁸⁸ IOSCO, Report on Governance Systems, p. 18; KAPALLE, Basler Kommentar, Kollektivanlagengesetz, nr. 1218 ad. Vor Art. 1.

⁸⁹ Art. 11 para. 1 Hague Trust Convention.

⁹⁰ Among others: THÉVENOZ, Convention de la Haye sur les trusts, p. 52.

⁹¹ KAPALLE, Basler Kommentar, Kollektivanlagengesetz, nr. 1208 ad. Vor Art. 1.

⁹² This clearly derives from a Swiss Federal Supreme Court Judgment of 7 February 1984 (BGE 110 II 74) = JdT 1984 I 598: "*die von der Fondsleitung für Rechnung der Anleger wie fiduziarisches Eigentum verwaltet werden, vom eigenen Vermögen der Fondsleitung aber zu trennen sind und deshalb eine als Sondervermögen bezeichnete Einheit bilden.*" Against: WASSMER, thesis, p. 10 et seq. and p. 77. Already from the tax consequences it can be seen that the relationship between the fund management company and the investors of the CIS must have a fiduciary character. For this reason, the income and wealth is taxed at the level of the investors and not at the level of the fund management company. For further details in this vein: HESS, thesis, p. 22 et seq.

⁹³ HESS, thesis, p. 19 et seq.

own legal personality and, therefore, is not a legal entity⁹⁴. As a result, neither the CIS nor its investors have control over investments, and control is generally vested exclusively in the fund management company⁹⁵, which will have the sole object of carrying on the business of the investment fund. There is a simple contractual legal relationship⁹⁶ between the investors and the fund management company on one side, and on the other, between the fund management company and a licensed Swiss bank acting as a custodian or depository bank. The relationship between the investors and the fund management company must be regulated in a collective investment agreement (fund contract)⁹⁷, which must be approved by the regulatory authority⁹⁸. Luc Thévenoz describes this contractual legal relationship by classifying it as a “*trust deed*”⁹⁹. However, one must keep in mind that this complex contractual relationship consists of various elements,¹⁰⁰ such as a mandate¹⁰¹ and deposit¹⁰². After the IFA revision of 1 July 1966, the contractual form CIS was explicitly classified as a mandate with the result that Art. 394 CO et seq. became directly applicable to the contractual relationship between the investors and the fund management company. The revised IFA of 18 March 1994 no longer contained such an explicit reference; from then on, the contractual relationship was an “*independently regulated contract sui generis*”,

⁹⁴ In this vein among others: MÜLLER, *Investmentgesellschaft*, p. 28; BÜRLI-BORNER, thesis, p. 16.

⁹⁵ VIITALA, thesis, p. 93.

⁹⁶ Swiss Federal Supreme Court Judgment of 11 July 1989, p. 14 et seq. (BGE 115 III 11).

⁹⁷ Art. 25 CISA.

⁹⁸ Art. 26 CISA.

⁹⁹ THÉVENOZ, *cendrillon*, p. 279 et seq.

¹⁰⁰ BÜNZLI/WINZELER, *Basler Kommentar, Kollektivanlagengesetz*, nr. 8 ad. Art. 25. For discussion on the legal relationship between the bank and its clients see GUGGENHEIM, *Verträge der schweizerischen Bankpraxis*, p. 9 et seq.; HORN, *Rechtsbeziehung*, p. 88 et seq.; KLEINER, p. 273 et seq.; WIEGAND, *Rechtsbeziehung Bank-Kunde*, p. 129 et seq.; MÜLLER, *Investmentgesellschaft*, p. 28.

¹⁰¹ Art. 394 CO et seq.

¹⁰² Art. 472 CO et seq.

which fundamentally differs from a mandate¹⁰³. This regulation still applies in Switzerland¹⁰⁴.

2.1.5.2 *Corporate Form*

Under Swiss law, a corporate form CIS is considered a legal entity with its own legal personality¹⁰⁵. The fund assets are owned by the corporate entity and the investors are simultaneously shareholders thereof¹⁰⁶.

An Investment Company with Variable Capital (SICAV) constituted under Swiss law is a legal entity according to Art. 52 CC et seq¹⁰⁷. This “*sui generis*” corporate form¹⁰⁸ was recently created by federal law, and its nature differs from the corporate form established under Luxembourg law. The particularity of this Swiss-SICAV is that its equity capital is not determined in advance, though it is oriented towards the respective provisions of the Luxembourg SICAV¹⁰⁹, provision for which in Swiss law was consistently requested in the past by investors and their advisors¹¹⁰. The SICAV-investor obtains his participation in the form of a share, which directly connects the

¹⁰³ Technical Explanations IFA, p. 20.

¹⁰⁴ For more detailed information in relation to the contractual relationships see BÜNZLI/WINZELER, Basler Kommentar, Kollektivanlagengesetz, nr. 6 ad. Art. 25.

¹⁰⁵ Among others: KAPALLE, Basler Kommentar, Kollektivanlagengesetz, nr. 1208 ad. Vor Art. 1.

¹⁰⁶ IOSCO, Report on Governance Systems, p. 4, 14; KAPALLE, Basler Kommentar, Kollektivanlagengesetz, nr. 1208 ad. Vor Art. 1.

¹⁰⁷ RAYROUX/VOGT, Basler Kommentar, Kollektivanlagengesetz, nr. 11 ad. Art. 36; MÜLLER, Investmentgesellschaft, p. 29. In a Circular Letter of 6 May 1994, a Luxembourg SICAV was characterized as a growth investment fund lacking juridical personality, despite the fact that it is regarded as a legal entity under the laws of Luxembourg. This characterization has been widely criticized by leading scholars, including among others: OBERSON, Jurisprudence, p. 143.

¹⁰⁸ HASENBÖHLER/KÜHNE/LENGAUER/AMSTUTZ/IMWINKELRIED/DÖMER, Recht der kollektiven Kapitalanlagen, p. 100.

¹⁰⁹ Technical Explanations CISA, p. 6420.

¹¹⁰ Among others: DEN OTTER, Anlagefondsaufsicht, p. 377; OERTLE, Asset Securitization, p. 169.

investor to the investment company¹¹¹. Through this share, the investor may exercise his shareholder rights. However, the purpose of the SICAV is expressly limited to the administration of assets¹¹².

2.1.5.3 Partnership Form

The “*Anglo-Saxon limited partnership*” and the “*Luxembourg SICAR*” were frequently and successfully used by Swiss investors to structure risk capital investments¹¹³. One of the main novelties of the CISA was the introduction of the Swiss limited partnership for Collective Investment¹¹⁴, a vehicle similar to the Anglo-Saxon limited partnership¹¹⁵, which was created as an alternative investment form with the objective to further develop capital risk investments in Switzerland. Similarly, as with limited partnerships (“*Kommanditgesellschaft*”; “*société en commandite*”)¹¹⁶, the Swiss limited partnership for Collective Investment is not a legal entity, but a partnership¹¹⁷ and therefore, is not itself equipped with legal personality “*per se*”. The

¹¹¹ Art. 36 para. 1 (b) CISA; BAUR, Gesetz über Kapitalanlagegesellschaften, nr. 71 ad. Einleitung.

¹¹² Art. 36 para. 1 (d) CISA.

¹¹³ DU PASQUIER/POSKRIAKOV, Basler Kommentar, Kollektivanlagengesetz, nr. 2 ad. Art. 98.

¹¹⁴ Art. 98-109 CISA. Switzerland, among other civil law systems, uses the term partnership “*per se*” neither in German nor in French. The concept is more an association of persons or company of persons. The legal nature and form may, however, differ in each country depending on their civil and commercial laws. See, for further details: VAN RAAD/BETTEN, International Guide to Partnerships.

¹¹⁵ The concept of “*partnership*” is not entirely equivalent in the common law and civil law systems. This can be observed through the tax analysis of partnerships in different countries, see: LE GALL, General report on international taxation of partnerships, p. 655.

¹¹⁶ Art. 594 CO et seq. Instead of creating a new legal form “*ab ovo*”, the legislator preferred to adopt a legal form already existing in the Swiss legal order, namely the limited partnership, according to Art. 594 CO. Under the CISA, this partnership was slightly modified so that it could serve as a collective investment vehicle for relevant investments.

¹¹⁷ DU PASQUIER/POSKRIAKOV, Basler Kommentar, Kollektivanlagengesetz, nr. 6-7 ad. Art. 98.

partners jointly hold the rights and obligations, and the partnership assets belong to their overall property¹¹⁸. However, in relation to third parties (i.e. in external relations), the limited partnership is considered a legal entity capable of acting, litigating and prosecuting¹¹⁹ as if it could hold or own legal rights in its own name. Granted with such “*quasi-legal personality*”¹²⁰, the limited partnership is to be considered – at least in its external relations - as the owner of the partnership assets, which are therefore distinguished from the partners’ private assets. In its capacity as a partnership, it can exercise all of its property rights – and obligations – independently of the partners.

The partners designate at least one general partner who will provide the partnership with “*unlimited liability*” and then, designate one or more limited partners, liable only to the extent of their registered investment¹²¹. The general partner needs to be a Swiss corporation, which can act as a general partner only in one Limited Partnership for Collective Investments¹²². Limited partners of a limited partnership for collective investments must be “*qualified investors*” within the meaning of Art. 10 para. 3 CISA¹²³.

2.1.5.4 Trust Form

One of the major forms in which CISs are structured is through trusts, which are well known in jurisdictions such as Canada, Hong Kong, Singapore, the United Kingdom, and Liechtenstein. Generally, the core principles underlying trusts are the same in all of these jurisdictions. The trust is essentially an unincorporated body¹²⁴ constituted under a trust deed¹²⁵. The trustee, generally an independent person with legal ownership, holds the assets of the CIS

¹¹⁸ Art. 99 CISA in conjunction with Art. 602 CO; BAUDENBACHER, Commentary CO, nr. 2 ad. Art. 594.

¹¹⁹ Art. 99 CISA in conjunction with Art. 602 CO; BAUDENBACHER, Commentary CO, nr. 3 ad. Art. 594.

¹²⁰ DU PASQUIER/POSKRIAKOV, Basler Kommentar, Kollektivanlagengesetz, nr. 7 ad. Art. 98.

¹²¹ Art. 98 para. 1 CISA.

¹²² Art. 98 para. 2 CISA.

¹²³ Art. 98 para. 3 CISA.

¹²⁴ KAPALLE, Basler Kommentar, Kollektivanlagengesetz, nr. 1208 ad. Art. Vor Art. 1.

¹²⁵ IOSCO, Report on Governance Systems, p. 17.

for its beneficiaries or, in other words, for the investors. Furthermore, in practice, the trustee often ensures that all regulations are complied with and that the fund manager acts in the best interests of the beneficiaries¹²⁶.

Even though no provisions allow for the constitution of a trust under Swiss law, Switzerland recognizes foreign trusts¹²⁷ and their effects¹²⁸. Therefore, this study will focus on the Unit Trust constituted under English law, which is well-known and is used as an investment vehicle across the world. The most important commercial element of such financial arrangements is the “unit” in which the investors/beneficiaries, otherwise known as the unit holders¹²⁹, acquire rights¹³⁰. Units are seen as a common means through which individual investors may indirectly trade in securities markets¹³¹, as the fund manager is generally obliged to buy back the units when investors want to redeem them¹³². Unit Trusts are not considered legal entities under civil law, but rather are based on complex contractual arrangements between the investors, the depositary and the trustee or, in other words, the fund management company¹³³. Toni Hess describes this relationship as “*eine besondere Art eines Treuhandverhältnisses*”¹³⁴.

¹²⁶ IOSCO, Report on Governance Systems, p. 5.

¹²⁷ Art. 11 para. 1 Hague Trust Convention.

¹²⁸ Among others: THÉVENOZ, Convention de la Haye sur les trusts, p. 52.

¹²⁹ For the legal status difference between a “Unit Trust Holder” and “shareholder”, see the decision of the High Court of Australia CHARLES v FEDERAL COMMISSIONER OF TAXATION, p. 609 (1954, 90 CLR 598).

¹³⁰ HUDSON, Equity & trusts, p. 736; PARKER/MELLOWS, Trusts, p. 3.

¹³¹ Among others: MWENDA, p. 71.

¹³² GRAZIADEI/MATTEI/SMITH, Commercial trusts, p. 459. SUPINO, thesis, p. 67 et seq.

¹³³ For further details on this complex legal relationship from a civil perspective: VIITALA, thesis, p. 81; IOSCO, Report on Governance Systems, p. 18.

¹³⁴ HESS, thesis, p. 48-49.

Figure 2.4: Comparison of the Legal Structure of CISs in Selected Countries

Country	Notation of the investment vehicle ¹	Ownership structure of the fund assets				Legal form
		Fund company	Fund management	Joint ownership of investors	Trustee as well as beneficiaries	
Switzerland	FCP ("Vertraglicher Anlagefonds")		•			Contractual form
	SICAV	•				Corporate form
	LP ("Kommanditg. für kollektive Kapitalanlagen")			•		Partnership form
United Kingdom	OEIC ("Open-ended investment companies")	•				Corporate form
	IT (Investment Trust) / VCT (Venture Capital Trust)				•	Trust form
	LP (Limited Partnership)			•		Partnership form
	AUT ("Authorized Unit Trust")				•	Trust form
Luxembourg	FCP ("Fonds commun de placement")			•		Contractual form
	SICAV	•				Corporate form
	SICAR (Société d'Investiss. à Capital Risque)	•		•		Corporate form
Austria	FCP ("Kapitalanlagefonds")			•		Contractual form
Singapore	CPF Unit Trust ("CPF Approved Unit Trust")				•	Trust form
	DUT Unit Trust ("Designated Unit Trust")				•	Trust form
	AUT ("Approved Unit Trust")				•	Trust form
	LAT ("Prescribed Locally Administered Trusts")				•	Trust form
Hong Kong	Mutual Fund	•				Corporate form
	Unit Trust				•	Trust form
Liechtenstein	Treuhänderschaft (without legal personality)				•	Contractual form
	SICAV	•				Corporate form
Canada	Mutual Fund Corporation	•				Corporate form
	Partnership			•		Partnership form
	Unit Trust / Mutual Fund Trust				•	Trust form

¹ Société d'Investissement à Capital Fixe (SICAF) are out of scope.

Source: Own figure

2.2 Scope of the Tax Analysis

With regards to this tax analysis, a few points must be clarified:

- The analysis will focus on the FCP¹³⁵, SICAV¹³⁶ and LP¹³⁷ forms, though the SICAF¹³⁸ and the CIS on real estate¹³⁹ are outside of the scope of this review;

¹³⁵ Art. 25-35 CISA.

¹³⁶ Art. 36-52 CISA.

¹³⁷ Art. 98-109 CISA.

¹³⁸ Art. 110-118 CISA.

¹³⁹ Art. 58-67 CISA.

- Attention will only be paid to investors holding a unit in private assets (*“Privatvermögen”*; *“fortune privée”*) and not in business assets (*“Geschäftsvermögen”*; *“fortune commerciale”*)¹⁴⁰;
- The income flows from investments to the CIS, and from the CIS to investors will be analyzed in detail. The management company and the custodian or depositary bank are outside the scope of the present tax analysis;
- The question of whether a permanent establishment exists under a DTC will not be addressed since the CIS holds an investment portfolio and does not perform any business activity; and
- The EU Savings Agreement will not be addressed¹⁴¹.

2.3 Direct Taxation of Collective Investment Schemes under Swiss Law

2.3.1 Hypothetical Taxation Issues

Before the taxation of Swiss CISs under Swiss domestic tax law is analyzed, consideration should be given to potential tax issues which may arise from the income flows (i) from investments to the CIS; and (ii) from the CIS to its investors. Depending on the jurisdiction, such income flows may generate three hypothetical taxation points in both *“fully-domestic scenarios”* and in *“cross-border scenarios”*. The CIS may be taxed at the investment level by a withholding tax. The CIS could also be taxed by way of annual final tax assessment, in the same way an ordinary corporation would be taxed. The same applies to investors, which may be subject to withholding tax at the CIS level, or which may be taxed directly by an annual final tax assessment.

In a fully-domestic scenario, Switzerland, like many other countries, has structured its tax system to ensure that the foregoing taxation points do not

¹⁴⁰ See Chapter 2.3.5.2.

¹⁴¹ Council Directive 2003/48/EC on taxation of savings income in the form of interest payments, 3 June 2003.

cause double or multiple taxation to be levied¹⁴². However, in an international context, imbalances in the principle of tax neutrality often cannot be eliminated due to the ineffectiveness of DTCs in this area¹⁴³.

2.3.2 Applicable Laws and Regulations: Circulars 25 and 24 on Collective Investment Schemes

On 1 January 2009 and 5 March 2009, the Federal Tax Administration issued administrative instructions concerning the direct taxation of CISs and their investors in Circular Letter 25 (Circular 25), and Swiss withholding tax and stamp duties in Circular Letter 24 (Circular 24). By adopting Circulars 24 and 25, the Federal Tax Administration overruled its previous Circulars 9 of 31 August 1979, 2 of 23 November 1989, 10 of 6 May 1994 and 31 of 12 July 1996, as well as the information leaflets concerning the tax treatment of investment foundations of 30 September 1996, concerning the country register in relation to the use of double tax conventions by Swiss investment funds of 1 January 2004, and concerning the notification procedure (*"affidavit procedure"*) of 30 April 1998, as well as the guidelines on collective investment instruments of 30 April 1999¹⁴⁴.

Circular 25 addresses the Swiss fiscal attribution rules regarding individual and corporate income taxes under the Federal Act of 14 December 1990 on the Federal Direct Tax¹⁴⁵.

Circular 24 outlines the tax consequences of Swiss withholding tax under the Federal Act of 13 October 1965 on the Withholding Tax Law¹⁴⁶ and its relevant Ordinance on Withholding Tax of 19 December 1966¹⁴⁷, as well as the

¹⁴² See Chapter 2.3.6.1.

¹⁴³ See Chapter 2.3.6.5.

¹⁴⁴ See para. 1 Circular 24; para. 2 Circular 25.

¹⁴⁵ Federal Act of 14 December 1990 on the Federal Direct Tax published in Systematic Collection of Federal Laws: SR 642.11.

¹⁴⁶ Federal Act of 13 October 1965 on the Withholding Tax Law published in Systematic Collection of Federal Laws: SR 642.21.

¹⁴⁷ Ordinance on Withholding Tax of 19 December 1966 published in Systematic Collection of Federal Laws: SR 642.211.

stamp duties under the Federal Act of 27 June 1973 on Stamp Duties¹⁴⁸ and its relevant Ordinance of 3 December 1973¹⁴⁹. In this Circular, the Federal Tax Administration addresses issues relating to relief from Swiss withholding tax for CISs domiciled in Switzerland¹⁵⁰. Additionally, it summarizes the practice of the Federal Tax Administration regarding treaty-based relief in relation to foreign withholding taxes for CISs and their investors¹⁵¹.

Neither Circular 24, nor Circular 25, contain specific provisions dealing with the treatment of “*carried interest*”¹⁵² (in the field of private equity¹⁵³) or “*performance fees*”¹⁵⁴ (with regards to hedge funds¹⁵⁵)¹⁵⁶. In a nutshell, carried interest and performance fees are fees which the manager of a private equity fund or hedge fund receives based on its own personal investment, usually only after a number of years, provided that certain goals (so-called “*hurdles*” or “*high watermarks*”) have been reached. The lack of provisions in Swiss law in relation to these fees led to a series of important and controversial discussions. According to an announcement by the Federal Tax Administration made on 5 September 2008¹⁵⁷, another Circular was planned to

¹⁴⁸ Federal Act of 27 June 1973 on Stamp Duties published in Systematic Collection of Federal Laws: SR 641.10.

¹⁴⁹ Federal Ordinance of 3 December 1973 on Stamp Duties published in Systematic Collection of Federal Laws: SR 641.101.

¹⁵⁰ Para. 2.1.7 Circular 24.

¹⁵¹ Para. 2.1.10 Circular 24.

¹⁵² Discussion Draft on STAFI Report, p. 23.

¹⁵³ Private Equity is generally a private method of financing whereby investors finance companies with risk capital. Private equity funds try, with a small participation interest, to exert pressure on the running of the enterprise, through shareholder activity, in order to bring about strategic changes. See: Discussion Draft on STAFI Report, p. 12; FRICK, thesis, p. 4 et seq., 28.

¹⁵⁴ Discussion Draft on STAFI Report, p. 23.

¹⁵⁵ Hedge funds are understood as a heterogeneous group of collective investment vehicles, which actively follow alternative investment strategies and are typically open only to institutional investors or certain wealthy individuals. Hedge funds strive for short-term capital gains from shares or derivatives, mostly through controlling majorities in companies. See: Discussion Draft on STAFI Report, p. 16; FRICK, thesis, p. 25, 28.

¹⁵⁶ Circular 24; Circular 25.

¹⁵⁷ The press release from the Swiss Bankers Association dated September 5, 2008 has been retrieved on 10 April 2009 from <http://www.swissbanking.org/en/home/medienmitteilungen.htm/medienmitteilungen-080905.htm>.

be issued in order to clarify the tax-related problems in relation to carried interest and performance fees¹⁵⁸. Although, following discussions between the cantonal tax authorities, a majority of cantons apply unwritten tax policies at cantonal and communal levels, the Circular has, as per the end of 2015, still not been published. The relationship between the requirements of international tax competition and the need for coherent practice in line with Swiss tax principles has led to controversy as to how such income should be taxed in Switzerland¹⁵⁹.

2.3.3 Taxation of Collective Investment Schemes

According to the tax transparency principle, which derives from Art. 10 para. 2 LDFT, a CIS is not considered a tax-subject for the purposes of Swiss income or wealth taxes. Such tax transparency may also be indirectly derived from Art. 20 para. 1 (e) LDFT¹⁶⁰, which states that income is attributed to the investor so long as the CIS does not own real estate, or generate income from real estate¹⁶¹. Hence, the present study will focus on CISs as fiscally-transparent entities (*“flow-through”*)¹⁶². The concept of transparency¹⁶³ has indirectly favored a trend towards equal fiscal treatment. Kurt Amonn went even further and has stated this to be the case *“whatever their legal form may be”*¹⁶⁴. However, in the case of a SICAF, this statement cannot be correct under Swiss law, since this type of investment company is considered to be a tax-subject for income and capital taxes¹⁶⁵. According to Kurt Amonn,

¹⁵⁸ See thereupon: Annexe I of Discussion Draft on STAFI Report, p. 53.

¹⁵⁹ See: Discussion Draft on STAFI Report, p. 35 et seq.

¹⁶⁰ Para. 3.1. Circular 25. Moreover: OESTERHELT, Basler Kommentar, Kollektivanlagengesetz, nr. 4, 5 ad. Vor Art. 1; OESTERHELT/WINZAP, kollektive Kapitalanlagen, Part II, p. 25 et seq.; HESS, thesis, p. 188, Footnote 11.

¹⁶¹ Art. 66 para. 3 in connection with Art. 72 LDFT; Para. 3.2. Circular 25. Moreover on the special case of CISs with real estate see in detail: HEUBERGER, Basler Kommentar, Kollektivanlagengesetz, nr. 354 et seq. ad. Vor Art. 1.

¹⁶² PFISTER, Rückerstattung der Verrechnungssteuer an inländische Investoren transparenter ausländischer kollektiver Kapitalanlagen, p. 19 et seq.

¹⁶³ Para. 2.1.2. Circular 24. In this vein also explicitly for Investment trusts, see:

AMONN, Steuerprobleme der schweizerischen Investment-Trusts, p. 60.

¹⁶⁴ AMONN, General report on the fiscal treatment of international investment trusts and mutual funds, p. 58.

¹⁶⁵ Para 3.1. Circular 25.

this constitutes a “*contradiction to the principle of transparency*”¹⁶⁶. However, in the reports of the International Fiscal Association of 1971, Austria, Belgium, Germany, France, Luxembourg, the Netherlands, Portugal and Switzerland illustrated the difficulties in achieving transparency for direct tax purposes. Despite those difficulties, such transparent treatment is important as the tax burden must be compared with that of a direct investment of individual investors, since from an economic perspective it is irrelevant whether someone invests capital for himself directly or whether one does it jointly with other investors indirectly through a CIS¹⁶⁷.

A CIS is only fully-transparent for direct tax purposes when it is classified as an “*accumulating fund*”¹⁶⁸. In this scenario, both accumulated (reinvested or undistributed) as well as distributed profits are taxed in the hands of Swiss resident investors, and the CIS is therefore fully tax transparent. However, if a CIS is classified as a “*distributing fund*” (and, therefore, not as an accumulating fund), undistributed profits will not be taxed at the fund level, nor at the level of Swiss resident investors, so long as no distribution is made¹⁶⁹. The lack of tax transparency in relation to distributing funds is further apparent in the application of the participation exemption at federal¹⁷⁰ and cantonal/communal levels¹⁷¹. Swiss capital companies and cooperatives, which hold through CISs (without SICAF) more than 10% of the nominal or share

¹⁶⁶ AMONN, General report on the fiscal treatment of international investment trusts and mutual funds, p. 62

¹⁶⁷ ZOLT, Taxation of Investment Funds, 1998, p. 974-975 focuses on the tax policies behind the drafting of tax provisions regarding CISs giving the “*ratio*” of neutral tax treatment for CISOs; AMONN, Steuerprobleme der schweizerischen Investment-Trusts, p. 165; AMONN, General report on the fiscal treatment of international investment trusts and mutual funds, p. 58, 60.

¹⁶⁸ For more details see Chapter 2.3.5.3.

¹⁶⁹ For more details see Chapter 2.3.5.3. In this vein see also: HESS/SCHERRER, Kollektivanlagegesetz, p. 385.

¹⁷⁰ Art. 69, 70 LDFT.

¹⁷¹ Art. 28 LDHT.

capital at federal level¹⁷² or hold share capital of the dividend-paying company with a market value of at least 1 million francs¹⁷³ cannot use the participation exemption according to federal and cantonal tax practices¹⁷⁴. This conclusion, outlined in the Circular Letter 25, is highly questionable as the aim of the participation exemption is to avoid any double taxation¹⁷⁵. To fully achieve this objective, access to the participation exemption should also be granted when Swiss capital companies and cooperatives hold, through CISs (not in the SICAF form), more than 10% of the nominal or share capital in the dividend-paying company at federal level, or share capital in the dividend-paying company with a market value of at least 1 million Swiss francs. This practice would be in line with the administrative practice in regard to partnerships granting the participation exemption to Swiss capital companies and cooperatives which hold, through partnerships, more than 10% of the nominal or share capital in the dividend-paying company at federal level, or hold share capital in the dividend-paying company with a market value of at least 1 million Swiss francs¹⁷⁶.

The same question arises, for instance, in respect of the partial taxation of dividends at the level of Swiss-resident investors of a CIS. The lack of a legal provision to this purpose may currently justify the refusal to grant partial taxation in such case. If one follows the principle of transparency, however, it is not clear why partial taxation should not be granted if the relevant requirements are fulfilled and can be proven¹⁷⁷. This is even more surprising

¹⁷² Art. 69 LDFT.

¹⁷³ Art. 69 LDFT.

¹⁷⁴ Para. 4.4. Circular 25; See therewith: HESS, thesis, p. 300-301; HESS/SCHERRER, *Kollektivanlagegesetz*, p. 440-441.

¹⁷⁵ OESTERHELT, *Basler Kommentar, Kollektivanlagegesetz*, nr. 204 et seq. ad. Vor Art. 1.

¹⁷⁶ See OESTERHELT, *Basler Kommentar, Kollektivanlagegesetz*, nr. 205 et seq. ad. Vor Art. 1.

¹⁷⁷ The tax authority could base the partial taxation on a literal interpretation of Art. 20 para. 1bis LDFT since the wording of this article only refers to Art. 20 para. 1 (c), but not to Art. 20 para. 1 (e). On the other hand, the refusal to grant partial taxation for income resulting from participations of private fortune could be based on para. 2 Circular 22 on Partial Taxation.

as, due comments submitted by the Swiss Funds and Asset Management Association and the Swiss Bankers Association, Art. 20 para. 1bis LDFT¹⁷⁸ does not explicitly speak of direct ownership of shares, even though this was initially the case in the original version of the provision as commented on in the Message of the Federal Council¹⁷⁹.

For this reason, the use of the term “*quasi transparent*”¹⁸⁰ is certainly more appropriate. With regard to other types of taxes, namely the withholding tax¹⁸¹, stamp duty¹⁸², real estate capital gains taxes in monistic cantons¹⁸³, real estate transfer tax¹⁸⁴ as well as the value added tax¹⁸⁵, CISs are never treated as transparent.

The non-taxation of the FCP as well as the LP is due to their lack of legal personality¹⁸⁶, and aligns with the requirements of Art. 49 para. 1 LDFT and Art. 20 para. 1 LDHT, as no legal persons are involved. However, it is remarkable that the SICAV enjoys equal tax treatment as it is organized in a corporate form and, as a consequence, is equipped with legal personality¹⁸⁷.

¹⁷⁸ Art 20 para. 1bis LDFT, headed “*Principle*” (“*Grundsatz*”), reads: “*Dividends (...) are to be taxed at a rate of 60% if these participations amount to at least 10% of the nominal or share capital of a capital company or cooperative company*”.

¹⁷⁹ KAPALLE/TAROLLI SCHMIDT, Kreisschreiben kollektiven Kapitalanlagen, p. 644.

¹⁸⁰ More precisely for income tax, profit tax, property tax and capital gain tax.

¹⁸¹ HESS, Commentary WHT, nr. 51 ad. Art. 5; OESTERHELT, Basler Kommentar, Kollektivanlagengesetz, nr. 35 et seq. ad. Vor Art. 1. However, this was not always the case. The previous regulation provided for the transparent treatment of an investment fund also for the purpose of compensation tax. See in this vein: PFUND, Investment trusts, p. 486 et seq. In detail see: Chapter 2.3.6.4.

¹⁸² OESTERHELT, Basler Kommentar, Kollektivanlagengesetz, nr. 4 in conjunction with nr. 11 et seq. ad. Vor Art. 1.

¹⁸³ OESTERHELT, Basler Kommentar, Kollektivanlagengesetz, nr. 4 in conjunction with nr. 144 et seq. ad. Vor Art. 1.

¹⁸⁴ OESTERHELT, Basler Kommentar, Kollektivanlagengesetz, nr. 4 in conjunction with nr. 163 et seq. ad. Vor Art. 1.

¹⁸⁵ WEIDMANN/ZINDEL, Basler Kommentar, Kollektivanlagengesetz, nr. 593 et seq. ad. Vor Art. 1.

¹⁸⁶ For a case involving a contractual fund, see: Swiss Federal Supreme Court Judgment of 11 July 1989, p. 14 et seq. (BGE 115 III 11); for limited partnership refer to: Swiss Federal Supreme Court Judgment of 11 October 1973, p. 2 (BGE 99 III 1); Swiss Federal Supreme Court Judgment of 16 November 1969, p. 549 (BGE 95 II 547).

¹⁸⁷ Technical Explanations CISA, p. 6420.

Following the wording of the law¹⁸⁸, a SICAV would actually have to be subject to income and capital taxes. The old Circular Letter 10 concerning Luxembourg SICAV-Funds was in support of this idea since it described a SICAV as a legal person¹⁸⁹, though a foreign one. “*A contrario*”, it must be concluded that the SICAV is, nevertheless, not a legal person in the sense of Art. 49 para. 1 LDFT and Art. 20 para. 1 LDHT, and is therefore to be treated as transparent for the purposes of income and capital taxes. The same conclusion can be drawn from Art. 10 para. 2 LDFT and Art. 7 para. 3 LDHT, according to which income and assets must be proportionately attributed to the investors. The Technical Explanations¹⁹⁰ and the practical specification from the FTA¹⁹¹ clearly state that the SICAV is not subject to income and capital taxes. This can be explained with and seen in light of the core principle of the CISA: “*same business, same risk, same rules*”¹⁹². However, in this regard, a more pertinent clarification or more careful drafting of the law would certainly have been to the benefit of those applying it¹⁹³.

2.3.4 Taxation of the Fund Management Company and the Investment Adviser

In the case of a contractual FCP, from a civil law perspective the fund assets belong to the fund management company. The fund management company which has its seat and effective place of management in Switzerland¹⁹⁴ is not taxed since it holds the fund assets for the investors in a way comparable to that of a fiduciary. In other words, the fund management company only has legal, but not beneficial ownership of the assets. However, it is not treated as a fiduciary and thus, the regulations on fiduciary relations¹⁹⁵ are not applicable. Nevertheless, the fund manager is not liable to tax¹⁹⁶. By analogy with a

¹⁸⁸ Art. 49 para. 1 LDFT; Art. 20 para. 1 LDHT.

¹⁸⁹ Art. 49 para. 3 LDFT.

¹⁹⁰ Technical Explanations CISA, p. 6429.

¹⁹¹ Para. 3.1 Circular 24.

¹⁹² Technical Explanations CISA, p. 6413.

¹⁹³ In this vein: OESTERHELT/WINZAP, *kollektive Kapitalanlagen*, Part I, p. 268.

¹⁹⁴ Art. 28 para. 1 CISA.

¹⁹⁵ Information on fiduciary relations of October 1967 issued by the Swiss Federal Tax Administration.

¹⁹⁶ HESS, thesis, p. 194; MÜLLER, *Investmentgesellschaft*, p. 102.

trustee, the fund manager is legally, but not economically or beneficially entitled to the fund assets¹⁹⁷ and must, at all times, consider the possibility of handing over the assets at the direction of the investors¹⁹⁸. The same applies to the investment adviser, which also lacks the economic benefit of the assets, consistent with the principle of financial capacity (*“Leistungsfähigkeitsprinzip”*; *“principe de l’imposition selon la capacité contributive”*)¹⁹⁹.

It must be kept in mind, however, that the fees which the fund management company receives must be taxed as income²⁰⁰. The same applies to the investment adviser, under the condition of being a tax resident in Switzerland.

2.3.5 Taxation of the Investor

2.3.5.1 Introduction

As already discussed, the flow-through character of Swiss CISs makes them transparent so that, in general, the income²⁰¹ and wealth²⁰² generated by the CIS is allocated directly and exclusively to the investors as if they had made the investments themselves. The income which passes through to investors retains its original character²⁰³. Proportionate parts of the aggregate income and wealth are allocated among the investors, even if, depending on the clas-

¹⁹⁷ See Chapter 3.3.

¹⁹⁸ WASSMER, thesis, p. 63; STEINER, thesis, p. 295; HESS/SIGG, Besteuerung der Anlagefonds und deren Anteilinhaber, p. 87.

¹⁹⁹ Art. 127 para. 2 FC.

²⁰⁰ Art. 50 LDFT resp. Art. 20 para. 2 LDHT. The investment adviser does not necessarily have to be organized under a capital company with its seat and headquarters in Switzerland. Provided that it is tax resident in Switzerland, the income it receives is covered by Art. 3 para. 2 LDFT resp. Art. 3 para. 2 LDHT.

²⁰¹ Art. 10 para. 2 LDFT resp. Art. 7 para. 3 LDHT. The income deriving from business assets will also be allocated, according to Art. 22 para. 1 (e) LDFT, directly and exclusively to the investors. See para. 3.3.2. Circular 25.

²⁰² Art. 13 para. 3 LDHT. The shares are calculated according to the Circular Letter on Withholding and Stamp Tax Law, para. 3.4.1. on the basis of NAV per 31 December of a respective calendar year.

²⁰³ This may depend on whether the CIS is classified as an accumulating or distributing fund.

sification of the CIS, there is no distribution being made “*per se*”. Swiss resident investors are subject to taxation at federal and cantonal/communal levels on all income generated by Swiss CISs and attributed to them. Such income is taxed as ordinary income with no special rates. The rate depends on the investor’s worldwide taxable income as well as his/her cantonal domicile in Switzerland.

The taxation of a Swiss resident investor in Switzerland, however, primarily depends on whether he/she holds the investment as his/her private or business asset²⁰⁴, and whether the CIS is classified as a distributing fund or an accumulating fund²⁰⁵.

If the investments are held as private assets, the taxation rule in Art. 20 para. 1 (e) LDFT resp. Art. 7 para. 3 LDHT²⁰⁶ applies, and so only income will be taxed²⁰⁷. However, if the investments of an individual are held as business assets, their taxation is determined by Art. 20 para. 1 (e) LDFT resp. Art. 7 para. 3 LDHT in addition, and so the investments will be subject to taxation in respect of any capital gains as well²⁰⁸. Consequently, it is obvious that the distinction between private and business assets has an important practical significance. In both cases, the income and assets of the CIS are taxable at the place where the investor resides in Switzerland²⁰⁹. Therefore, investors in a Swiss CIS who reside outside of Switzerland are not subject to unlimited

²⁰⁴ See Chapter 2.3.5.2.

²⁰⁵ See Chapter 2.3.5.3.

²⁰⁶ Art. 22 para. 1 (e) LDFT in conjunction with para. 3.3.2. Circular 25. Against: HESS, thesis, p. 299; less explicit or left open in AGNER/JUNG/STEINMANN, Commentary LDFT, nr. 16 ad. Art. 20; LOCHER, Commentary LDFT, nr. 149 ad. Art. 20.

²⁰⁷ The wording of Art. 20 para. 1 (e) LDFT is, however, incomplete as not only profits from direct real property holding are excepted from the assessment base of the income tax, but also the profits that go back to capital gains, as well as the repayments of capital. Therein: Para. 3.3.2. Circular 25; HESS, thesis, p. 301; REICH, Commentary LDFT, nr. 117 ad. 20; LOCHER, Commentary LDFT, nr. 151 ad. Art. 20; HESS/SCHERRER, Kollektivanlagegesetz, p. 394.

²⁰⁸ Art. 22 para. 1 (e) LDFT in conjunction with para. 3.3.3. Circular 25.

²⁰⁹ The case law of the Swiss Federal Supreme Court Judgment of 27 January 2000 = StE 2000 A 24.35 Nr. 1 E 3; Swiss Federal Supreme Court Judgment of 3 May 1972 (BGE 98 Ia 212); Swiss Federal Supreme Court Judgment of 8 May 1953 = ASA 22 (1953/1954) on non-commercial partnerships is also applicable to the LP.

tax liability, since no business within the meaning of Art. 4 para. 1 (a) LDFT resp. Art. 4 para. 1 LDHT occurs within Switzerland.

2.3.5.2 *Delimitation between Private and Business Assets*

In this chapter, the analysis will focus on investors holding investments in CISs as private assets²¹⁰. The distinction is of great practical importance since, if such investments are held as business assets, capital gains are subject to income tax, in addition to investment income²¹¹. Moreover, the taxation of income from business assets follows the principle of “*book value*” (“*Buchwertprinzip*”; “*principe de la valeur comptable*”)²¹², and it is irrelevant whether the income or capital gains are accumulated or distributed. Therefore, the distinction between private and business assets is of real importance. Private assets are defined negatively: what is not classified as a business asset according to Art. 18 para. 2 phrase 3 LDFT is considered a private asset. According to this Article, business assets are all assets which fully or predominantly serve self-employment. Thus, business assets require an individual to have an independent activity²¹³. According to the case law of the Swiss Federal Supreme Court, asset management can also constitute a form of self-employment if the requirements of a professional real estate dealer²¹⁴ or professional securities dealer²¹⁵ are met.

Under an FCP, SICAV or LP, it will also be important for the fund manager to determine whether its professional management of assets will be attributed to an investor holding investments as private or business assets. The CISA Technical Explanations, referring to an “*obiter dictum*” of the Swiss

²¹⁰ See Chapter 2.2.

²¹¹ Art. 18 para. 2 LDFT.

²¹² HESS/SCHERRER, *Kollektivanlagegesetz*, p. 394.

²¹³ LOCHER, *Commentary LDFT*, nr. 124 et seq. ad. Art. 18; YERSIN/NOËL, *Commentary LDFT*, nr. 1 et seq. ad. Art. 18; REICH, *Commentary LDFT*, nr. 5 ad. Art. 18; REICH, *Commentary LDHT*, nr. 5 ad. Art. 18.

²¹⁴ For further case law see: LOCHER, *Commentary LDFT*, nr. 25 et seq. ad. Art. 18; Circular letter 8 of 21 June 2005.

²¹⁵ Swiss Federal Supreme Court Judgment of 2 December 1999 = StE (2000) B 23.1 Nr. 45 = ASA 69 (2000/01), p. 789 et seq.

Federal Supreme Court²¹⁶, states that the *actions* of the fund manager cannot be attributed to the investors. The investors are not qualified as professional securities dealers based solely on the actions of the fund manager²¹⁷. This applies on condition that the investor himself does not have an influence on the investment strategy of the CIS²¹⁸. Since it is now ensured by statute that there is an actual separation between the investors in and the manager of a CIS, the practice under the investment funds law within the scope of the CISA is also valid for the new forms of CIS, such as the SICAV and LP²¹⁹. This also applies to fund managers which may personally participate in the CISs that they administer.

This does not mean, however, that investments in CISs may never be classified as business assets. A taxpayer may be considered a professional securities dealer by reason of his investments in CISs when he/she fulfills the requirements of the Federal Court's case law (short holding period, variety and frequency of transactions, financing by debt, connection with professional activity, use of specialized know-how, etc.)²²⁰. However, in practice, only the holding period and the financing of the units are truly decisive. If the purchase of securities is completely leveraged, the financial risk assumed justifies on its own the assumption of the activity directed at the purchase²²¹. The professional management of fund assets through a fund manager is, however, inconsequential for such a taxpayer. Toni Hess has stated that CIS interests are only regarded as business assets when the investor himself has a direct influence on the investment strategy of the CIS²²². However, whether an investor is a professional securities dealer and, consequently, the units of the CIS are business assets may only be determined after evaluating the personal

²¹⁶ Swiss Federal Supreme Court Judgment of 21 October 1996 = ASA 66 (1997/1998), p. 377 et seq.

²¹⁷ Para. 3.3.1 Circular Letter 24; Technical Explanations CISA, p. 6430.

²¹⁸ Technical Explanations CISA, p. 6430

²¹⁹ Technical Explanations CISA p. 6430.

²²⁰ Circular 8; Swiss Federal Supreme Court Judgment of 18 September 1997 = StE 1998 B 23.1 Nr. 38

²²¹ Swiss Federal Supreme Court Judgment of 9 July 1999 = ASA 69, p. 652

²²² HESS, thesis, p. 306.

situation of a given taxpayer²²³, and the result may vary from canton to canton.

2.3.5.3 *Distinction between Distributing and Accumulating Funds*

For Swiss tax purposes, a distinction must be drawn between distributing funds (“*Ausschüttungsfonds*”; “*fonds de distributions*”) and accumulating funds (“*Thesaurierungsfonds*”; “*fonds d’accumulation*”)²²⁴. The distinguishing factors are the distribution policy of the CIS and any distribution obligations comprised in the constitutional documents²²⁵ approved by the regulatory authorities²²⁶. All CISs that must distribute at least 70% of their net profit (including net income and income carried forward from previous years) are subject to the taxation rules applicable to distributing funds²²⁷. In this respect, it should be noted that undistributed and, consequently, retained profits may be accumulated without any income or withholding tax consequences²²⁸. What is decisive for the characterization as a distributing fund is not only the actual distribution of at least 70% of the net profits, but also the existence of an obligation thereto in the constitutional documents.

On the other hand, an “*accumulating fund*” is defined negatively, in that all CISs which do not qualify as distributing funds are subject to the taxation rules applicable to accumulating funds²²⁹. More precisely, an accumulating fund is a fund that is not under the obligation to distribute more than 70% of its net profits²³⁰. A positive legal definition would certainly have been more

²²³ SPORI, Portfolio-Anlagen, p. 381 in conjunction with Footnote 128; HESS, thesis, p. 304 et seq.; HESS/SCHERRER, Kollektivanlagegesetz, p. 394; AGNER/JUNG/STEINMANN, Commentary LDFT, nr. 2 ad. Art. 49.

²²⁴ Para. 2.1.2 Circular 24.

²²⁵ Constitutional documents include a fund agreement and possibly a prospectus for a FCP; statutes, investment regulations and possibly a prospectus for a SICAV, a partnership agreement as well as possibly a prospectus for a LP.

²²⁶ Para. 2.1.2 Circular 24.

²²⁷ Para. 2.1.2 and 2.1.5.3 Circular 24. This Article corresponds to the regulation of the previous law of Circular 2 of 23 November 1989.

²²⁸ Para. 2.1.5.3 Circular 24.

²²⁹ Para. 2.1.2 Circular 24.

²³⁰ HEUBERGER/OESTERHELT, Collective Investment Vehicles, p. 31.

practical and desirable. In an accumulating fund, both accumulated (reinvested or undistributed) and distributed profits are being taxed in the hands of Swiss resident investors, which, for direct tax purposes, fulfill the concept of transparency. The income is considered realized when it is entered into the CIS's accounts²³¹. Unlike distributing funds, profits may not be neutrally accumulated as far as income and withholding taxes are concerned, even though no distribution actually occurs.

2.3.6 Taxation of Investments made by Collective Investment Schemes

This chapter deals with the tax consequences of investments made by CISs from both a domestic and an international tax perspective. Chapter 2.3.6.1 deals exclusively with investments made in Switzerland, where all parties involved (the CIS, the investor and the investment itself) are located in Switzerland. Under these circumstances, DTC provisions do not need to be analyzed or applied, since only Swiss domestic tax law comes into play. Accordingly, this Chapter outlines the Swiss withholding tax levied at the investment level and at the level of the CIS, as well as whether there is a procedure for the CIS or resident investors to obtain a refund of such withholding tax, and the applicable reporting procedures. These last two sections, therefore, outline the impact of the Swiss withholding tax at the investor level first, and then at the level of the CIS level. Lastly, this chapter analyses the case of a Swiss investor with investments in a third country.

The subsequent Chapter 2.3.6.5 serves merely as an introduction to the relevant problems arising from "*cross-border scenarios*". These situations are discussed in greater detail in Chapter 6 and Chapter 7. It should be noted that in "*cross-border scenarios*", domestic Swiss tax law applies. The analysis outlined in this chapter is an overview of the mechanisms provided by Swiss domestic law in order to avoid the Swiss withholding tax on distributions from Swiss CISs to foreign investors, with an emphasis on the exemption and reimbursement methods. Also, the chapter explains the systematic inconsistency regarding Switzerland's taxation right as the source state at the CIS level from a Swiss domestic law and international/cross-border perspective.

²³¹ Para. 3.3.2 Circular 25.

2.3.6.1 *Investments Made in the Residence State: “Fully-Domestic Scenario”*

Source income taxation arising in the context of a *domestic scenario*, in which all the parties, including the CIS, the investor and the investment itself, are domiciled or located in Switzerland, does not raise any particular issues because in such circumstances only Swiss domestic tax law has to be taken into consideration. Consequently, no problems are encountered regarding a refund claim for Swiss withholding tax (“*Verrechnungssteuer*”; “*impôt à la source*”). First, income received by the CIS may be subject to Swiss withholding tax at the investment level²³². Second, income paid may be subject to withholding tax at the level of the CIS²³³, depending on its distribution character²³⁴. Most countries, such as Switzerland, have structured their domestic tax laws in order to avoid any double taxation²³⁵ or double non-taxation²³⁶. CISs must be a viable economic alternative to direct investments and should not result in a higher tax burden²³⁷. However, special attention must be paid to taxation at these two levels since, in an international context, this particularity is an important disadvantage for Switzerland in comparison to other “*fund centers*” which do not levy withholding tax at the level of the distribution to investors²³⁸. The repayment of capital, income from real estate, as well as the distribution of capital gains are not subject to withholding tax if declared through a separate coupon, and so these have become increasingly important for Switzerland in its attempts to stand out as an international fund center.

²³² See Chapter 2.3.6.2.

²³³ See Chapter 2.3.6.4.

²³⁴ See Chapter 2.3.5.3.

²³⁵ See Chapter 4.1.4 for a definition of “*double taxation*”.

²³⁶ See Chapter 4.1.6 for a definition of “*double non-taxation*”.

²³⁷ Amongst others: HELMINEN, *The Dividend Concept*, p. 11 et seq.

²³⁸ OESTERHELT/WINZAP, *kollektive Kapitalanlagen*, Part I, p. 270. Prominent international fund centres such as Luxembourg, Ireland, the United Kingdom as well as offshore jurisdictions such as Jersey, Guernsey, Bermuda, the British Virgin Islands and the Bahamas do not have source taxation on distributions or on accumulated profits. However, other countries, such as Switzerland, may levy withholding tax at the CIS level. For a detailed analysis see: BONGAARTS/ED, *General report on the taxation of investment funds*, p. 39.

2.3.6.2 *Swiss Withholding Tax at the Investment Level*

In Switzerland, withholding tax is levied on certain income deriving from investments, such as interest from Swiss bonds and other similar debt instruments, interest on deposits with Swiss banks, profit distributions (dividends) from Swiss legal entities, and profit distributions from CISs²³⁹, at a rate of 35%²⁴⁰. However, as mentioned previously, the repayment of capital, income from real estate, and the distribution of capital gains are not subject to Swiss withholding tax so long as they are declared through a separate coupon²⁴¹.

2.3.6.3 *Refund of Swiss Withholding Tax for the Benefit of the Swiss Collective Investment Scheme*

In terms of the Swiss CIS obtaining a refund of Swiss withholding tax, it is irrelevant whether the CIS is a distributing fund or an accumulating fund²⁴² - the Swiss CIS (unless it is a SICAF²⁴³) is entitled to claim a full refund of the

²³⁹ Art. 4 para. 1 WTL.

²⁴⁰ Art. 13 para. 1 (a) WTL.

²⁴¹ Art. 5 para. 1 (b) WTL.

²⁴² In addition, under the previous Swiss federal legislation governing investment funds the Federal Tax Administration did not distinguish between accumulating and distributing funds in this context. See therein: HESS, thesis, p. 492 et seq.

²⁴³ A SICAF cannot file a refund claim based on Art. 26 WTL because the profits are not subject to the withholding tax by virtue of Art. 4 para. 1 (c) WTL, but based on the equalization of capital companies pursuant to Art. 9 para. 3 phrase 2 WTL. A SICAF, however, can reclaim the withholding tax that would be levied on securities based on Art. 24 para. 2 WTL. See Chapter 2.1.3 for a definition of the term “*Collective Investment Schemes*”. SICAFs and Real Estate Funds are outside the scope of the present tax analysis.

35% Swiss withholding tax²⁴⁴ levied on Swiss investments. The refund is requested by the fund manager in the case of a FCP, by the company itself in the case of a SICAV, or by the general partner in the case of a LP²⁴⁵.

However, the Swiss CIS must fulfill a number of conditions in order to claim a refund of Swiss withholding tax. The first theoretical condition to be met is that of Swiss “*beneficial ownership*”, that is to say, the “*right to use*” (“*Recht zur Nutzung*”; “*droit de jouissance*”)²⁴⁶. It is important to note that, in practice, this requirement is rarely determinative for a CIS²⁴⁷. For instance, within a FCP, the “*right to use*” belongs to the investors and not to the fund management company²⁴⁸, due to the fiduciary relationship in place. The reimbursement of the Swiss withholding tax to individual investors would be inefficient in practice, as it would be difficult, not to say impossible, for investors to prove the requisite condition for a refund. Furthermore, a CIS may have thousands of investors each requesting a refund, which would impose an overwhelming burden on tax administrations for possibly very small amounts. For the sake of efficiency and simplicity, the refund claim should be made by the CIS²⁴⁹. The other requirements such as the “*absence*

²⁴⁴ Art. 26 WTL in conjunction with HESS, Commentary WHT, p. 633 et seq. and para. 2.1.7 Circular 24. A SICAV and an LP can reclaim withholding tax under either Art. 26 WTL or Art. 24 para. 2 WTL. For further details: OESTERHELT, Basler Kommentar, Kollektivanlagengesetz, nr. 271 ad. Vor Art. 1. However, according to the Federal Tax Administration the SICAV and LP can reclaim the withholding tax only under Art. 26 WTL and clearly not under Art. 24 para. 2 WTL. According to Art. 26 WTL the “*right to use*” requirement must not be met. See: OESTERHELT, Basler Kommentar, Kollektivanlagengesetz, nr. 274 ad. Art. 1.

²⁴⁵ The refund claim pursuant to Art. 26 WTL is defined too narrowly: an “*incorporated*” resident liable to tax under Art. 4 para. 1 (c) should also be entitled to a refund, if the fund administration and depositary bank are located abroad. See: HESS, Commentary WHT, p. 636.

²⁴⁶ Art. 21 para. 1 (a) WTL. For further details see: PFISTER, Rückerstattung der Verrechnungssteuer an inländische Investoren transparenter ausländischer kollektiver Kapitalanlagen, p. 22 and Chapter 6.5.2.1.2.

²⁴⁷ OESTERHELT, Basler Kommentar, Kollektivanlagengesetz, nr. 274 ad. Art. 1; OESTERHELT/WINZAP, kollektive Kapitalanlagen, Part III, p. 131.

²⁴⁸ HESS, Commentary WHT, nr. 2 ad. Art. 26.

²⁴⁹ HESS, Commentary WHT, nr. 3 ad. Art. 26.

of tax avoidance” (“*Steuerumgehung*”; “*évasion fiscale*”)²⁵⁰, “reimbursement within a timeframe”²⁵¹ (“*Rückerstattungsanspruch innerhalb einer Zeitfrist*”; “*remboursement dans un certain délai*”²⁵², “domicile” (“*Wohnsitz*”; “*domicile*”)²⁵³ and “reporting” (“*Deklaration*”; “*déclaration*”)²⁵⁴ shall not be analyzed in detail, since their fulfillment does not “*per se*” depend on the existence of a CIS.

2.3.6.3.1 Reporting Procedure for Qualified Holdings

The reporting procedure (“*Meldeverfahren*”; “*déclaration remplaçant le paiement*”) for withholding tax pursuant to Art. 26a WTO is also applicable to profits from qualified holdings of CISs since 1 January 2009²⁵⁵. In the past, its application was limited to capital companies and cooperatives. This procedure is now also granted for CISs that directly hold at least 10%²⁵⁶, but according to Art. 26a WTO at least 20% of the nominal or share capital of a Swiss company or cooperative²⁵⁷ which is entitled to a refund of withholding tax²⁵⁸. The discrepancy can be explained due to the fact that the WTO has not been updated yet. The effect of the reporting procedure for qualified holdings is that dividends for which the decision of payment was made during an ordinary or extraordinary general meeting²⁵⁹ may be paid out gross without being subject to Swiss withholding tax.

²⁵⁰ Art. 21 para. 2 WTL.

²⁵¹ Art. 32 para. 1 WTL.

²⁵² Art. 31 para. 1 WTL.

²⁵³ Art. 22 para. 1 WTL.

²⁵⁴ Art. 25 WTL.

²⁵⁵ Art. 26a WTO in conjunction with para. 2.1.7.2 Circular 24.

²⁵⁶ Para. 2.1.7.2.1 Circular Letter 24.

²⁵⁷ Para. 2.1.7.2 Circular 24 in conjunction with Art. 26 para. 1 WTO.

²⁵⁸ Art. 26 para. 3 WTO.

²⁵⁹ The reporting procedure is also applicable to the liquidation of dividends in cash. However, it is not applicable to the payment of in-kind, interim, natural dividends or bonus shares.

2.3.6.4 *Swiss Withholding Tax at the Collective Investment Scheme Level*

For the purposes of Swiss withholding tax, CISs are not treated as fiscally-transparent. All distributions made to investors (as well as retained profits by accumulating funds) are subject to the Swiss withholding tax at a 35% rate²⁶⁰, regardless of whether fund assets are invested in domestic or foreign securities²⁶¹. Moreover, even a foreign CIS may be subject to Swiss withholding tax if it is qualified as tax resident pursuant to Art. 9 para. 1 WTL²⁶². To qualify as such, the SICAV or LP must either have its seat in Switzerland or must be effectively managed from Switzerland. In the case of a FCP, the units are not issued by the FCP itself but rather by the fund manager. It is therefore decisive for the fund manager to either have its statutory seat (registered office) in Switzerland or be effectively managed from Switzerland. However, the repayment of capital, income from real estate and the distribution of capital gains are not subject to the Swiss withholding tax as long as they are declared with a separate coupon²⁶³. Moreover, undistributed income of a distributing fund is not subject to the withholding tax as long as it remains undistributed.

In the case of the SICAV and the LP, the CIS itself is the taxpayer for withholding tax²⁶⁴, unlike the FCP in which the taxpayer is the fund manager.

²⁶⁰ Art. 13 para. 1 (a) WTL.

²⁶¹ HESS/SCHERRER, Kollektivanlagegesetz, p. 388.

²⁶² See for further details: Para. 3.1.2 Circular 24; HESS/SCHERRER, Kollektivanlagegesetz, p. 388; OESTERHELT, Basler Kommentar, Kollektivanlagengesetz, nr. 41 et seq. ad. Vor Art. 1. See thereto a court decision which characterized a Liechtenstein CIS being managed from Switzerland as a Swiss resident pursuant to Art. 9 para. 1 WTL, with the result that the foreign CIS was subject to withholding tax in Switzerland. Swiss Federal Supreme Court Judgment of 2 February 1978 (BGE 104 Ib 280) = ASA 49 (1980/81), p. 133 = Pra 68 (1979), 26 ff. (Nr. 10). Furthermore, para. 3.1.2 Circular 24 enumerates which services (investment, fund administration, depositary bank function, product management, various activities in connection with an administrative board) can be conducted from Switzerland without the risk of triggering a qualification of resident for withholding tax purposes.

²⁶³ Para. 3.3.2 Circular 25; Art. 5 para. 1 (b) WTL; Art. 28 para. 1 WTO.

²⁶⁴ Art. 10 para. 2 WTL.

The deduction of withholding tax must occur at the time that the distribution is paid out to investors²⁶⁵.

2.3.6.4.1 Refund of Swiss Withholding Tax to Swiss Resident Investors

Swiss resident investors are able to claim a refund of the withholding tax based on Art. 22 para. 1 WTL, regardless of whether the fund is a distributing or accumulating fund²⁶⁶. The withholding tax can generally be reclaimed by individuals or investors if they fulfill the conditions discussed in the foregoing chapter²⁶⁷.

2.3.6.4.2 Reporting Procedure for Qualifying Investors

CISs with qualifying investors can use the reporting procedure to fulfill their withholding tax obligation²⁶⁸ to the extent that qualifying beneficiaries would themselves have been entitled to claim a refund of the withholding tax²⁶⁹. Qualifying investors in the sense of Art. 38 para. 1 (a) WTO are *“tax-exempt (emphasis added by the author) domestic institutions of professional provision, social security and compensation funds, assurance companies subject to the supervision of the state or domestic public assurance companies”*.

2.3.6.5 *Investments Made in the Source State: “Cross-Border Scenario”*

In this chapter, a brief overview in relation to CISs in a *“cross-border scenario”* will be presented in advance of the detailed analysis and examination in chapter 6 as regards the application of DTCs to CISs. This chapter presents in detail the mechanisms offered by Swiss domestic law in order to avoid the levy of Swiss withholding tax on distributions from Swiss CISs to foreign investors, in particular the exemption (Art. 11 para. 2 WTL in con-

²⁶⁵ Art. 14 para. 1 WTL in conjunction with para. 2.1.5.3 Circular 24.

²⁶⁶ In this vein: OESTERHELT, Basler Kommentar, Kollektivanlagengesetz, p. 76.

²⁶⁷ See Chapter 2.3.6.3.

²⁶⁸ Para. 2.1.6.1 Circular 24.

²⁶⁹ Art. 38 para. 2 (a) WTO; Para. 2.1.6.1.1 Circular 24.

nection with Art. 34 para. 1 WTO) and reimbursement (Art. 27 WTL) methods. At the end of this chapter the systematic inconsistency regarding Switzerland's taxation right as the source state at the CIS level will be outlined from a Swiss domestic law and international/cross-border perspective.

Taxation of income at source, arising in the context of a "*cross-border scenario*", is far more complex and uncertain²⁷⁰ than the *fully-domestic scenario*, due to the lack of provisions addressing the issues concerning CISs and DTCs²⁷¹. The tax treatment that applies in a purely "*domestic scenario*" will not generally be satisfactory in a "*cross-border scenario*", as CISs are "*ipso facto*" not entitled to treaty benefits. This non-applicability may be due to different elements such as the legal form of the CIS itself, the lack of attention paid to CISs by the applicable Swiss DTCs²⁷² or due to incomplete relief from domestic taxes²⁷³. Some provisions were included in the 2010 OECD Commentary in an attempt to deal with the uncertainties²⁷⁴. However, such uncertainties will remain in the absence of worldwide harmonization – the fact that there are substantial differences from country to country, and the preference of countries to deal with this complexity on an individual and pragmatic basis instead of attempting to introduce a coherent worldwide tax system based on uniform principles.

In conclusion, the lack of clearer provisions regarding the application of DTCs to CISs as well as the uncertainties resulting from the above factors have lead to heterogeneous and inconsistent practices. Unfortunately, there is no case law available which is able to shed light on this matter. Even the Federal Tax Administration has not communicated its official position²⁷⁵.

²⁷⁰ PATO, Investment Funds, p. 197; AMONN, General report on the fiscal treatment of international investment trusts and mutual funds, p. 70.

²⁷¹ Among others: BAKER & MCKENZIE, Kollektive Kapitalanlagen, p. 209 et seq.

²⁷² The only Swiss DTC provision that, until recently, contained rules on the treaty entitlement of CISs, was Art. 27 Nr. 9 of the DTC with the United Kingdom, which was abolished by the revision protocol of 26.06.2007 as of 31.12.2008. In this vein also: BONGAARTS/ED, General report on the taxation of investment funds, p. 43.

²⁷³ AMONN, General report on the fiscal treatment of international investment trusts and mutual funds, p. 72.

²⁷⁴ OECD Commentary 2014, nr. 6.8-6.34 ad Art. 1.

²⁷⁵ With the exception of special bilateral agreements (known as Memorandum of Understanding) that have been concluded with certain Contracting States in regards to the application of DTCs to CISs.

Consequently, international legal systems are not yet prepared nor equipped to appropriately respond to the taxation of cross-border activities. In the words of John Avery Jones: “*Taxpayers have become global; tax authorities have not*”²⁷⁶. The taxation of CISs has been discussed on several occasions in the course of the IFA World Conventions (1962 in Athens, 1971 in Washington, 1997 in New Delhi and most recently at a seminar held in Kyoto in 2007). In this context, on 31 May 2010, the OECD Committee published a report titled “*The Granting of Treaty Benefits with respect to Income of Collective Investment Vehicles*”²⁷⁷. In its first part, “*de lege lata*”, the report deals with the interpretation of the general provisions regarding the personal scope of application and the treaty entitlement of CISs. In its second part, “*de lege ferenda*”, it proposes specific treaty provisions to be included in future DTCs. Both the interpretation by the OECD Committee and the proposals regarding specific treaty provisions will be examined in more detail below.

However, on closer inspection, concurrent double (or multiple) taxation may arise due to the existence of two levels of taxation - as is the case in a “*domestic scenario*”. On the first level, the country where the investment is located may, as the source state, levy withholding tax on dividends or interest payments at the level of the investment (source taxation)²⁷⁸, whereas realized and distributed capital gains²⁷⁹ as well as other income²⁸⁰ are usually not subject to taxation in the source state but in the residence state. On the second level, the country of residence of the CIS and its investors may, depending on its domestic law, subject the investor to withholding tax at the level of the CIS (source taxation). Generally, distributed income is additionally taxed at

²⁷⁶ AVERY JONES, Are Tax Treaties Necessary, p. 53.

²⁷⁷ See Footnote 1237.

²⁷⁸ As stated in Chapter 3.2, it is presumed in this analysis that the activity carried out by the CIS in the source state does not create a permanent establishment but a portfolio investment. In the case of a permanent establishment, the taxation would be made by an assessment and, therefore, not by way of a withholding tax.

²⁷⁹ Art. 13 para. 5 OECD Model.

²⁸⁰ Art. 21 OECD Model. See for further details with regard to Art. 21 OECD Model on other income: Chapter 2.3.6.5.3.

the level of the investor, based on the principle of worldwide income taxation, by means of a final annual tax assessment (residence taxation)²⁸¹.

“*Prima facie*” therefore, investments made in the source state in a “*cross-border scenario*” through a foreign CIS constituted in a contractual form appear satisfactory, since the foreign investors²⁸² and not the FCP²⁸³ may be eligible for DTC benefits. In Switzerland, the concept of transparency is followed in this case due to the nature of the contractual arrangement. Following the Report of Athens of 1962, several countries have allowed direct relief from domestic withholding taxes on the basis of domestic regulations. Moreover, some countries have even agreed in DTCs to refund foreign withholding taxes²⁸⁴. A few Swiss DTCs included specific provisions concerning their application to CISs by way of amendments to DTCs concluded with some contracting states, such as Australia, Denmark, Germany, France, the United Kingdom²⁸⁵, Japan, Canada, the Netherlands, Norway, Austria, Sweden and Spain²⁸⁶. Only the amendments to the DTCs with Denmark and the United Kingdom explicitly indicate, besides FCPs, that SICAVs and LPs are entitled investment forms²⁸⁷. It is remarkable to observe that the number of DTCs including such provisions has increased; this had already been noticed in the

²⁸¹ As for instance in Switzerland according to Art. 6 para. 1 resp. Art. 52 para. 1 LDFT.

²⁸² Para. 2.1.10.1 Circular 24; HESS, thesis, p. 530; AMONN, *Steuerprobleme der schweizerischen Investment-Trusts*, p. 339; SCHERER/BURGY, *National report on the taxation of investment funds*, p. 812.

²⁸³ LOCHER, *Einführung internationales Steuerrecht Schweiz*, p. 208; ALTENBURGER, *Taxation of Swiss-based investment funds and certificate holders*, p. 87 et seq.

²⁸⁴ In this vein: AMONN, *General report on the fiscal treatment of international investment trusts and mutual funds*, p. 72.

²⁸⁵ Until 31 December 2008, the DTC between Switzerland and the UK provided for the treaty entitlement of investment funds in Art. 27 para. 9 (for the origin of the provision see MÉNÉTREY, *Modification de la convention*, p. 545 et seq.). However, this provision was revoked with the revision protocol of 27 June 2007 as of 31 December 2008 and replaced with the above mentioned regulation. Since then, CISs must rely on the revision protocol in order for treaty benefits to be applicable to shareholders residing in Switzerland.

²⁸⁶ Annex III of Circular 24.

²⁸⁷ Annex III of Circular 24. The other amendments to the DTC, which do not yet explicitly indicate the entitled investment forms, must be analogically applied to FCPs, SICAVs and LPs. In this vein also: OESTERHELT, *Basler Kommentar, Kollektivanlagengesetz*, nr. 291 ad. Vor Art. 1.

General Report of the International Fiscal Association from 1997 published by Lynne J. Ed and Paul J. M. Bongaarts²⁸⁸. According to these amendments, DTC benefits may be claimed fully²⁸⁹ or partially²⁹⁰ by CISs on behalf of, and by reference to, qualifying Swiss resident investors in Switzerland²⁹¹.

However, a closer examination reveals administrative difficulties which arise with regards to the relief of withholding tax collected on income. The solution seems simple only in theory. Practically, this situation leads to complications and inadequacies because interests in CISs are frequently held through layers of intermediaries²⁹² and so the cost connected with this bears, as a rule, scant relation to the potential refund claim²⁹³. To be able to apply the corresponding DTC, the investor must be able to provide evidence that it indirectly receives income, for example, dividend or interest payments, through a CIS, which is not always easy to document. In some cases, such evidence cannot be provided and the tax administration will argue that the investor receives revenue from a CIS and not proceeds from Swiss securities. Such a formalistic approach would prevent the application of a DTC²⁹⁴. Hence, relief from a DTC is often illusory for investors and thus, in most cases, may end up “*going unclaimed*”²⁹⁵. This is clearly to the advantage of the tax administration as they earn money without providing the service of

²⁸⁸ BONGAARTS/ED, General report on the taxation of investment funds, p. 43.

²⁸⁹ A full refund of the withholding tax collected on interest can be claimed under the DTC with Denmark (Art. 11 para. 1 DTC CH – DK), Germany (Art. 11 para. 1 DTC CH – D), France (Art. 12 para. 1 DTC CH – F), Norway (Art. 11 para. 1 DTC CH – N) and Austria (Art. 11 para. 1 DTC CH – A). A full refund of the withholding tax collected on dividends can only be claimed under the DTC with Denmark (Art. 10 para. 1 DTC CH – DK).

²⁹⁰ The withholding tax collected on dividends can be reduced by 15% under the DTCs with Australia (Art. 10 para. 2 DTC CH-AUS), Germany (Art. 10 para. 2 (c) DTC CH – D); France (Art. 11 para. 2 (a) DTC CH – F), Japan (Art. 10 para. 2 (b) DTC CH – J), Canada (Art. 10 para. 2 (c) DTC CH – CAN), Norway (Art. 10 para. 2 DTC CH – N), Austria (Art. 10 para. 2 DTC CH – A), Sweden (Art. 10 para. 2 phrase 1 DTC CH – S) and Spain (Art. 10 para. 2 (b) DTC CH – E).

²⁹¹ Annex III of Circular 24.

²⁹² CFA Report, nr. 20.

²⁹³ LUSSEER, Anlagefonds, p. 26.

²⁹⁴ In this vein: OESTERHELT/WINZAP, kollektive Kapitalanlagen, Part III, p. 135.

²⁹⁵ CFA Report, nr. 37.

processing the claims. Indeed, if such claims were actually made, the tax administration would undoubtedly be overwhelmed²⁹⁶.

In such a scenario, cross-border double taxation²⁹⁷ (or double non-taxation²⁹⁸) is likely to arise. Concurrent double or multiple tax charges may be eliminated by either unilateral provision in the relevant domestic law²⁹⁹; the existence and application of DTCs³⁰⁰ - the focus of this study - or, rarely, by multilateral³⁰¹ or supranational³⁰² measures. In reality, these measures are often insufficient to eliminate the imbalances to the principle of tax neutrality which arise from the interference between tax jurisdictions. Despite this, attention must be paid to the relevant DTC between the source state and the residence state which, as a result, may reduce the rate of the withholding tax on dividend and interest payments in the source state, combined with an exemption or a relief in the residence state for taxes paid in the source state³⁰³.

2.3.6.5.1 Exemption and Reimbursement Methods based on Domestic Law (if at least 80% of Income is from Foreign Sources)

In Swiss domestic law there are two important exceptions to the above rules for foreign investors³⁰⁴. The first is the “*exemption method*”, also known as

²⁹⁶ This has already been stated by the General Report of 1962 in Athens by RENK, General report on fiscal problems with investment trusts, LXIX-LXX.

²⁹⁷ Please refer to Chapter 5.1.3 for a definition of “*double taxation*”.

²⁹⁸ See Chapter 4.1.4.

²⁹⁹ See thereupon Chapter 4.2.1.1.

³⁰⁰ Please refer to Chapter 4.2.1.2.

³⁰¹ See thereupon Chapter 4.2.1.3.

³⁰² See thereupon Chapter 4.2.1.4.

³⁰³ Art. 23 A and B OECD Model.

³⁰⁴ A foreign investor is considered to be a person who is not a Swiss resident. Nationality does not play any role (in this vein: HESS, thesis, p. 514). Also, it is irrelevant whether the foreign investor is a resident of a Contracting State with which Switzerland has concluded a DTC (such as offshore jurisdictions for instance). Many different entities, such as foreign foundations and trusts for example, may be considered foreign investors for purposes of the affidavit procedure if the requirement of the “*right of use*” is fulfilled. For further details see: HESS, Entlastung von Quellensteuern auf Zinsen und Dividenden bei Anlagefonds und Anteilsinhabern, p. 23. However, one must bear in mind that the Federal Tax Administration can, at any time, restrict the circle of foreigners

the “*affidavit procedure*”, in which CISs, according to Art. 11 para. 2 WTL in connection with Art. 34 para. 1 WTO, have the possibility to not levy a withholding tax on distributions paid out to foreign tax residents at the level of the CIS. Therefore, in the case of accumulating funds, a reinvestment of 100% of the generated profits is possible³⁰⁵. The second exception is the “*reimbursement method*”, according to which the Swiss withholding tax deducted from the CISs can be fully reclaimed by foreign resident investors pursuant to Art. 27 WTL³⁰⁶. These two methods are only applicable provided that at least 80% of the CIS’s income derives from foreign sources and that the investor is domiciled outside of Switzerland³⁰⁷. It is irrelevant whether the investor resides in a state with which Switzerland has concluded a DTC³⁰⁸. However, if the CIS generates less than 80% of its profits from foreign sources, Art. 27 WTL is not applicable and the only available possibility is a refund claim based on a DTC between the foreign investor’s country of residence and the country of source³⁰⁹.

(Art. 36 para. 3 WTO), for whom a certificate of residence can be issued. If a foreign investor is merely interposed by use of an offshore company and the income actually accrues directly or indirectly to a resident, the Federal Tax Administration can deny the application of the affidavit procedure (OESTERHELT, Basler Kommentar, Kollektivanlagengesetz, nr. 122 ad. Vor Art. 1; HESS, thesis, p. 514-515). In doubtful cases, the affidavit statement will not be issued until proof is provided that all beneficiaries are domiciled or seated abroad (Para. 2.1.5.6.3 Circular 24).

³⁰⁵ The withholding tax must be collected for Swiss investors; this triggers the necessity to separate domestic and foreign investors over varied classes of shares. In practice, however, compliance with such limitation is difficult to achieve.

³⁰⁶ HESS, Entlastung von Quellensteuern auf Zinsen und Dividenden bei Anlagefonds und Anteilsinhabern, p. 21.

³⁰⁷ Foreign sources include, for example, profits from foreign shares, bonds, investment funds and real estate located abroad. Capital gains issued through a separate coupon are not subject to the withholding tax and therefore, are not taken into consideration when determining income of foreign source. For further information: HESS, thesis, p. 516-517; para. 2.1.9.2.4 Circular 24; PFUND/ZWAHLEN, Commentary WTL, nr. 37 ad. Art. 11; HESS, Entlastung von Quellensteuern auf Zinsen und Dividenden bei Anlagefonds und Anteilsinhabern, p. 21.

³⁰⁸ ALTENBURGER, Taxation of Swiss-based investment funds and certificate holders, p. 87 et seq.; HESS, Commentary WTL, p. 646.

³⁰⁹ See Chapter 2.3.6.5.2.

With the introduction of these rules, Switzerland has reinforced its competitiveness as a location for investments in CISs by foreign investors³¹⁰. The Swiss fund business could never have developed to the level it has without these rules³¹¹. Nevertheless, it is questionable whether the 80% threshold has been set too high³¹². If the threshold were reduced, CISs would be able to invest more than 20% of their assets in Swiss investments without having to levy Swiss withholding tax on their distributions to foreign investors.

2.3.6.5.2 Reimbursement Method based on Double Tax Conventions (if less than 80% of Income is from Foreign Sources)

A foreign resident investor in a CIS which receives less than 80% of its income from foreign sources cannot benefit from the “*affidavit procedure*”. The only possible way for such an investor to potentially claim a refund of the withholding tax in the source state would be through the use of a DTC. As a general rule, fiscally-transparent (“*flow-through*”) entities cannot benefit from a DTC. However, if a DTC were to apply between the foreign investor (resident state) and the CIS (source state) it is uncertain to what extent Switzerland, as the source state, should have the right to tax the CIS’s distributions in this “*cross-border scenario*”, since the distributions are not covered³¹³ by the dividend Article of the DTC³¹⁴, nor by the interest Article³¹⁵. However, it would be covered by the “*catch-up clause*” in Art. 21 OECD

³¹⁰ OESTERHELT, Basler Kommentar, Kollektivanlagengesetz, nr. 121 ad. Vor Art. 1.

³¹¹ In this vein: HESS, Commentary WHT, p. 646.

³¹² At the WTL’s consultation stage as explored by Toni Hess, Federal Council Borel had proposed to grant foreign investors the possibility to claim a refund of the withholding tax. Federal Council Bonvin considered the proposal unsustainable, because it did not fulfil the purpose of the Swiss withholding tax as a security tax: “*Elle ouvre un chemin commode à tous les étrangers qui possèdent des obligations ou des actions suisses. Il leur suffira de créer un fonds de placement et d’y placer leur fortune en Suisse pour échapper complètement à l’impôt anticipé (...)*”. Borel’s motion was defeated by the majority. (Amtl. Bull. SR 1964, p. 372 et seq.). Recently, Stefan Oesterhelt correctly affirmed that the threshold of 80% is set too high and could or even should be reduced to 50% in the extent that the foreign resident investors are domiciled in a contracting state with which Switzerland has concluded a DTC. See OESTERHELT, Basler Kommentar, Kollektivanlagengesetz, nr. 121 ad. Vor Art. 1.

³¹³ OESTERHELT, Basler Kommentar, Kollektivanlagengesetz, nr. 120 ad. Vor Art. 1.

³¹⁴ Art. 10 OECD Model.

³¹⁵ Art. 11 OECD Model.

Model, the “*other income*” Article³¹⁶. According to this rule, the income shall be taxable only in the investors’ state of residence. This would eliminate the taxing right of Switzerland as the source state. However, the Federal Tax Administration applies the “*predominant income test*”³¹⁷, determining the qualification of income as solely dividend or interest payments, which clearly demonstrates the systematic inconsistency of the treatment of CIS distributions in a “*cross-border scenario*” involving Switzerland³¹⁸.

2.3.6.5.3 Systematic Inconsistency regarding Switzerland’s Taxation Right as the Source State at the CIS level

Contrary to the opinion held by Toni Hess³¹⁹, a refund of Swiss withholding tax pursuant to Art. 27 WTL is not a flaw in the system “*per se*”. Toni Hess correctly noted that the ability under Swiss domestic law of foreign investors including those based in non-DTC countries, to reclaim the Swiss withholding tax is inconsistent with the Swiss tax system³²⁰. According to Stefan Oesterhelt, the ability to reclaim Swiss withholding tax lies in the fact that pursuant to Art. 4 para. 1 (c) WTL, the Swiss withholding tax is levied at the level of the CIS, on foreign income that may have already been taxed at source³²¹. Without a corrective provision such as the one contained in Art. 27 WTL, this could lead to economic double taxation. Stefan Oesterhelt’s argument cannot be compared to the case of a corporation that may also invest in foreign investments which may have already been taxed at the source and on which Swiss withholding tax is levied at the level of the corporation on dividend payments, pursuant to Art. 4 para. 1 (b) WTL. Instead, the approach represented here is relevant by reference to other hybrid entities, such as partnerships and trusts for which, likewise, no withholding tax is levied at

³¹⁶ The following DTCs contain no article drafted in accordance with Art. 21 OECD Model as at August 2009: Argentina (1997); Australia (1980); China, People’s Rep.(1990); India (1994); Indonesia (1988); Canada (1997); Singapore (1975); Thailand (1996); Trinidad and Tobago (1973); Vietnam (1996); Malaysia (1974); Mexico (1993); Pakistan (2005); Philippines (1998).

³¹⁷ See Footnote 327.

³¹⁸ See Chapter 2.3.6.5.3.

³¹⁹ HESS, thesis, p. 521.

³²⁰ HESS, Entlastung von Quellensteuern auf Zinsen und Dividenden bei Anlagefonds und Anteilsinhabern, p. 16.

³²¹ OESTERHELT, Basler Kommentar, Kollektivanlagengesetz, nr. 119 ad. Vor Art. 1.

the level of the entity in Switzerland. Partnerships are transparent not only for income tax purposes but also for withholding tax purposes. It is unjustifiable that Swiss withholding tax is levied upon CISs at the entity-level, but not upon partnerships or trusts, based solely on the fact that they are organized under a different legal form³²².

Moreover, it is uncertain to what extent Switzerland, as the source state, should have the right to tax distributions of a CIS in a “*cross-border scenario*”, because the CIS may not be covered³²³ by the dividend Article³²⁴ or by the interest Article³²⁵. Most likely, the income paid from the CISs to its investors should be characterized as “*other income*” in accordance with Art. 21 OECD Model³²⁶. This Article entirely eliminates the taxing right of the source state (Switzerland) according to which the items of income shall be taxable only in the state of residence of the investors (Foreign Country). However, the Federal Tax Administration applies the questionable - and not systematically appropriate - “*predominant income test*”³²⁷ determining the qualification of income either as dividend or interest payments³²⁸. According to this approach, Switzerland’s taxing right is not entirely eliminated. Considering the economic advantages that this practice offers Switzerland, it may be understood that it would not wish to give this taxing right up under a DTC. However, this approach is highly questionable as only those distributions of a CIS considered a company (such as a SICAV, and certainly not a

³²² See Chapter 7.1.2.1.2.4.

³²³ OESTERHELT, Basler Kommentar, Kollektivanlagengesetz, nr. 120 ad. Vor Art. 1.

³²⁴ Art. 10 OECD Model.

³²⁵ Art. 11 OECD Model.

³²⁶ In this vein also: OESTERHELT, Basler Kommentar, Kollektivanlagengesetz, nr. 265 ad. Vor Art. 1. The following DTCs do not contain an Article drafted in accordance with Art. 21 OECD Model as per August 2009: Argentina (1997); Australia (1980); China, People’s Rep.(1990); India (1994); Indonesia (1988); Canada (1997); Singapore (1975); Thailand (1996); Trinidad and Tobago (1973); Vietnam (1996); Malaysia (1974); Mexico (1993); Pakistan (2005); Philippines (1998).

³²⁷ If more than 50% of the income of the CIS is derived from dividends, the distribution is qualified as a “*dividend*” and, therefore, the reimbursement of the withholding tax is based on the dividend article of the respective DTC (Art. 10 OECD Model). However, if more than 50% of the income is derived from interest, the distribution is qualified as interest and, therefore, the reimbursement is based on the interest article of the respective DTC (Art. 11 of the OECD Model).

³²⁸ HEUBERGER/OESTERHELT, Collective Investment Vehicles, p. 33.

FCP or LP) could be characterized as “*dividends*” and, therefore, could fall under Art. 10 OECD Model.

In conclusion, if a CIS is not constituted in the legal form of a company according to the source state’s domestic law³²⁹, it will not be able to distribute income in a manner which qualifies them as “*dividends*”. Consequently, Art. 10 OECD Model would not apply. However, even if the CIS qualified as a company, this would mean that the investor’s state of residence has only a limited taxing right. The central question therefore becomes what the scope of term “*dividends*” is in the context of Art. 10 para. 3 OECD Model. It could be that all income derived by the hybrid entity is regarded as dividends or, alternatively, that only income which is then distributed is characterized as dividends. It is therefore possible that income deriving from a CIS which qualifies as an accumulating fund may, therefore, not be covered by the dividend article. According to Art. 10 para. 1 OECD Model, it is obvious that the investor’s state of residence only has a limited taxing right when dividends are seen as effectively paid out by a company which is a resident of a contracting state.

³²⁹ Whether the resident state of the investors would treat the CIS as a resident company is not decisive.

2.4 Summary Overview of the Tax Consequences of Collective Investment Schemes in Switzerland

Figure 2.5: Overview of the Tax Consequences of CISs in Switzerland

Types of Collective Investment Schemes (CISs) <i>which are held in private assets and do not hold immovable property</i>		Taxable income	Subject to Swiss withholding tax on CIS level ⁷	Fiscal attribution and realization of the taxable income	Eligibility to obtain the reimbursement of the withholding tax in the Domestic Scenario	Eligibility to obtain the reimbursement of the withholding tax in the Cross-Border Scenario	
Contractual Fund (FCP)							
Distributing Fund ¹	Income distributed	Yes	Yes ^{3, 6}	Investor (up to the amount realized)	CIS LEVEL ⁸	INVESTOR LEVEL	This topic will be analysed in the following chapters ^{3, 6}
	Income not distributed	No	No				
Accumulating Fund ²	Income distributed	Yes	Yes ^{3, 6}	Investor			
	Income not distributed	Yes	Yes ^{3, 6}				
Distributing Fund & Accumulating Fund	Capital Gains distributed	No ⁹	No ¹⁰	—	—	—	
	Capital Gains not distributed	No ⁹	No ¹⁰	—	—	—	
Collective Investment Schemes Assets		No	—	—	—	—	
Investment Company with Variable Capital (SICAV)							
Distributing Fund ¹	Income distributed	Yes	Yes ^{3, 6}	Investor (up to the amount realized)	CIS LEVEL ⁸	INVESTOR LEVEL	This topic will be analysed in the following chapters ^{3, 6}
	Income not distributed	No	No				
Accumulating Fund ²	Income distributed	Yes	Yes ^{3, 6}	Investor			
	Income not distributed	Yes	Yes ^{3, 6}				
Distributing Fund & Accumulating Fund	Capital Gains distributed	No ⁹	No ¹⁰	—	—	—	
	Capital Gains not distributed	No ⁹	No ¹⁰	—	—	—	
Collective Investment Schemes Assets		No	—	—	—	—	
Limited Partnership for Collective Investment (LP)							
Distributing Fund ¹	Income distributed	Yes	Yes ^{3, 6}	Investor (up to the amount realized)	CIS LEVEL ⁸	INVESTOR LEVEL	This topic will be analysed in the following chapters ^{3, 6}
	Income not distributed	No	No				
Accumulating Fund ²	Income distributed	Yes	Yes ^{3, 6}	Investor			
	Income not distributed	Yes	Yes ^{3, 6}				
Distributing Fund & Accumulating Fund	Capital Gains distributed	No ⁹	No ¹⁰	—	—	—	
	Capital Gains not distributed	No ⁹	No ¹⁰	—	—	—	
Collective Investment Schemes Assets		No	—	—	—	—	

¹ At least 70 % of the net earnings per year (including earnings from previous financial years) has to be distributed in order to be classified as "distributing fund" (Para. 2.1.2 Circular Letter 24). It is not decisive whether the CIS makes an effective distribution of at least 70% of the net profit, decisive is only whether there is an obligation in the constitutional documents.

² Less than 70% of the net earnings per year (including earnings from previous financial years) has to be distributed in order to be classified according to the Circular as "accumulating fund" (para. 2.1.2 Circular Letter 24). It is not decisive whether he makes an effective distribution of at least 70% of the net profit, moreover if there is an explicit obligation in the constitutional documents.

³ To this principle there is an exception based on Swiss domestic tax law without applying a DTC: There is no Swiss withholding tax on the distribution or the reinvestment of income if more than 80% of the income is derived from foreign sources and for instance the custodian bank can confirm that the unit-holder is resident outside Switzerland (so-called "affidavit procedure").

⁴ The WHT on CIS level may be refunded to the investors if the conditions according to CHAPTER 2.3.5.4.4 are met.

⁵ The WHT on investment level may be refunded to the CIS if the conditions according to CHAPTER 2.3.5.3 are met.

⁶ To this principle there is an exception based on Swiss domestic tax law without applying a DTC: The Swiss withholding tax on the distribution or the reinvestment of income can be refunded to the foreign investor if more than 80% of the income is derived from foreign sources (so-called "reimbursement procedure").

⁸ Reporting procedure for qualifying investors

⁹ Tax free capital gain if declared with separate coupons.

¹⁰ No withholding tax if capital gain is declared with separate coupons.

Source: Own figure

3 Foreign Trusts under Swiss Law

*(The trust is) the greatest and most distinctive achievement performed by Englishmen in the field of jurisprudence and is almost essential to civilization.
(Frederic William Maitland, 1856 - 1906)*

3.1 General Introduction to Trusts

3.1.1 Introduction

The trust is a legal institution which originates from the common law tradition³³⁰ and, in common with most other civil law jurisdictions, is not codified in Swiss law³³¹. The trust has a long history, going back as far as the 11th century³³². This history means that Swiss courts have a long tradition of recognizing foreign trusts, although over time they have experienced difficulties in defining them and determining the law applicable thereto³³³. Before the Hague Trust Convention of 1 July 1985 on the Law Applicable to Trusts and their Recognition came into force in Switzerland on 1 July 2007³³⁴, foreign

³³⁰ PERRIN, Recognition of Trusts, p. 630.

³³¹ Some civil law countries such as Japan, Panama, Liechtenstein, Mexico, Colombia and Argentina have introduced institutions based on the Anglo-Saxon Trust into their legal systems.

³³² Among others: BOGERT, Trusts, p. 6 et seq.; WATT, Trusts and Equity, p. 4 et seq.; REYMOND, Trust et le droit suisse, p. 124a et seq.; SUPINO, thesis, p. 34 et seq.; BRUNNER, thesis, p. 11 et seq.; MOOSMANN, thesis, p. 3; HARTMANN, thesis, p. 13 et seq.; DANON, thesis, p. 9 et seq.; PERRIN, thesis, p. 5 et seq.

³³³ See decision of the Cantonal Administrative Court of 22 January 1874 in “Pugh v. Schlesinger”; Swiss Federal Supreme Court Judgment of 29 January 1970 in “Harrison v. Schweizerische Kreditanstalt” (BGE 96 II 79); Swiss Federal Supreme Court Judgment of 3 September 1999 (“NDG v. C Trust Co Jersey”) = SJ 2000 I 269.

³³⁴ Today, the Convention is in force in twelve States: The United Kingdom of Great Britain and Northern Ireland (since 1992), Italy (since 1992), Australia (since 1992), Hong Kong (since 1992), Canada (since 1993), Malta (since 1996), the Netherlands (since 1996), Luxembourg (since 2004), Liechtenstein (since 2006), San Marino (since 2006), Switzerland (since 2007) and Monaco (since 2008). In light of its limited number of members, the Convention has not yet proven successful. In most Asian countries as well as the United States, this Convention is not yet in force. The United States have

trusts were recognized by Swiss judges, although they faced considerable legal uncertainties regarding their enforceability under foreign law³³⁵ and in determining the laws applicable to trusts³³⁶. The Hague Trust Convention ensures efficient recognition of trusts, cohesion as to the applicable law and improves legal security at the international level³³⁷. In particular, it facilitates the characterization of trusts in countries in which trusts are unknown to their legal system. Even countries with their own trust law, such as Liechtenstein, have ratified the Hague Trust Convention³³⁸. Before the entry into force of the Convention, a comparative or functional approach was used³³⁹, such as that expressed in the cases of “*Re Aktiebolaget*” of 26 May 1936³⁴⁰

signed the Convention but have not ratified it. In this vein also: GUILLAUME, The Hague Trusts Convention, p. 2.

³³⁵ In the literature as well as in the explanatory work related to the Technical Explanations of the Hague Trust Convention of December 2005, the Federal Council was often asked whether the ratification of the Hague Trust Convention was justified and in line with the prohibition of “*maintenance foundations*” (“*Unterhaltstiftungen*”; “*fondations de maintenance* (or “*fidéicomis de famille*” according to Art. 335 para. 2 CC”) and “*fideicommissums*” according to Art. 335 para. 2 CC. See thereto: Technical Explanation Hague Convention, p. 559 and 564; BAUER-BALMELLI/WIDMER/HARBEKE, Switzerland-Trusts, p. 2. The important yet controversial question is whether Art. 335 para. 2 CC can be regarded as “*loi d’application immédiate*” and may prevent the recognition of a trust in Switzerland. According to current Swiss case law, it can clearly be stated that Art. 335 para. 2 CC is not considered as “*loi d’application immédiate*”. See thereto: Swiss Federal Supreme Court Judgment of 17 November 2009 (BGE 135 III 614).

³³⁶ Art. 17 SPILA.

³³⁷ Art. 1 HTC. In this vein also: GUILLAUME, The Hague Trusts Convention, p. 2, 3.

³³⁸ Art. 930 and Art. 931 PGR.

³³⁹ CRETTEI, thesis 2007, p. 52: “*L’approche comparative ou fonctionnelle s’impose chaque fois qu’il s’agit d’intégrer des concepts juridiques étrangers au droit du for.*” More precisely, KNOEPFLER/SCHWEIZER/OTHENIN-GIRARD, p. 146 describes the comparative or functional approach as: “*(...) le fait que les concepts juridiques et les catégories ne se recouvrent pas d’un système à l’autre implique souvent une recherche menée à partir des faits bruts et des conséquences juridiques qu’ils produisent dans le système juridique étranger en cause. C’est le cas, par la force des choses, lorsque des institutions de droit étranger, inconnues du droit du for, doivent lui être intégrées (...).*”

³⁴⁰ Swiss Federal Supreme Court Judgment of 26 May 1936 in “*Re Aktiebolaget Obligationensinteressenter v. Bank für Internationalen Zahlungsausgleich*”, Swiss Federal Supreme Court Judgment of 26 May 1936 (BGE 62 II 140) = JT 1936 I 552. For a detailed analysis: REYMOND, Trust et le droit suisse, p. 163a et seq.

and “*Harrison v. Crédit Suisse*” of 29 January 1970³⁴¹. Foreign trusts were acrobatically twisted into forced comparisons with traditional Swiss civil legal concepts, a “*procrustean bed*” of the traditional Swiss civil law completed by Eugen Huber, such as mandates (“*Aufträge*”; “*mandates*”)³⁴², fiduciary agreements (“*Treuhand*”; “*fiducies*”)³⁴³, donations (“*Schenkungen*”; “*donations*”)³⁴⁴, contracts in favour of a third person³⁴⁵ (“*Verträge zugunsten eines Dritten*”; “*stipulations pour autrui*”), usufructs (“*Nutznießungen*”; “*usufruits*”)³⁴⁶ and foundations (“*Stiftungen*”; “*foundations*”)³⁴⁷, to which they were the closest in their effects. In the well-known court decision of “*Harrison v. Crédit Suisse*”³⁴⁸, the Swiss Federal Supreme Court

³⁴¹ See Footnote 333. For a critical review with regard to this judgment please refer to DANON, thesis, p. 108 et seq.

³⁴² Art. 394 et seq. CO.

³⁴³ The fiduciary agreement is certainly the institution with the closest relations to trusts. This institution has, however, not been taken into account in Switzerland in the Civil Code or the Code of Obligations. It is a creation of case law introduced by the famous Swiss Federal Supreme Court Judgment of 17 March 1905 (“*Grüiring-Dutoit v. Kappeler*”, ATF 73 II 86). See thereto, among others: DUNAND, thesis, p. 18; THÉVENOZ, cendrillon, p. 264; THÉVENOZ/DUNAND, Swiss Fiducie, p. 310; DANON, thesis, p. 112 et. seq.

³⁴⁴ Art. 239 et seq. CO.

³⁴⁵ Art. 112 CO.

³⁴⁶ Art. 745 et seq. CC.

³⁴⁷ Art. 80 et seq. CC.

³⁴⁸ Swiss Federal Supreme Court Judgment of 29 January 1970 in “*Harrison v. Schweizerische Kreditanstalt*” (BGE 96 II 79).

characterized a “*private express trust*”³⁴⁹ as a combination of contracts governed by contract law³⁵⁰. After the introduction of the Swiss Private International Law Act (SPILA) of 18 December 1987, the Court expressly confirmed that a “*private express trust*”, to the extent it features a sufficient organization, could be treated as an “*organized patrimony*” and, thus as a “*corporation*” in the sense of Art. 150 et seq. SPILA. The Swiss Federal Supreme Court confirmed, for instance, that, if there is a trust deed and if the trust is organized under the laws of the Government of Jersey, this may be sufficient to qualify the trust as an organized estate³⁵¹. However, Art. 150 et seq. SPILA clearly left room for uncertainty, as it was difficult to determine the meaning of “*sufficiently organized*”³⁵².

Since the ratification of the Hague Trust Convention on 26 April 2007, foreign trusts have been broadly recognized in Switzerland as a “*sui generis*” legal relationship³⁵³, and the legal uncertainties previously encountered have been largely eliminated³⁵⁴. According to Alfred Von Overbeck, a rapprochement between the “*civil law*” and the “*common law*” has been created. Illustratively, he states “*destinée à jeter des ponts entre pays de common law et pays de civil law*”³⁵⁵. However, trusts are still not an institution in Swiss domestic law; and even after the enactment of the Hague Trust Convention and

³⁴⁹ In a private express trust, parties manifested their intention in writing or orally in order to create a trust. Among others: BOGERT, Trusts, p. 19 et seq.; HAYTON/MATTHEWS/MITCHELL, Trusts, p. 71 et seq.; DANON, thesis, p. 22 et seq.; MOOSMANN, thesis, p. 36; MOWBRAY/TUCKER/LE POIDEVIN/SIMPSON/BRIGHTWELL, Trusts, p. 23. According to WATT, Trusts and Equity, p. 78 et seq. three certainties (certainty of intention, certainty of the subject and certainty of object) have to be satisfied in order to create a private express trust. In this vein: PERRIN, thesis, p. 32 et seq.; HUDSON, Equity & trusts, p. 63; HARTMANN, thesis, p. 32 et seq.

³⁵⁰ Swiss Federal Supreme Court Judgment of 29 January 1970 (BGE 96 II 79);

THÉVENOZ, Trusts in Switzerland, p. 202; CRETTE, thesis 2007, p. 52.

³⁵¹ Decision of the Swiss Federal Supreme Court Judgment of 3 September 1999 in “*NDG v. C Trust Co Jersey*”) = SJ 2000 I 269.

³⁵² PERRIN, Recognition of Trusts, p. 632; MAYER, Vermögensseinheit, p. 26-27.

³⁵³ THÉVENOZ, Trusts in Switzerland, p. 52.

³⁵⁴ Technical Explanations Hague Trust Convention. In this vein also among others: GUTZWILLER, Schweizerisches Internationales Trustrecht, p. 13.

³⁵⁵ OVERBECK, Trust, p. 372.

the amendments to the relevant Swiss federal laws³⁵⁶, no “*Swiss trusts*” in the proper sense exist³⁵⁷. Furthermore, one must bear in mind that judges in most jurisdictions may, at any time, declare foreign trusts ineffective or non-existent (“*sham trust*”)³⁵⁸ in accordance with the maxim “*he who comes to equity must come with clean hands*”³⁵⁹.

3.1.2 Economic Significance

Foreign trusts are a reality in the financial center of Switzerland due to their economic significance in wealth planning³⁶⁰. Pierre Lepaulle had already made this observation back in 1932: “*Le trust est l’ange gardien de l’Anglo-Saxon, il l’accompagne partout, impassible, depuis son berceau jusqu’à sa tombe. Il est à son école comme à son association sportive, il le suit le matin à son bureau comme le soir à son club; il est à ses côtés le dimanche à l’église ou au comité de son groupe politique; il soutiendra sa vieillesse jusqu’à son dernier jour, puis il veillera au pied de son tombeau et étendra encore sur ses petits-enfants l’ombre légère de ses ailes*”³⁶¹. According to a January 2008 analysis conducted by the Swiss Banking Institute, over 2 billion Swiss Francs are held in foreign trusts, representing a global percentage of 56% of the private wealth held in private assets by Swiss banks³⁶².

³⁵⁶ Swiss Private International Law Act (SPILA) of 18 December 1987 and the Swiss Federal Debt Enforcement and Bankruptcy Act (BL) of 11 April 1989.

³⁵⁷ Amongst others: RYSER, double taxation treaties, p. 310; GUILLAUME, The Hague Trusts Convention, p. 3. It must be stated that the introduction of trusts in Swiss law was a discussed option at the time of the ratification of the Hague Trusts Convention. However, the Swiss legislator gave up on this idea for time reasons.

³⁵⁸ For more information, see Chapter 3.1.3.2.

³⁵⁹ HUDSON, Equity & trusts, p. 74-75. DANON, thesis, p. 55 et seq. comparing with the concept of simulation in Swiss law according to Art. 18 CO.

³⁶⁰ VOLKART/GEIGER/WÜNSCH, Trusts in der Vermögensverwaltung, p. 22; THÉVENOZ, Trusts in Switzerland, p. 177; RYSER, double taxation treaties, p. 309; GUTZWILLER, Schweizerisches Internationales Trustrecht, p. 233.

³⁶¹ LEPAULLE, Traité théorique et pratique, p. 114.

³⁶² VOLKART/GEIGER/WÜNSCH, Trusts in der Vermögensverwaltung, p. 21.

3.1.3 Definition of Trusts

This Chapter provides (i) a general definition of trusts³⁶³ as well as (ii) a definition of what are considered “*sham trusts*” from a Swiss legal perspective³⁶⁴.

3.1.3.1 General Definition of Trusts

To this day, more than a hundred varieties and sub-varieties of the “*triangular relationship*” between settlor, trustee and beneficiary exist, due to the lack of international formal harmonized requirements³⁶⁵. No standard definition or delimitation of the core concept of the trust, or its “*heart*”³⁶⁶, exists which would encompass and include all of its complex particularities³⁶⁷, even though the concept of trusts has become increasingly referred to with the rise of internationalization. Moreover, as Harald Bösch correctly criticizes, the abstract delimitation of this definition does not precisely define the concept of trusts³⁶⁸. Rather, the trust concepts deriving from various jurisdictions are sometimes so different that it is questionable whether there are any essential core elements to constitute a common law trust. David John Hayton

³⁶³ See Chapter 3.1.3.1.

³⁶⁴ See Chapter 3.1.3.2.

³⁶⁵ Amongst others: PEYROT, thesis, p. 19; DANON, thesis, p. 27 et seq.; CRETTEI, thesis 2007, p. 18 et seq.; MOOSMANN, thesis, p. 30 et seq.; BÖCKLI, Angelsächsische Trust – Zivilrecht und Steuerrecht, p. 10-11; LANDOLF/GRAF, Trust im schweizerischen Steuerrecht, p. 6-7; SORROSAL, Wesensmerkmale von Trusts, p. 53 et seq.; ANDINA, Besteuerung von in der Schweiz wohnhaften Empfängern, p. 205; GUTZWILLER, Schweizerisches Internationales Trustrecht, nr. 9 et seq.; RYSER, Rapports de trust, p. 749; FAVRE, Approche fiscale du trust, p. 169; HAYTON/MATTHEWS/MITCHELL, Trusts, p. 64; MOWBRAY/TUCKER/LE POIDEVIN/SIMPSON/BRIGHTWELL, Trusts, p. 15 et seq.; NABHOLZ, Besteuerung von irrevocable discretionary Trusts, p. 6 et seq.

³⁶⁶ DANON, thesis, p. 7.

³⁶⁷ Hague Convention, ad. Art. 2; BÖCKLI, Angelsächsische Trust – Zivilrecht und Steuerrecht, p. 10-11; MOOSMANN, thesis, p. 30 et seq.; SUPINO, thesis, p. 30 et seq.; BIEDERMANN, thesis, p. 20 et seq.; CRETTEI, thesis 2007, p. 11; DANON, thesis, p. 8; SCHNITZER, Part I, p. 198; Principles of European Trust Law which has been reproduced in DUNAND, thesis, p. 523 et seq. (French Version) and in HAYTON/KORTMANN/VERHAGEN, p. 13 et seq. (English and French versions).

³⁶⁸ BÖSCH, thesis, p. 165.

illustratively pointed out this difficulty with his famous statement: “*like an elephant, a trust is difficult to describe but, easy to recognize*”³⁶⁹. Alfred von Overbeck has suggested it may be better to describe the trust instead of attempting to define it, due to its hundreds of varieties and sub-varieties³⁷⁰, or as Peter Böckli put it: “*eine derart reiche Fauna im Tiergarten des Trustsrechts*”³⁷¹. The question of whether an essential core concept of the trust exists has been discussed by leading specialists at the 1997 International Bar Association (IBA) conference³⁷². At a conference entitled “*Taxation of Trusts in Civil Law Jurisdictions*” held in 2008 in Neuchâtel, Joanna Wheeler stated that she “*finds it self-evident that such an essential core exists*”. However, the vote taken after the debate revealed surprisingly that the audience split exactly 50:50³⁷³.

To this end, Maurizio Lupoi has developed five minimal invariant elements which are inevitable for a trust to qualify as such³⁷⁴. In conclusion, and in light of the above, it is impossible to identify one precise definition of a trust. However, for the sake of the present analysis, the basic model of an Anglo-Saxon trust will be used as the starting point³⁷⁵.

The following table provides an overview of five distinct quasi-definitions briefly summarizing the trust’s basic and common components.

Figure 3.1: Definitions of the Trust Concept

Source	Definition

³⁶⁹ HAYTON, *Vertrouwd met de trust*, p. 3.

³⁷⁰ OVERBECK, *La Convention de La Haye*, p. 32 suggests that one should describe instead of define the trust concept due to its many varieties and sub-varieties: “*Il paraît impossible de saisir le trust dans une définition générale et probablement vaut-il mieux (...) se contenter d’une description plutôt que d’une définition (...). La figure classique du trust : celle d’un settlor ayant conféré des droits sur un patrimoine à un trustee qui doit exercer ces droits en faveur de bénéficiaires. Mais de multiples variations existent sur cette figure de départ.*”

³⁷¹ BÖCKLI, *Angelsächsische Trust – Zivilrecht und Steuerrecht*, p. 12.

³⁷² WHEELER, *Taxation of Trusts in Common Law Jurisdictions*, p. 31.

³⁷³ WHEELER, *Taxation of Trusts in Common Law Jurisdictions*, p. 31.

³⁷⁴ LUPOI, *Comparative study*, p. 269-273.

³⁷⁵ BÖCKLI, *Angelsächsische Trust Part I*, p. 713.

HAYTON/MATTHEWS/ MITCHELL	<i>"A trust is an equitable obligation, binding a person (called a trustee) to deal with property (called trust property) owned by him as a separate fund, distinct from his own private property, for the benefit of persons (called beneficiaries or, in old cases, <i>cestuis que trust</i>), of whom he may himself be one, and any one of whom may enforce the obligation³⁷⁶."</i>
BORGERT	<i>"A trust is a fiduciary relationship in which one person is the holder of the title to the property subject to an equitable obligation to keep or use the property for the benefit of another. The settlor of a trust is the person who intentionally causes the trust to come into existence. The trustee is the person who holds title for the benefit of another. The trust property is the property interest which the trustee holds subject to the rights of another. The beneficiary is the person for whose benefit the trust property is to be held or used by the trustee³⁷⁷."</i>

³⁷⁶ HAYTON/MATTHEWS/MITCHELL, Trusts, p. 2.

³⁷⁷ BOGERT, Trusts, p. 1.

PRINCIPLES OF EUROPEAN TRUST LAW	<i>“In a trust, a person called the ‘trustee’ owns assets segregated from his private patrimony and must deal with those assets (‘the trust fund’) for the benefit of another person called the ‘beneficiary’ or for the furtherance of a purpose.</i> <i>There can be more than one trustee and more than one beneficiary, a trustee may himself be one of the beneficiaries.</i> <i>The separate existence of the trust fund entails its immunity from claims by the trustee’s spouse, heirs and personal creditors.</i> <i>In respect of the separate trust fund a beneficiary has personal rights and may also have proprietary rights against the trustee and against third parties to whom any part of the fund has been wrongfully transferred³⁷⁸.”</i>
CIRCULAR LETTER 30/20 on Trusts	<i>“The term ‘trust’ describes a legal relationship, having effect against third parties, that is created, on the basis of a constitutive document (trust deed), when the settlor transfers specific assets to one or several persons (trustees), upon which rests the obligation to administer the assets and utilize them in the purpose established beforehand by the settlor in favor of one or several persons (beneficiaries)³⁷⁹.”</i>
IBFD International Tax Glossary	<i>“(…). In view of the many different forms which the trust takes in different countries it is not possible to provide a single definition. However, under the Hague Convention the term ‘trust’ is</i>

³⁷⁸ The English and French versions are reproduced in: HAYTON/KORTMANN/VERHAGEN, ad. Art. 1.

³⁷⁹ Translated from the German and French version of the Circular 30/20: “*Der Begriff bezeichnet ein Rechtsverhältnis, welches entsteht, wenn der Errichter (Settlor) auf der Grundlage einer Errichtungsurkunde (Trust Deed) bestimmte Vermögenswerte auf eine oder mehrere Personen (Trustees) überträgt mit der Aufgabe, diese zum Vorteil der Begünstigten mit Wirkung gegenüber jedermann zu verwalten und zu verwenden*”. However, it must be stated that the last sentence of the German version is unclear, not to say wrong. Therefore, the French version of Circular 30/20 is decisive.

	<i>defined as ‘the legal relationships created – inter vivos or on death – by a person, the settlor, when assets have been placed under control of a trustee for the benefit of a beneficiary or for a specified purpose’. A typical common law trust is characterized by virtue of a division between the legal and equitable estates (ownership) whereby legal title to the trust property is vested in the trustee, while equitable title belongs to the beneficiaries. Other forms commonly typify the connection between the trustee and beneficiary by reference to a contractual relationship³⁸⁰.’’</i>

Thus, the trust concept differs considerably between common law jurisdictions³⁸¹ and those jurisdictions influenced by the civil law system³⁸². Motivated by practical considerations and competition between legal systems, some civil law jurisdictions have introduced trust-like concepts, based on the Anglo-Saxon trust model, with varying success³⁸³. These “*civil law trusts*”, however, differ considerably from the classic Anglo-Saxon trusts illustrated in English and US case law³⁸⁴. In this study, where the trust concept or its main characteristics are to be used, the traditional delimitations above and the following criteria deriving from Art. 2 of the Hague Trust Convention will be referred to³⁸⁵:

³⁸⁰ Information retrieved on 4 January 2009 from <http://online2.ibfd.org/itg/>.

³⁸¹ Among others: the United Kingdom, the United States, Canada, Australia, New Zealand, South Africa, Scotland, Québec, Ireland, Jersey, Northern Ireland, Bahamas, Bermudas, The Cayman Islands.

³⁸² Among others: Japan, Panama, Liechtenstein, Mexico, Columbia, Argentina.

³⁸³ The trust concept also exists in Gibraltar, Malaysia, Singapore, Pakistan, the Philippines, Colombia, Costa Rica, Ecuador, El Salvador, Guatemala, Honduras, Peru, Venezuela and Russia.

³⁸⁴ LUPOI, Civil Law Trust, p. 967 et seq.

³⁸⁵ BOITELLE, Trust Convention, p. 908; NOSEDA, Praktische Auswirkung, p. 482;

NOSEDA, Hague Trust Convention, p. 37.

Figure 3.1: Definition of the Trust Concept according to the Hague Trust Convention

Art. 2 Definition

¹ For the purpose of this Convention, the term “trust” refers to the legal relationship created – inter vivos or on death – by a person, the settlor, when assets have been placed under the control of a trustee for the benefit of a beneficiary or for a specified purpose.

² A trust has the following characteristics:

- (a) The assets constitute a separate fund and are not a part of the trustee’s own estate;
- (b) Title to the trust assets stands in the name of the trustee or in the name of another person on behalf of the trustee;
- (c) The trustee has the power and the duty, in respect of which he is accountable, to manage, employ or dispose of the assets in accordance with the terms of the trust and the special duties imposed upon him by law.

³ The reservation by the settlor of certain rights and powers, and the fact that the trustee may himself have rights as a beneficiary, are not necessarily inconsistent with the existence of a trust.

Source: Art. 2 of the Hague Trust Convention

However, Art. 2 of the Hague Trust Convention lacks certain structural elements in relation to the separation between the settlor and the trust³⁸⁶ and the duality of legal and equitable ownership³⁸⁷. Moreover, the Art. 2 conception of the trust corresponds neither to the Anglo-Saxon model nor to any other known models. This definition is so broad that it may encompass an undetermined number of legal constructions³⁸⁸ from the “civil law” (i.e. the “*fiducie*” of Luxembourg) as well as the “common law” (i.e. the “*Anstalt*” of Liechtenstein which derives from common law), and does not only refer to a specific definition of a common law trust from a specific jurisdiction. Florence Guillaume concludes this illustratively: “*The Hague Trusts Convention applies to trusts and all legal institutions which have the same characteristics, whatever they are called*”³⁸⁹. This has led Maurizio Lupoi to use the term “*shapeless trust*”³⁹⁰. Jonathan Harris goes as far as stating that Art. 2 of

³⁸⁶ LUPOI, Comparative study, p. 339.

³⁸⁷ SMITH, Trusts in Civil Law, p. 665; BARRIERE, thesis, p. 187-188.

³⁸⁸ BARRIERE, thesis, 186-187.

³⁸⁹ GUILLAUME, The Hague Trusts Convention, p. 5.

³⁹⁰ LUPOI, Comparative study, p. 339 - 340.

the Hague Trust Convention should not be used as a definition³⁹¹. This argument clearly goes too far; Art. 2 HTC nevertheless provides a definition that can serve as a point of reference. The Article indicates the minimum requirements for a legal institution to qualify as a trust under the Convention. First, a person (the settlor) transfers ownership of selected personal assets to another person (the trustee), who, second, must manage the assets in the interest of a third person (the beneficiary). Third, the settlor may appoint one or more trustees³⁹². Additionally, a fourth condition may be drawn from Art. 3 HTC specifying that “*the Convention applies only to trusts created voluntarily and evidenced in writing*”³⁹³. When an entity does not fulfill these characteristics, the qualification must follow the traditional method of Swiss private international law on a case-by-case basis³⁹⁴.

3.1.3.2 Definition of “*Sham Trusts*” under Swiss Law

The concept of a “*sham trust*” is comparable to the simulation under Art. 18 CO in Swiss domestic law, where the actual will of the contracting parties differs from the will represented toward a third party and the third party is deceived as a result³⁹⁵. Such trusts are considered void and non-existent from a civil law perspective. Specifically, a “*sham*” exists where formal or material legal acts or documents serve to deceive a third party about the rights and obligations between the parties (i.e. the settlor and the trustee) and to conceal the true rights and obligations between the parties. The settlor and the trustee must agree to and be aware of this “*sham*” nature of the trust either at the time the trust is established or at a later point after the trust has already been established³⁹⁶.

³⁹¹ HARRIS, The Hague Trusts Convention, p. 116. In this vein: CHENAUX, Ratification de la Convention de La Haye sur le trust, p. 158.

³⁹² In this vein also: GUILLAUME, The Hague Trusts Convention, p. 6-7.

³⁹³ The Swiss legislator excluded “*constructive trusts*” from the Convention’s scope of application. See thereto: Message of the Federal Council of 2 December 2005 regarding the approbation and execution of the Hague Trusts Convention, FF 2006, p. 561 et seq., nr. 1.6.1.2.

³⁹⁴ GUILLAUME, The Hague Trusts Convention, p. 18.

³⁹⁵ SCHWANDER, Sham, p. 249.

³⁹⁶ In this vein, SCHWANDER, Sham, p. 249 et seq.

The Swiss Federal Supreme Court has stated that a “*sham trust*” exists where the settlor uses a trust in an artificial, unnatural way, which is specifically the case when the settlor keeps effective control over the trust’s assets and wishes to reclaim said assets at some point³⁹⁷. In order to determine whether a trust should be qualified as a “*sham trust*” from a civil law perspective, in addition to the general definition of the Swiss Federal Supreme Court outlined above, criteria for whether a trust is to be considered fiscally-transparent for tax purposes should be used as indicators of the existence of a sham³⁹⁸. However, the qualification of a trust as fiscally-transparent from a tax law perspective does not necessarily make the trust a “*sham trust*” and therefore non-existent from a civil law perspective, as these tax law criteria serve merely as indicators and cannot individually be considered constitutive of a “*sham trust*”. As a result, even if a trust is considered fiscally-transparent and thus not recognized from a tax law perspective, it may still be recognized from a civil law perspective and is not to be considered a “*sham trust*”, which would be viewed as non-existent *ex tunc* from a civil law perspective³⁹⁹, even if it meets certain criteria for fiscal-transparency.

In the author’s opinion, the fact that a trust meets the criteria of transparency from a Swiss tax law perspective should have absolutely no effect on its qualification from a civil law perspective, as these two qualifications are completely independent from each other.

3.1.4 Characteristics of the Trust Concept

After outlining a number of quasi-definitions and having compared the views put forward by several commentators⁴⁰⁰, it is now possible to briefly

³⁹⁷ Swiss Federal Supreme Court Judgment of 12 April 2012 = AJP 11, 2013, p. 1695 et seq., for further details see ARTER, Sham Trusts, p. 1699 et seq.

³⁹⁸ See Decisions of the Swiss Federal Administrative Court of 27 September 2011 (A-6680/2010 and A-6756/2010), cons. 4.4; of 20 October 2011 (A-7976/2010, A-7978/2010, A-7979/010, A-7980/2010, A-7982/2010, A-7983/2010) cons. 6.2.2; of 10 January 2011 (A-6053/2010), cons. 7.3.3. For further details see also: ARTER, Sham Trusts, p. 1704.

³⁹⁹ SCHWANDER, Sham, p. 249.

⁴⁰⁰ Among others: Para. 2 Circular 30/20; DANON, thesis, p. 13 et seq.; BERAUDO, Les trusts anglo-saxons, p. 8 et seq.; BÖCKLI, Angelsächsische Trust – Zivilrecht und Steuerrecht, p. 19 et seq.; SUPINO, thesis, p. 88 et seq.; PERRIN, thesis, p. 17 et seq.

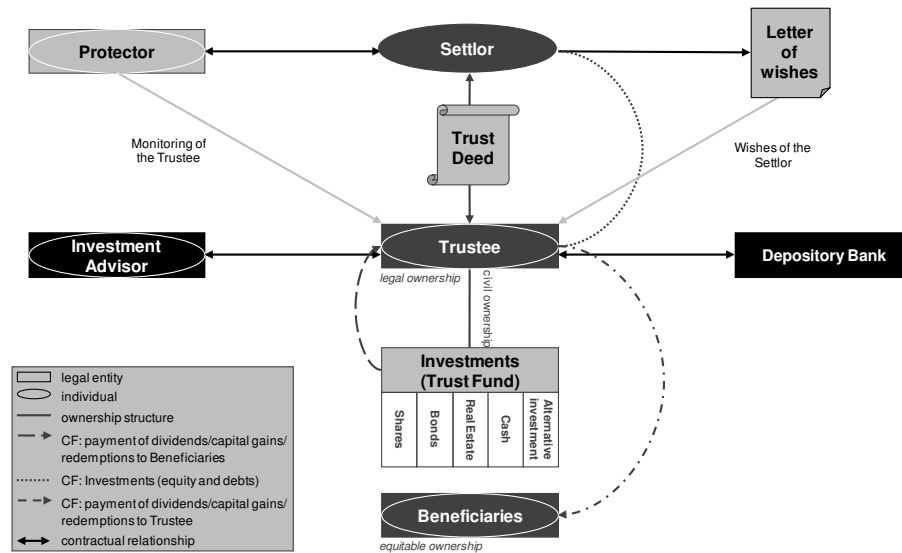
summarize the main characteristics of a trust. However, a detailed analysis of these main characteristics would be outside of the scope of this research.

- Act of unilateral nature;
- Non-contractual nature;
- Absence of legal personality;
- Fiduciary relationship;
- “*Inter vivos*” or testamentary character;
- Legal ownership by the trustee and not by the settlor;
- Segregation of assets;
- Real subrogation;
- Tracing remedy; and
- Rule against perpetuities.

3.1.5 Possible Structure of the Trust

In light of the foregoing, the trust relationship and its parties may be schematized, as shown in the diagram below.

Figure 3.2: Structure of a Trust Relationship



Source: Own figure

3.2 Scope of the Tax Analysis

This study will focus on private express trusts. In doing so, the following will be taken into account:

- It is assumed that the parties have expressly manifested their intention to create the trust⁴⁰¹;
- Attention will only be paid to the transfer of private assets (*“Privatvermögen”*; *“fortune privée”*) and not of business assets (*“Geschäftsvermögen”*; *“fortune commerciale”*)⁴⁰²;
- A *“fixed interest trust”* shall refer to a trust whose income consists of periodical items which, under the terms of the governing instrument,

⁴⁰¹ See Footnote 349.

⁴⁰² See Chapter 2.3.5.2.

are to be paid out on an arising basis and are, therefore, not accumulated;

- The trustee directly holds the investments and so its ownership of them is not structured through an underlying or subsidiary company⁴⁰³;
- Since the trust holds an investment portfolio and does not perform any business activity, the question of whether it has a permanent establishment under a DTC will not be addressed. Indeed, in the case of a permanent establishment, the taxation would be by way of an assessment and, therefore, not by way of a withholding tax; and
- No attention is paid to the problems arising from the EU Savings Agreement⁴⁰⁴.

3.3 Direct Taxation of Trusts under Swiss Law

3.3.1 Hypothetical Taxation Issues

Tax problems arise from (i) income flows from the trust assets to the trustee; and (ii) from the attribution rules for income in relation to the settlor, the trustee and the beneficiary, which vary depending on their domiciles. The income flow and the attribution rules for income may generate, depending on the country, three hypothetical taxation points in both the domestic and international scenarios. At an international level, taxation of the trust structure may arise by means of a withholding tax, in which case the trust and the trustee could directly be taxed by a yearly final tax assessment. The same may apply, depending on the constitution of the trust, to the beneficiary or the settlor, which may also be subject to withholding tax, either at the level of the trust or trustee, or directly by a yearly final tax assessment. A detailed understanding of these three levels of taxation is of considerable importance in order to comprehend how the tax burden operates.

⁴⁰³ See Chapter 3.3.4.

⁴⁰⁴ Council Directive 2003/48/EC on taxation of savings income in the form of interest payments, 3 June 2003.

In a fully domestic scenario, Switzerland, as many other countries, has structured its tax system to ensure that the foregoing hypothetical taxation points do not create double (or multiple) taxation⁴⁰⁵. However, in an international context, such imbalances often cannot be eliminated due to the ineffectiveness of DTCs⁴⁰⁶.

3.3.2 Applicable Laws and Regulations: Circular Letters 30 and 20 on Trusts

Neither the Hague Trust Convention, nor Swiss domestic tax laws contain provisions which deal specifically with the treatment of foreign trusts. The Convention expressly states in its Art. 19 that “*nothing in the Convention shall prejudice the powers of States in fiscal matters*”. However, it is fair to say that it has nonetheless influenced the tax treatment of trusts in Switzerland⁴⁰⁷. In the past, the lack of provisions in Swiss law led to fundamental differences among cantons, in which fiscal practices were sometimes so divergent that one might have even wondered whether the rules emerged in the same country. This differing tax treatment led to unwelcome legal uncertainty, yet was interesting from a tax planning perspective as it offered different scenarios instead of a single, unfavorable solution.

Such difficulties are not limited to Switzerland. Even from an international perspective “*a trust is a financial intermediary which causes considerable difficulty in any tax system*”⁴⁰⁸. However, such controversy is understandable as Switzerland and other civil law countries recognize the “*splitting of the right of property*” into legal and beneficial ownership⁴⁰⁹. Therefore, one would not expect the fiscal income attribution rules of income to be so complicated that a Circular is necessary to interpret them. Generally, in Switzerland, tax laws follow the civil law characterization, as was observed by Ernst Käzigi: “*Das Steuerrecht folgt grundsätzlich dem Zivilrecht. Dies bedeutet dass der zivilrechtlich massgebende Tatbestand idR auch steuerrechtlich*

⁴⁰⁵ See Chapter 2.3.6.1.

⁴⁰⁶ See Chapter 2.3.6.5.

⁴⁰⁷ DANON, Critique de la Circulaire du 22 août 2007, p. 444-445.

⁴⁰⁸ TILEY/COLLISON, UK Tax Guide, p. 783.

⁴⁰⁹ RYSER, Double Taxation Treaties, p. 314. For a more detailed analysis: OBERSON, Trust, p. 477; PEYROT, thesis, p. 22 et seq.; PANNATIER KESSLER, Trusts, p. 20 et seq.; DANON, thesis, p. 11 et seq.

*massgebend ist*⁴¹⁰. This principle was also observed from an Italian perspective by Guglielmo Maisto: “The tax regime applicable to a trust (...) to a large extent (...) depends on a preliminary private law characterization on the basis of which the tax regime is then determined”⁴¹¹, and from a German perspective by Jörg Verstl: “Danach werden ausländische Institute in die inländische Steuerrechtsordnung durch einen Vergleich ihrer privatrechtlichen Natur mit den Kategorien der inländischen Rechtsordnung eingeordnet”⁴¹². However, with regard to the taxation of trusts in Switzerland, there are fundamental deviations from the civil law approach⁴¹³. Many trusts have not been established for reasons of tax avoidance but nevertheless they are not recognized, even though their structure is perfectly compliant from a civil law point of view and is not constitutive of a sham transaction or simulation (“*Scheingeschäft*”; “*simulation*”) according to Art. 18 CO⁴¹⁴. Therefore, Ernst Känzig points out that, in principle, only “*ein zivilrechtlich nichtiges Rechtsgeschäft für die Steuerbehörden grundsätzlich nichtig*”⁴¹⁵. This deviation from the civil law approach is explicable by the economic reality interpretative rule (“*wirtschaftliche Betrachtungsweise*”; “*interprétation selon la réalité économique*”). Fiscal attribution rules regarding trust structures are increasingly based on economic substance rather than on formal

⁴¹⁰ KÄNZIG, Commentary LDFT, p. 37. This has been stated in a Swiss Federal Supreme Court Judgment of 4 June 1987 = in RDAF 1990, p. 37 et seq. = ASA 57, p. 267; Swiss Federal Supreme Court Judgment of 15 July 1955 = in RDAF 1956, p. 141, 143 and Swiss Federal Supreme Court Judgment of 3 December 1954 O in RDAF 1956, p. 131. The same applies in many other foreign jurisdictions such as Belgium. See: QUAGHEBEUR, Belgium’s De Facto Position on the Taxation of Trusts, p. 661. Against the Swiss Federal Supreme Court Judgment of 2 April 1993 = RDAF 1996, p. 138 which states when the conditions of tax evasion are met “(...) l’autorité fondera l’imposition non pas sur cette forme mais au contraire sur la situation qui aurait dû être l’expression appropriée du but économique poursuivi par les intéressés”.

⁴¹¹ MAISTO, Taxation of Trusts in Civil Law Countries, p. 243.

⁴¹² VERSTL, thesis, p. 63.

⁴¹³ See Chapter 3.3.7.2.2.

⁴¹⁴ Various judgments by the Swiss Federal Supreme Court have been rendered thereto. Among others: Swiss Federal Supreme Court Judgment of 13 December 1996 = RDAF 1997, p. 687 = ASA 66, p. 560; Swiss Federal Supreme Court Judgment of 3 February 1995 = RDAF 1997, p. 392 = ASA 64, p. 641; Swiss Federal Supreme Court Judgment of 25 November 1983 = RDAF 1984, p. 362 = ASA 53, p. 54.

⁴¹⁵ KÄNZIG, Commentary LDFT, p. 37.

private law characterizations⁴¹⁶. Among these rules the defining factor is whether there has been definitive alienation (*“Veräusserung”*; *“aliénation”*) of the trust assets and income⁴¹⁷, according to the true economic reality of the situation⁴¹⁸, which analysis may clearly differ from the private law characterization of trust structures. It may be concluded with regard to Circular 30/20 and based on the federal and cantonal tax practices that, contrary to Robert Danon’s view⁴¹⁹, Swiss attribution rules follow in principle, with regard to trust structures, formal private law characterizations and thus exceptionally adopt an economic (substance-over-form) approach⁴²⁰.

In response to this situation, the Swiss Tax Conference (STC) issued Circular 30 on the taxation of trusts on 22 August 2007. This Circular outlines and interprets the Swiss fiscal attribution rules under the Federal Acts of 14 December 1990 on Federal Direct Tax (LDFT) and on the Harmonization of Cantonal and Communal Direct Taxes (LDHT)⁴²¹. The first law concerns individual and corporate income taxes at a federal level, while the second provides detailed rules on individual income and net wealth taxes as well as corporate income and capital taxes at a cantonal and communal level. Surprisingly, Circular 30 also outlines topics falling outside of its competence, such as the practice of the Federal Tax Administration regarding relief from Swiss withholding taxes for Swiss citizens who are subject to Swiss tax liability, and for persons residing in foreign contracting states. Additionally, it outlines the practice of the Federal Tax Administration regarding treaty-based relief for Swiss residents from foreign withholding taxes. However, Circular 30 addresses neither cantonal nor communal gift and inheritance taxes, as these have not yet been harmonized by virtue of the LHDT.

⁴¹⁶ This economic approach towards characterization also applies in principle to Liechtenstein foundations. This line of reasoning is very similar to the fiscal attribution rules regarding trust structures in relation to family foundations. See Footnote 488.

⁴¹⁷ NOSEDA, Taxation of Trusts, p. 10.

⁴¹⁸ Para. 3.7 Circular 30/20. In detail DANON, thesis, p. 176 et seq.

⁴¹⁹ DANON, Critique de la Circulaire du 22 août 2007, p. 449 ; DANON, thesis, p. 186.

⁴²⁰ See Chapter 3.3.7.2.

⁴²¹ JUNG, International Taxation, p. 143.

On 27 March 2008, the Federal Tax Administration confirmed in Circular 20 that the rules published on 22 August 2007 in Circular 30 are applicable to federal income tax and to the withholding tax.

However, several years after having been published, it is still not clear whether these non-binding recommendations at the cantonal and communal levels⁴²² have harmonized the different practices applied by the 26 cantonal tax administrations. The Circular will probably not be applied at cantonal level with the same strength as it will be applied at federal level. The major cantonal fiscal diverging practices between the German (Canton Zurich) and French (Canton Vaud) speaking Cantons now seem to be unified by the Circular Letter⁴²³. Xavier Oberson describes this result as the “*compromis helvétique*”⁴²⁴. The fiscal practice of Circular 30, which has only recently been adopted by the Canton of Zurich after extensive negotiations⁴²⁵, essentially follows the practice of the French-speaking Cantons. Indeed, the Canton of Zurich decided to give up its method which consisted of taxing the trust as a foundation⁴²⁶. As Robert Danon outlined, there is no legal basis for the practice of taxing the trust as a foundation under the current tax laws⁴²⁷. The trust clearly does not qualify as legal person in terms of Art. 49 para. 3 LDFT and Art. 20 para. 2 LHDT⁴²⁸.

The practice of taxing a trust as a foundation therefore clearly violated Art. 49 para. 3 LDFT and Art. 20 para. 2 LHDT⁴²⁹. In the author's opinion, this practice has become even more questionable since the entering into force of the Hague Trust Convention in Switzerland in 2007. According to the latter's

⁴²² NIEDERER, Neue Besteuerungspraxis, p. 1501.

⁴²³ See the two fiscal practices of the Canton of Zurich and the Canton of Vaud in: OBERSON, Trust, p. 484.

⁴²⁴ OBERSON, Trust, p. 484.

⁴²⁵ FINANZDIREKTION DES KANTONS ZURICH, nr. 11, 450.

⁴²⁶ BETSCHART, Grundzüge der Trustbesteuerung, p. 162 et seq.

⁴²⁷ DANON, Note sur le statut du trust, p. 377, for further details see Chapter 3.3.3.

⁴²⁸ DANON, Note sur le statut du trust, p. 377. Art. 49 para. 3 LDFT and Art. 20 para. 2 LHDT clearly state that “*foreign legal entities are treated in the same way as the Swiss legal entities they are closest to in their legal form or actual structure*”. Already the first requirement which consists of assessing whether the foreign trust can be qualified as a foreign legal person cannot be fulfilled. If this requirement is fulfilled, the assimilation to a Swiss legal person could take place in a second step.

⁴²⁹ DANON, Note sur le statut du trust, p. 376 et seq.

Art. 2 para. 1, the mechanism of a trust is described as follows: “*the legal relationships created – inter vivos or on death – by a person, the settlor, when assets have been placed under the control of a trustee for the benefit of a beneficiary or for a specified purpose*”. It is therefore clearly not assimilable to a legal person such as a foundation⁴³⁰.

However, this does not dismiss the fact that the traditional English trust⁴³¹ - which is the main focus of this study - remains an extremely flexible device, allowing, from a civil law perspective, almost as many variants as can be imagined or are desired⁴³². In general, the Swiss tax authorities have made considerable efforts in order to understand the various forms of trust relationships⁴³³.

Despite this, leading practitioners and academics have widely criticized the inconsistencies and pitfalls arising from Circular 30 as well as the practice binding the cantonal tax administrations in their application of Swiss federal income tax law and Swiss withholding taxes arising from Circular 20. Examples include the non-recognition of certain trusts for tax purposes, the difference in tax treatment between foreign and Swiss resident settlors, the non-

⁴³⁰ See Swiss Federal Supreme Court Judgment of 29 January 1970 (“*Harrison v. Schweizerische Kreditanstalt*”, ATF 96 II 88). This had already been observed by SCHNITZER, Part II, p. 215 et seq. in the year 1965, where it was stated that the foundation could not be compared to an Anglo-Saxon trust.

⁴³¹ DANON, thesis, p. 9 et seq.; BÖCKLI, Angelsächsische Trust – Zivilrecht und Steuerrecht, p. 7 et seq.; CRETTELLI, thesis 2007, p. 12 et seq.; PERRIN, thesis, p. 5 et seq.; SUPINO, thesis, p. 34 et seq.; THÉVENOZ, Trusts in Switzerland, p. 178 and 184; REYMOND, Trust et le droit suisse, p. 126a; LANDOLF/GRAF, Trust im schweizerischen Steuerrecht, p. 2 et seq.; GUILLAUME, Incompatibilité du trust avec le droit suisse, p. 4.

⁴³² The many variants of a trust can be explained by the many purposes and possibilities it can be used for. The trust’s flexibility in structure is due to the different rights and duties of the trustee and to the divergent interests of the beneficiaries.

⁴³³ This can also be said for Belgium after the second decision of the Belgian Ruling Commission of 8 December 2009 (nr. 700.112) and the third decision of the Belgian Ruling Commission of 22 December 2009 (nr. 900.329). QUAGHEBEUR, Belgium’s De Facto Position on the Taxation of Trusts, p. 665.

coverage of gift and inheritance taxes and the conversion effect, which are not in line with the trust's absence of legal personality⁴³⁴.

3.3.3 Taxation of the Trust

Unlike under the legal systems of Canada⁴³⁵ and the United States⁴³⁶, a trust is not recognized as a tax-subject under Swiss law⁴³⁷, since it is not considered to be an individual⁴³⁸ or legal person⁴³⁹, and is neither considered to be a foreign legal person⁴⁴⁰ deriving from the incorporation theory, nor a deemed legal person. Further, a trust is not considered to be a foreign partnership nor another foreign community of persons lacking juridical personality⁴⁴¹. Circulars 20 and 30 have expressly confirmed this⁴⁴².

⁴³⁴ JUNG, International Taxation, p. 143 et seq.; DANON, Critique de la Circulaire du 22 août 2007, p. 436 et seq.; JUNG, Neue Schweizer Besteuerungspraxis, p. 62 et seq.; AMONN, Trustbesteuerung, p. 493 et seq.; OBERSON, Trust, p. 475 et seq.; NIEDERER, Neue Besteuerungspraxis, p. 1499 et seq.; BÖCKLI, Angelsächsische Trust – Zivilrecht und Steuerrecht, p. 60 et seq.; DANON, thesis, p. 367 et seq.; CRETTE, thesis 2007, p. 35 et seq.; LANDOLF/GRAF, Trust im schweizerischen Steuerrecht, p. 1 et seq.; RYSER, double taxation treaties, p. 310 et seq.; NOSEDA, Taxation of Trusts, p. 7; CRETTE, législation étrangère, p. 135 et seq.; BETSCHART, Grundzüge der Trustbesteuerung, p. 158 et seq.; FAVRE, Approche fiscale du trust, p. 169 et seq.; PETER, Die liechtensteinische Stiftung, p. 163 et seq.

⁴³⁵ In Canada a trust is legally characterized as an individual.

⁴³⁶ In the United States, a trust is characterized as a legal entity but is taxed as an individual.

⁴³⁷ Para. 5.1 Circular 30/20. The present Circulars expressly reject the former solution of the Tax Authority of the Canton of Zurich according to which the trust was treated as a quasi legal entity assimilated to a foundation in which its assets, which could not be attributed to the settlor or beneficiary, were to be attributed to the trust itself. See BETSCHART, Grundzüge der Trustbesteuerung, p. 162 et seq.

⁴³⁸ Art. 3 LDTF; Art. 3 LHDT.

⁴³⁹ Granting trusts with legal personality in Swiss tax law would not be in line with the incorporation theory deriving from the SPILA.

⁴⁴⁰ Art. 49 para. 3 LDTF; Art. 20 para. 2 LHDT.

⁴⁴¹ Art. 11 LDTF; Art. 20 para. 2 LHDT. These Articles apply to entities whose members have a “*personal relationship*”, such as heir communities or common law partnerships, but which do not exist in the trust relationship.

⁴⁴² Para. 2.2 Circular 30/20.

3.3.4 Excursus on the Taxation of Underlying Companies in Offshore Jurisdictions

However, the lack of recognition of trusts as independent tax-subjects does not imply that underlying companies with registered seats, often in low-tax jurisdictions, cannot be subject to unlimited tax liability in Switzerland⁴⁴³, so long as their place of effective management (*“Ort der tatsächlichen Geschäftsleitung”*; *“lieu de gestion*

⁴⁴³ Art. 50 LDTF; Art. 20 para. 1 LHDT. See in this regard the latest court decisions by the Zurich Tax Court of Appeal of 25 March 2013 (DB.2012.293 and ST.2012.330). These holdings were confirmed in two decisions by the Administrative Court of Zurich on 2 April 2014 (SB.2013.00037 and SB.2013.00038) and by a Swiss Federal Supreme Court Judgment of 16 May 2013 (2C_1086/2012, 2C_1087/2012).

effective de l'administration")⁴⁴⁴ is located in Switzerland. In a widely criticized decision of 4 December 2003⁴⁴⁵, the Swiss Federal Supreme Court subjected for the first time a foreign company to unlimited tax liability in Switzerland, based on the fact that its "*place of effective management*" was in Switzerland⁴⁴⁶. This result is even more surprising in that the decision maker (the single shareholder making the

⁴⁴⁴ For a definition of the "*place of effective management*" in the intercantonal context as well as in international relationship between Switzerland and States without double tax conventions refer to the following definitions published by the Swiss Federal Supreme Court in various judgments: Swiss Federal Supreme Court Judgment of 10 May 1992, cons. 1 (ATF 55 I 84): "*die Fäden des Geschäftsverkehrs der Gesellschaft zusammenlaufen*"; Swiss Federal Supreme Court Judgment of 22 June 1928, cons. 2 (ATF 54 I 308): "*wirtschaftlichen und tatsächlichen Mittelpunkt dieser ökonomischen Existenz hat*"; Swiss Federal Supreme Court Judgment of 17 May 1924, cons. 2 (ATF 50 I 101): "*die normalerweise am Sitz sich abspielende Geschäftsführung besorgt wird*"; Swiss Federal Supreme Court Judgment of 17 Mai 1924, cons. 2 (ATF 50 I 101): "*wo jene Handlungen ergriffen werden, welche in ihrer Gesamtheit der Erreichung des statutarischen Zwecks dienen*"; Swiss Federal Supreme Court Judgment of 27 June 1919 (ATF 45 I 190): "*die Fäden der Geschäftsführung zusammenlaufen und die wesentlichen Unternehmensentscheide fallen*"; Swiss Federal Supreme Court Judgment of 5 September 1985: "*welche in ihrer Gesamtheit der Erreichung des statutarischen Zweckes dienen*"; Swiss Federal Supreme Court Judgment of 16 Mai 2013, cons. 2.5.3-2.5.4 (2C_1086/2012, 2C_1087/2012): functioning substance ("*funktionsadequate*" *Substanz*). For the purpose of determining the "*place of effective management*", it is neither relevant where the strategic decisions on the highest company level are being taken, nor where pure administrative tasks (e.g. book-keeping) are being executed, nor where board meetings are being held. Rather, the determination of the "*place of effective management*" is based on where the ongoing business of the company in regard to its corporate purpose - including the related day-to-day decisions - are taking place. The definition of the "*place of effective management*" set by the Zurich Tax Court of Appeal in its decision of 25 March 2013 (DB.2012.293 and ST.2012.330), which was confirmed by the Administrative Court of Zurich on 2 April 2014 (SB.2013.00037 and SB.2013.00038), is comparable to the definition set by the Swiss Federal Supreme Court Judgment of 16 Mai 2013. In particular, the Judgment held in cons. 2.2 that the "*place of effective management*" is where the functioning substance ("*funktionsadequate*" *Substanz*) of the company lies and namely, where the important day-to-day decisions are being taken. It is explicitly stated that the actual administration cannot be executed by a third party under a mandate. Moreover, for asset management companies it is decisive that they have the power of disposition over the administered assets.

⁴⁴⁵ WIDMER/MOSER, *Aussensteuerrecht*, p. 499 et seq.

⁴⁴⁶ Decision of the Swiss Federal Supreme Court Judgment of 4 December 2003 (BGer 2A.321/2003) = StE 2005 B 71.31 Nr. 1, 2002 A 24.22 Nr. 5. For a detailed analysis: WIDMER/MOSER, *Aussensteuerrecht*, p. 497 et seq.

corporate decisions) was not even domiciled in Switzerland. Thus, offshore companies may now be treated as tax residents, and be subject to unlimited (income) tax liability in Switzerland, if they are effectively managed from Switzerland. Contrary to the majority opinion, it is no longer sufficient for the offshore company to have a local representative other than its domestic organs at its registered office; the “*place of effective management*”, which can be defined differently depending on the context⁴⁴⁷, should clearly be located at the company’s registered seat. The court decision of 4 December 2003 has recently been confirmed by Federal Tribunal Judgment of 16 Mai 2013⁴⁴⁸ as well as the Zurich Tax Court of Appeal Decision of 25 March 2013⁴⁴⁹ and the Administrative Court of Zurich Decision of 2 April 2014⁴⁵⁰. However, an important question to address is whether an offshore underlying company administrated by a Swiss resident trustee⁴⁵¹ who is a member of the board of directors, is considered to be effectively managed from Switzerland. Interestingly, according to the Federal Tax Administration, in such circumstances the “*place of effective management*” is considered to be outside of Switzerland if the settlor and the beneficiary are not Swiss residents and if the remuneration for the services provided to the trust or to the offshore company is granted in accordance with the arm’s length principle⁴⁵².

A recent Swiss court decision has provided insight as to the interpretation of the notion of “*place of effective management*” within a complex Jersey trust structure⁴⁵³. The Zurich Tax Court of Appeal assessed the question of

⁴⁴⁷ MAUTE/HEILINGER, *Tatsächliche Verwaltung*, Part I, p. 751; MÄUSLI, thesis, p. 58; WIDMER/MOSER, *Aussensteuerrecht*, p. 499.

⁴⁴⁸ Swiss Federal Supreme Court Judgment of 16 Mai 2013 (2C_1086/2012, 2C_1087/2012).

⁴⁴⁹ Zurich Tax Court of Appeal of 25 March 2013 (DB.2012.293 and ST.2012.330).

⁴⁵⁰ Administrative Court of Zurich of 2 April 2014 (SB.2013.00037 and SB.2013.00038).

⁴⁵¹ In practice, the trustee usually renders his services through a legal person called a “*trust company*” in order to ensure a limitation of risks.

⁴⁵² See the practice of the Federal Tax Administration for Federal Direct Tax and Swiss Withholding Tax published in: JUNG, *International Taxation*, p. 146, Footnote 26. STOCKAR/HOCHREUTENER, *Praxis WTL*, nr. 22 ad. Art. 9 specifies that “*Handelt es sich dabei um eine sog. “Underlying Company”, wird diese steuerlich dem Trust zugerechnet, da sie einzig dazu dient, für diesen nach aussen als Eigentümerin des Trustvermögens auftreten zu können*”.

⁴⁵³ See: Zurich Tax Court of Appeal of 25 March 2013 (DB.2012.293 and ST.2012.330) which has been confirmed recently by the Administrative Court Zurich of 2 April 2014 (SB.2013.00037 and SB.2013.00038).

whether the “*place of effective management*” of a Jersey company, held by a Jersey trust, with the objective to administer the undeclared funds of a family, was located in Switzerland. Also, if in this study, the trustee holds the investments directly and, accordingly, not through an underlying company⁴⁵⁴, the problems regarding the seat and the “*place of effective management*” are not relevant to the separate taxation or to the tax residency of the trust⁴⁵⁵. Nevertheless, the recent Swiss court decision will be analyzed in detail.

3.3.4.1 *The Meaning of the “Place of Effective Management” according to the Administrative Court of Zurich Decision of 2 April 2014*

3.3.4.1.1 Factual Background

In this case, the Administrative Court of Zurich had to consider the following situation. C, a tax resident in the canton of Zurich, settled (hereinafter referred to as “*settlor*”) a trust (hereinafter referred to as “*F-Trust*”) in Jersey in 1997 where he deposited, for the benefit of the family, undeclared assets. D Ltd, a company incorporated in Jersey, was appointed as trustee (hereinafter referred to as “*trustee*”). Furthermore, an attorney domiciled in the canton of Zurich, acting as a Protector, had been appointed to control the trustee’s obligations and duties. The beneficiaries of the trust were the settlor, his wife and their children (hereinafter referred to as “*beneficiaries*”).

At the same time, a subsidiary company, A. Ltd. (hereinafter referred to as the “*underlying company*”) was incorporated in Jersey. The undeclared assets were transferred into this underlying company through a loan of CHF 30 Mio. The capital of the underlying company amounted to only GBP 10. The shares were owned by the trust.

The purpose of the underlying company was the management of the assets. Its activities were limited to administrative services, book-keeping and accounting services. External asset managers and banks were appointed by the trustee, and they effectively took the asset management decisions. The underlying company deposited the assets on bank accounts in Switzerland and concluded contracts which entrusted Swiss banks or external companies to manage the

⁴⁵⁴ See Chapter 3.2.

⁴⁵⁵ Para. 4.2 Circular 30/20.

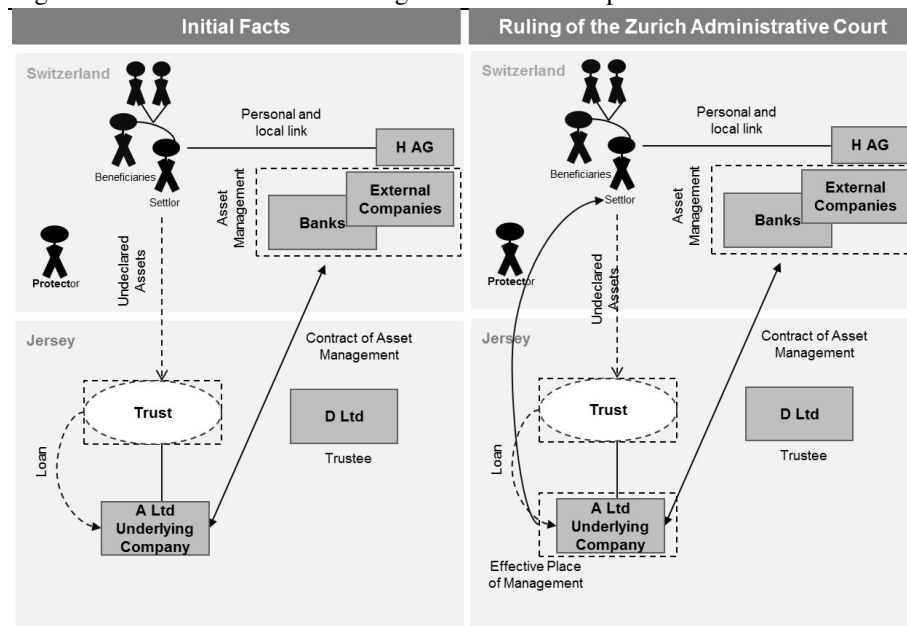
assets. Subsequently, the underlying company reimbursed the loan to the settlor through the trust.

It should be taken into consideration that the settlor had all the necessary professional know-how in financial matters and asset management. Furthermore, he effectively kept control over the assets since he knew one of the external asset managers personally.

In the process of a voluntary disclosure, the Swiss tax authorities found that the underlying company was effectively managed by the settlor from his place of domicile in the canton of Zurich rather than from the place of its incorporation in Jersey. Therefore, the underlying company was subject to unlimited tax liability in Switzerland.

This decision was appealed to Administrative Court of the Canton of Zurich. However, the decision was affirmed.

Figure 3.3: Effective Place of Management Case of 2 April 2014



Source: Own figure

3.3.4.1.2 Findings of the Administrative Court of Zurich

Pursuant to Swiss tax legislation, legal entities are subject to unlimited tax liability in Switzerland when their seat or “*place of effective management*” is in Switzerland⁴⁵⁶. The fact that the seat of the underlying company is located in Jersey is not questioned by the Court. However, the latter considered that the “*place of effective management*” of the underlying company was located in Switzerland⁴⁵⁷.

As a consequence of this finding, the Court then had to define the notion of “*place of effective management*”. In a first step, it referred to the definition set in the Message of the Federal Council concerning the Federal Act on Harmonized taxes. According to this definition, “*the place where the effective management is exercised is the place where the social business is held and where important corporate decisions concerning the company are taken*”. This definition is no different than the notion of “*effective management of business*” which is commonly used in international double tax conventions⁴⁵⁸. In other words, the “*place of effective management*” is located where the acts necessary for the achievement of the company’s purpose are regularly undertaken. The place where the company has its effective and economic center of existence and from where management decisions are commanded also needs to be taken into account. Thus, the management of current business within the corporate purposes and the center of gravity of the management are the predominant factors to determine the “*place of effective management*”.

Moreover, the Administrative Court of Zurich found that there was a difference between pure administrative management and the company’s governing bodies’ activities, the latter being limited to the control over the effective management of fundamental decisions-making processes. The place where the board of directors meetings and the general meetings are held as well as the place of residence of the shareholders were held not to be decisive. On

⁴⁵⁶ Art. 50 LDFT; Art. 20 para. 1 LDHT.

⁴⁵⁷ Administrative Court of Zurich Decision of 2 April 2014, cons. 2.1 (SB.2013.00037 and SB.2013.00038).

⁴⁵⁸ Administrative Court of Zurich Decision of 2 April 2014, cons. 2.2 (SB.2013.00037 and SB.2013.00038).

the contrary, with regard to asset management companies, the power of disposal over the managed assets was found to be essential for the determination of the “*place of effective management*”⁴⁵⁹.

The Court also clarified that the burden of proving the existence of a connecting criteria justifying a tax liability lies with the tax authority. The statutory seat is determined according to the register of commerce, but the effective seat or, in other words, the “*place of effective management*” is determined according to where the management takes place in the specific circumstances of each case. This analysis may require important means and efforts, in particular due to the fact that the company has no duty to cooperate. However, if the “*place of effective management*” appears most likely to be in Switzerland, this was held a sufficient evidence to reverse the burden of proof, meaning that it is for the company to prove that its “*place of effective management*” is not in Switzerland.

In the case at hand, the underlying company’s sole activity was the “*investment trading*” of C’s assets, brought into the Trust, in the interest of C and his family. This asset management activity was outsourced to third parties (I Bank and the J AG) within Switzerland. The court noted that it was hardly conceivable that external parties were chosen for the current administration activities, since third parties could not be entrusted with such management. This would have meant handing over the decisive influence over both the business and its management. As a consequence, the management of the underlying company could only be undertaken either by the settlor (C) or the trustee (D Ltd.).

The following elements show, according to the Court, that the trustee (D Ltd.) has not undertaken the effective management of the underlying company. Despite the fact that the trustee (D Ltd.) provided the two “*directors*” of the underlying company and was in charge of the selection and supervision of the investment managers, it is most likely that the effective management is not at the level of the trustee (D Ltd.) or the two “*directors*”, but with the settlor (C). Also, the fact that the trustee made a “*company secretary*” available who was in charge of the “*bookkeeping and accounting*”,

⁴⁵⁹ Administrative Court of Zurich Decision of 2 April 2014, cons. 2.2 (SB.2013.00037 and SB.2013.00038).

and who provided “*administrative services in relation to the above company’s activities*” should not be decisive. Indeed, these activities should be understood as simple administrative activities of minor importance.

Another point raised by the Court is that the services provided by D Ltd. were provided to other companies domiciled in Jersey as well, meaning that the trustee (D Ltd.) was acting towards the underlying company within a standard framework and without having a managerial position. The high fees received by D Ltd. as compensation for its services were not found to be sufficient to conclude that D Ltd. was in charge of the effective management of the underlying company. Rather, it suggests that D Ltd. was a service provider for the underlying company and not a leader able to interfere in managerial company activities. Another important point is that even if D Ltd. provided a “*registered office*” to the underlying company, the latter had no premises in Jersey. In fact, premises are an important indicator for defining the “*place of effective management*”. Therefore, the Court concluded that a genuine activity of the underlying company in Jersey was scarcely existent. As a consequence, it was found to be unlikely that the effective management lied with D Ltd. or its directors, the latter having more of a formal character lacking any substantial influence on the course of the company’s activities.

According to the Court, it seemed more likely that the settlor (C) actually held the effective management of the underlying company. The reasons for this finding were the following: It appeared that settlor (C) had a power of decision over the trust’s distribution and modification of the asset management contracts and investment profiles. Moreover, it was shown that settlor (C)’s power of decision was used actively, as during the transaction when the trustee (D Ltd.) was instructed to transfer assets of a certain amount in Swiss francs from the underlying company into the bank account held by settlor (C) after agreement with the latter. From that moment, it seemed difficult to consider that settlor (C) was limited to the role of a passive creditor in the transaction since a substantial proportion settlor (C)’s assets was concerned over which he had always had full disposal.

Concerning the relations between the external I Bank and C, the Court stated that it appeared that the latter met the account manager in charge of I Bank at least twice a year. C also had excellent know-how and competencies in financial matters. It would be hard to believe that he did not use this knowledge in private. Thus, it was held that C’s work was not limited to basic decision making, but that his role went beyond a simple supervisory

body. Evidently he had the opportunity to influence, at any time, the activities of the underlying company despite the fact that for the Bank I he had no power of signature.

From an operational point of view, this type of company (asset management company) is managed regardless of the investors. Thus, the financial structure of the present company is hardly conceivable.

Finally, it was held to be extremely probable for the present trust–company construction that the concealment of the assets was the primary concern, the civil legal independence of the assets and inheritance considerations being only of secondary importance. C could easily maneuver the activities of the underlying company on which he had a decisive influence. Consequently, it was concluded that the effective management was executed by C and that the “*place of effective management*” was located in Switzerland. Accordingly, the underlying company was found to be subject to an unlimited tax liability in Switzerland as well as in the canton of Zurich due to the attachment in Switzerland through the “*place of effective management*”.

3.3.4.1.3 Critique in relation to the “Place of Effective Management”

The considerations of the Zurich Tax Court of Appeal confirmed the authoritative principle of the legal seat⁴⁶⁰ and how the decision of where the legal seat is for purposes of taxation is determined based on where the Court considers the company has more substance or activities. As Marcel Jung correctly points out, it is likely that the Court would have come to a different conclusion if A Ltd, the underlying company, had disposed of its own employed personnel and rented offices in Jersey, or if the two directors of A Ltd. had chosen and actively monitored the asset managers themselves⁴⁶¹. However, it appeared that at least twice a year C met the account manager in charge of I Bank. It could even be conceivable that C used his expertise in financial matters.

⁴⁶⁰ See: Zurich Tax Court of Appeal Decision of 25 March 2013, cons. 2.3 (DB.2012.293 and ST.2012.330) which has recently been confirmed by the Administrative Court of Zurich Decision of 2 April 2014.

⁴⁶¹ JUNG, Internationale Steuerplanung mit Offshore-Gesellschaften, Part II, p. 616.

In the author's view, the Court decision would be better substantiated if the issue of own personnel and own offices had been analyzed in more detail. In principle, a private asset management company does not have necessarily its own personnel and own offices. Thus, whether in cases like this one there are other factors that could be weighed in order to establish that there is a place of establishment in a place where there are no offices or personnel. Otherwise, in cases like the one at hand there is potential for a mismatch when the decisions are actually made from a location (meaning that the place of effective management is there) but there are no employees or offices. Additionally, the Court could have articulated other factors why the settlor was effectively managing the assets.

Additionally, it was decided that the underlying company, A Ltd., an asset management company, has not delegated its sole activity "*investment trading*" to third parties (I Bank and J AG) within Switzerland. In this regard, the Court stated that the company management could not be delegated to third parties. It held that, if an asset management company delegated its asset management to a professional external asset manager with specialized expertise in a certain market, this did not mean that the company's management had been delegated to the external asset manager.

Here, all the the strategic decisions of allocating capital, monitoring investments as well as risk assessment were left to the asset management company domiciled in Jersey. Considering that all asset management contracts were executed by the directors of the underlying company located in Jersey and all bank documents in relation to the single transactions were provided by the underlying company, it is doubtful that the "*place of effective management*" is at the settlor's domicile in Zurich as the Court found.

3.3.5 Excursus on other Legal Institutions

According to the Circulars, only foreign trusts validly created according to Chapter II of the Hague Trust Convention are fiscally recognized in Switzerland⁴⁶². The Circulars clearly differentiate the trust relationship from other

⁴⁶² Hague Convention, ad. Art. 6-10.

institutions with similar objectives, such as foundations⁴⁶³ and fiduciary relationships⁴⁶⁴, to which the Circulars do not apply. Additionally, in their respective paragraphs 2.4, the Circulars indirectly exclude Liechtenstein legal institutions such as “Anstalten”, “Stiftungen” and “Treuhänderschaften”, by reserving the right to exclude them in specific circumstances. The Circulars only state that “*Anstalten, Stiftungen und Treuhänderschaften nach liechtensteinischem Recht unterscheiden sich aufgrund ihrer Ausgestaltungsformen stark vom Rechtsinstitut des Trusts und werden deshalb im vorliegenden Kreisschreiben nicht weiter ausgeführt*”⁴⁶⁵. A more rational explanation for this exclusion, especially in the case of the “Treuhänderschaft”, would have been preferable, as this institution may, depending on its civil arrangement, fulfill the criteria of a trust as established by the Circulars.

Klaus Biedermann came to the conclusion that the Liechtenstein laws on the “Treuhänderschaft” are an adaptation of Anglo-Saxon trust law⁴⁶⁶. His conclusions have been adopted by numerous other authors. However, Harald Bösch demonstrated that these laws are not merely an adoption of Anglo-Saxon ideas, but instead represent a synthesis of ideas from various legal systems, such as German fiduciary laws, in addition to the traditional principles of Anglo-Saxon trusts⁴⁶⁷.

However, the influence of various legal orders is irrelevant for tax purposes when their main elements are fulfilled. According to an analysis carried out by Maurizio Lupoi - which substantially follows Donovan Waters’ viewpoint⁴⁶⁸ - five key elements are necessary in order for a “Treuhänderschaft” to be characterized as a traditional English law trust⁴⁶⁹. First, there must be a transfer of assets to the trustee or a unilateral declaration of trust. Second, the assets that have been transferred to the trustee must be kept separate from the rest of his patrimony (segregation of the assets). Third, the settlor must cease to have any legal right to the assets. The fourth element requires the existence of beneficiaries or a specific purpose of the trust, making the exercise

⁴⁶³ Para. 2.2 Circular 30/20.

⁴⁶⁴ Para. 2.3 Circular 30/20.

⁴⁶⁵ Para. 2.4 Circular 30/20.

⁴⁶⁶ BIEDERMANN, thesis, p. 12, 561.

⁴⁶⁷ BÖSCH, thesis, p. 291 et seq.

⁴⁶⁸ WATERS, Trust, p. 427-435.

⁴⁶⁹ LUPOI, Comparative study, p. 269-273.

of the rights transferred to the trustee a function. The fifth element is that the entire operation must possess a fiduciary character. If these five requirements are present, the “*Treuhänderschaft*”⁴⁷⁰ should be assimilated to the common law trust and should not unjustifiably be excluded, as is indirectly suggested by paragraph 2.4 of Circulars 30 and 20. This view is also shared by the practice of the Canton of Zurich, which recognizes and applies Circular 20 to Liechtenstein “*Treuhänderschaften*”.

3.3.6 Taxation of the Trustee and the Protector

Upon creation of the trust, the trustee becomes the legal owner⁴⁷¹ (“*zivilrechtlicher Eigentümer*”; “*propriétaire de droit civil*”) of the trust assets and income. The trustee has no “*equitable interest*” over such assets and income⁴⁷² and thus it cannot be taxed on them, as long as the trust assets remain separate from his private assets⁴⁷³. The same applies to the person supervising the trust relationship, known as the protector⁴⁷⁴. This position is

⁴⁷⁰ See Art. 897 PGR for the first element, 915 PGR for the second element, 897 PGR for the third element, Art. 897 PGR for the fourth element and Art. 925 PGR for the fifth element. In this vein also: LUPOI, Comparative study, p. 301-315.

⁴⁷¹ The Circulars translate the German expression “*zivilrechtlicher Eigentümer*” and the French expression “*propriétaire de droit civil*” to “*legal interest*” in English. This translation does not seem accurate. The trustee has legal ownership of the trust assets and income that have been transferred to him and is; therefore, the legal owner.

⁴⁷² Para. 4.2 Circular 30/20.

⁴⁷³ OBERSON, Trust, p. 486; LANDOLF/GRAF, Trust im schweizerischen Steuerrecht, p. 20. However, other authors reject the analogy with the fiduciary, even though they come to the same conclusion by invoking the principle of financial capacity. In this vein: RYSER, Rapports de trust, p. 757.

⁴⁷⁴ A more detailed analysis with regard to the duties of a protector can be found in BONNARD, Protecteur, p. 673-676; DANON, thesis, p. 53-54; ARTER, Protektor eines Trusts, p. 729 et seq; HAYTON/MATTHEWS/MITCHELL, Trusts, p. 41-47. The definition of a protector may be found on page 3 of the 1989 International Trusts Amendment Act from the Cook Islands.

consistent with the principle of financial capacity⁴⁷⁵ since both the trustee and protector lack economic ownership of the trust assets and income⁴⁷⁶.

However, if the trustee or protector is simultaneously the settlor or the beneficiary, then it has both legal *and* economic ownership of the trust assets and income. Additionally, the trustee and the protector will be taxable on the fees they receive for their services if their seat⁴⁷⁷ or residence⁴⁷⁸ is in Switzerland⁴⁷⁹. Nevertheless, the trustee remains the person controlling the assets under an irrevocable discretionary trust.

In this light, the Circulars' approach towards Swiss resident settlors appears questionable⁴⁸⁰. The solution offered by the Canton of Zurich, to assimilate an irrevocable discretionary trust to a foundation and hence subject it to taxation, tends to concede a quasi-fiscal personality to the trust⁴⁸¹. Indeed, under the principle of financial capacity, the trustee, and not the settlor, holds control of the trust assets and may decide, within the limits of his discretionary power, on how to distribute the assets. Certain authors advocate, "*de lege ferenda*", the American solution, i.e. separate taxation of the trust assets at the trustee level⁴⁸².

⁴⁷⁵ Art. 127 para. 2 FC.

⁴⁷⁶ In this vein among others: DANON, thesis, p. 271; RYSER, *Rapports de trust*, p. 757; OBERSON, *Trust*, p. 486: the principle of financial capacity ensures that a taxpayer will not be taxed on an element over which such taxpayer has no power of disposition.

⁴⁷⁷ Art. 50 LDFT; Art. 20 para. 1 LHDT.

⁴⁷⁸ Art. 3 para. 1 LDFT; Art. 3 para. 1 LHDT.

⁴⁷⁹ Para. 4.2 Circular 30/20.

⁴⁸⁰ In this vein: OBERSON, *Trust*, p. 486.

⁴⁸¹ BETSCHART, *Grundzüge der Trustbesteuerung*, p. 158 et seq.; LANDOLF/GRAF, *Trust im schweizerischen Steuerrecht*, p. 18; PETER, *Die liechtensteinische Stiftung*, p. 171 et seq.

⁴⁸² DANON, thesis, p. 370 et seq.; OBERSON, *Trust*, p. 491; CRETTEI, thesis 2007, p. 114 et seq. Against: OPEL, *Familienstiftung und Trust*, p. 284 et seq. "*Denkbar ist eine persönliche Zugehörigkeit und damit unbeschränkte Steuerpflicht des Trusts aufgrund tatsächlicher Verwaltung in der Schweiz*".

3.3.7 Taxation of the Settlor and the Beneficiary

3.3.7.1 *Tax Consequences based on the Distinction between Revocable and Irrevocable Trusts*

The distinction between revocable and irrevocable trusts⁴⁸³ is crucial in light of the situation frequently arising in which parties pretend to set up a trust, when in reality the settlor maintains control over the trust (directly or indirectly). An example of this would be where the trustee complies with the instructions of the settlor⁴⁸⁴ regarding dispositions of trust assets, thereby negating the core principles underlying the trust relationship.

Generally, the tax consequences depend on which of the settlor or the beneficiary obtains some economic benefit from the trust, and whether the settlor retains some control over the trust. In the latter case, the revocability leads, in Switzerland as in many other countries, to the attribution of the trust assets and/or income to the person actually controlling the trust – usually the settlor – without any retroactive effect⁴⁸⁵. The defining factor is the issue of definitive alienation (“*Veräußerung*”; “*aliénation*”) of the trust’s assets and income⁴⁸⁶, according to the true economic reality of the situation (“*wirtschaftliche Betrachtungsweise*”; “*contenu économique*”)⁴⁸⁷, which may differ from the strict legal position. This line of reasoning is very similar to the “*substance over form*” concept in relation to family foundations⁴⁸⁸. Peter Böckli points out that this concept is, in reality, assimilated to the “*contract-over-form*” concept, according to which the beneficial owner is

⁴⁸³ See Chapter 3.3.8.1 to Chapter 3.3.8.3.

⁴⁸⁴ See Chapter 3.3.7.1.

⁴⁸⁵ In comparison to other jurisdictions: HAYTON/KORTMANN/VERHAGEN, p. 63; BERAUDO, *Les trusts anglo-saxons*, p. 73.

⁴⁸⁶ NOSEDA, *Taxation of Trusts*, p. 10.

⁴⁸⁷ Para. 3.7 Circular 30/20. In detail DANON, *thesis*, p. 176 et seq.

⁴⁸⁸ Decision of the Swiss Federal Supreme Court Judgment of 16 May 1951 = ASA 19, p. 524 = RDAF 1951, p. 293. See also: Swiss Federal Supreme Court Judgment of 21 October 1966 = ASA 35, p. 467; Swiss Federal Supreme Court Judgment of 8 October 1965 = RDAF 1967, p. 240 = ASA 35, p. 233; Swiss Federal Supreme Court Judgment of 3 June 1959 = RDAF 1960, p. 254; Swiss Federal Supreme Court Judgment of 29 March 1956 = RDAF 1956, p. 242 = ASA 24, p. 481; MÄUSLI, *Steuerliche Überlegung*, p. 118-119.

the person who is being given rights under a contract⁴⁸⁹. Robert Danon, in the same line, compares the substance over form concept to the “*grantor trust rules*”, which are anti-abuse provisions adopted in some common-law jurisdictions⁴⁹⁰. However, he challenges the principle of taxation under Swiss tax law according to the true economic reality: “(...) *il nous paraît que cette vision économique des choses n’est pas compatible avec les principes régissant le droit fiscal suisse*”⁴⁹¹. He concludes, based on a federal court decision, that Swiss attribution rules follow, in the absence of tax avoidance, a formal private law characterization⁴⁹². However, in this regard it must be stated that, based on the Circular Letter 30/20 on trusts, trust relationships are subject to a look-through approach for tax purposes; in particular, the beneficial owner of the income becomes taxable, rather than the legal owner based on an economic (substance-over-form) approach⁴⁹³.

The economic reality determines whether a revocable or irrevocable trust exists. This analysis does not only take into account the formal designation or characterization indicated in the trust deed (“*Errichtungsurkunde*”; “*document de constitution*”)⁴⁹⁴. The economic reality may be ascertained by examining the content of the trust deed and by analyzing the specific situation. The demarcation between revocable and irrevocable trusts is of great importance as it forms the basis of the fiscal attribution of trust assets and income. In view of the complexity prevailing in trust relationships, one finds it difficult to draw a clear line between these two notions. Circular 30/20 lists nine factors, which are partly based on the case law relating to family foundations, which should be taken into account to decide whether a trust is revocable or irrevocable. The Circular follows a restrictive approach, since a trust

⁴⁸⁹ BÖCKLI, Angelsächsische Trust – Zivilrecht und Steuerrecht., p. 9.

⁴⁹⁰ Among others as explored in DANON, thesis, p. 68 et seq.; Sec. 671 - 679 of the Internal Revenue Code (IRC) of the United-States.

⁴⁹¹ DANON, Critique de la Circulaire du 22 août 2007, p. 448; OBERSON, Trust, p. 476. Against: LOCHER, Grenzen der Rechtsfindung, p. 179 et seq. Against: PONCE, L’évasion fiscale en droit interne, p. 129-130. Swiss Federal Supreme Court Judgment of 14 November 2008, cons. 2.3 to 2.6 = RDAF 2009, p. 460.

⁴⁹² Swiss Federal Supreme Court Judgment of 16 May 1951 = ASA 19, p. 524 = RDAF 1951, p. 293. DANON, Critique de la Circulaire du 22 août 2007, p. 449 ; DANON, thesis, p. 186.

⁴⁹³ BOYER/HILDEBRANT, National report on attribution of income, p. 640.

⁴⁹⁴ BÖCKLI, Angelsächsische Trust – Zivilrecht und Steuerrecht, p. 8-9; VON AH, Trusts im Schweizer Steuerrecht, p. 3.

will be treated as revocable if one of the following powers remains with the settlor:

- To benefit from capital distributions of the trust assets;
- To benefit from distributions of the trust income;
- To remove/replace the trustee;
- To appoint or cause the appointment of new beneficiaries;
- To replace the protector (who in turn has powers comparable to those of a trustee);
- To amend the trust deed or cause it to be amended;
- To revoke the trust;
- To require liquidation of the trust;
- To exercise a veto over the trustee's decisions with respect to the trust assets and income.

Such a restrictive approach does not fully grasp the complexity of the subject matter⁴⁹⁵. The attribution of the trust assets and income cannot be dependent on one specific factor; therefore, it is crucial to consider the economic reality and the specific contextual circumstances of the trust relationship in order to establish whether a given trust is revocable or irrevocable⁴⁹⁶.

3.3.7.2 *Taxation Principles Based on an Economic (Substance-Over-Form) Approach*

3.3.7.2.1 General Introduction

In this chapter, the analysis will focus on the relationship between tax law and civil law⁴⁹⁷. The author will attempt to answer the question of whether

⁴⁹⁵ In the same vein: BÖCKLI, Angelsächsische Trust – Zivilrecht und Steuerrecht, p. 50; AMONN, Trustbesteuerung, p. 498.

⁴⁹⁶ BÖCKLI, Angelsächsische Trust – Zivilrecht und Steuerrecht, p. 50.

⁴⁹⁷ See Chapter 3.3.7.2.2.

the economic (substance-over-form) approach taken by the Circular Letter 20/30 in respect to the taxation of trusts is justified in light of the objective and purpose of Swiss law⁴⁹⁸. Under this chapter, the author will try to determine whether this approach is in line with the Swiss law principles developed under a civil law system. Furthermore, this chapter will outline the author's critical thoughts on the delimitation between revocability and irrevocability of a trust⁴⁹⁹ as well as the suggested solutions in connection with this issues⁵⁰⁰.

3.3.7.2.2 The Influence of Civil Law on Tax Law

The relationship between civil law and tax law is a sensible and necessary starting point for analyzing the taxation of trusts in Switzerland. Unlike in Germany where the fields of civil law and tax law have been totally segregated over time and are seen as entirely distinct⁵⁰¹, Swiss doctrine and case law have resisted a complete separation. As a result, the relationship between civil law and tax law is complicated and interdependent⁵⁰². Generally, the approach taken by the courts and advocated by scholars over time in regard to such provisions can be divided into (i) the interpretation according to civil law terms, (ii) the interpretation according to the economic reality and (iii) a dualistic interpretive approach based on whether a statute is founded in civil law or stems from an economic context. In the following subchapters, these different approaches and their development by the Swiss Federal Supreme Court and Swiss legal scholars are discussed chronologically.

Although a certain independence of tax law has always been considered essential for regulations on tax matters to develop organically, caution has been exercised by Swiss legal scholars - contrary to the developments in

⁴⁹⁸ See Chapter 3.3.7.2.2.

⁴⁹⁹ See Chapter 3.3.8.1.

⁵⁰⁰ See Chapter 3.3.8.1.

⁵⁰¹ See LOCHER, *Rechtsmissbrauchüberlegungen*, p. 678.

⁵⁰² KOLLER, *Privatrecht und Steuerrecht*, p. 265; BÖCKLI, *Angelsächsische Trust*, Part I, p. 710.

Germany - to avoid what Ernst Blumenstein called “*isolationistic exaggerations and fanaticism*” (“*isolationistische Übertreibungen und Fanatismus*”; “*exagérations isolationnistes et fanatisme*”)⁵⁰³.

The possible consequences of the interdependence between tax law and civil law have been the object of an important debate amongst Swiss scholars⁵⁰⁴. Additionally, the Swiss Federal Supreme Court’s inconsistent approach over time has further complicated the issue⁵⁰⁵. In order to understand the degree of interdependence between tax law and civil law in Switzerland, an analysis of the changes in the position of the Swiss Federal Supreme Court as well as the historical development of Swiss legal doctrine is essential⁵⁰⁶.

3.3.7.2.3 Overview of the Swiss Federal Supreme Court's Position and

⁵⁰³ BLUMENSTEIN, *Gegenseitige Beziehungen*, p. 171a/172a.

⁵⁰⁴ See Chapter 3.3.7.2.3.3. Amongst others: BLUMENSTEIN, *Gegenseitige Beziehungen*, p. 1 et seq.; KOLLER, *Privatrecht und Steuerrecht*, p. 1 et seq.; LOCHER, *Rechtsmissbrauchsüberlegungen*, p. 1 et seq.; RIVIER, *Interprétation*, p. 355 et seq.; RYSER/ROLLI, *Précis de droit fiscal Suisse Impôts directs*, p. 1 et seq.; DUBS, *Wirtschaftliche Betrachtungsweise und Steuerumgehung*, p. 569 et seq.; HÖHN/WALDBURGER, *Steuerrecht*, Vol. 1, 9th edition, Bern 2001, p. 1 et seq.; DESAX, *Methodologie der Rechtsprechung*, p. 31 et seq.; HÖHN, *Wirtschaftliche Betrachtungsweise im Steuerrecht*, p. 387 et seq. and more recently MATTEOTTI, *Wirtschaftliche Betrachtungsweise und Steuergerechtigkeit*, p. 217 et seq.; PONCE, *L’évasion fiscale en droit interne*, p. 125 et seq.; GLAUSER, *fiscale et interprétation économique*, p. 727 et seq.

⁵⁰⁵ See Chapter 3.3.7.2.3.2. Amongst others: Swiss Federal Supreme Court Judgement of 12 November 1926 (BGE 52 I 280); Swiss Federal Supreme Court Judgement of 1 November 1933 (BGE 59 I 272); Swiss Federal Supreme Court Judgement of 17 June 1983 (BGE 109 Ia 97); Swiss Federal Supreme Court Judgement of 14 March 1975 (BGE 101 Ib 44); Swiss Federal Supreme Court Judgement of 14 May 1976 (ATF 102 Ib 50); Swiss Federal Supreme Court Judgement of 6 June 1983 (BGE 109 Ib 110); Swiss Federal Supreme Court Judgement of 17 June 1983 (BGE 109 Ia 97); Swiss Federal Supreme Court Judgement of 19 December 1984 = ASA 54, p. 211; Swiss Federal Supreme Court Judgement of 4 June 1987 = ASA 57, p. 267; Swiss Federal Supreme Court Judgement of 19 November 2008 (BGer 2C_393/2008).

⁵⁰⁶ See Chapter 3.3.7.2.5.

the Position of the Swiss Legal Doctrine

3.3.7.2.3.1 Introduction

This paragraph analyses the interdependent relationship between tax law and civil law as elaborated by (1) the Swiss Federal Supreme Court in its case law and (2) the historical development of Swiss legal doctrine.

3.3.7.2.3.2 Development of the Swiss Federal Supreme Court Case Law

3.3.7.2.3.2.1 Interpretation According to Civil Law Terms

The earliest autonomous stance of the Swiss Federal Supreme Court is characterized by the presumed necessity to separate tax statutes from terms of civil law⁵⁰⁷. The Tribunal never offered legal reasoning for this position. Instead, it presumed the separation of civil law from tax law to be necessary due to the principle of legal certainty and “*the nature of the matter on hand*”⁵⁰⁸, thus importing the opinion prevailing in Germany at the time. Presumably, the court believed that taking an interpretive approach in accordance with civil law for provisions containing civil law terms would increase legal certainty. Accordingly, in cases where the legislator willfully formulated a tax provision containing civil law terms, this provision had to be interpreted according to civil law terms only⁵⁰⁹. This resulted in the same method being applied when interpreting civil law and tax law provisions, since tax law provisions frequently contained civil law terms⁵¹⁰. Ernst Blumenstein, in analyzing the Federal Tribunal’s approach to the interpretation of civil law and tax law provisions, argued that civil law terms almost always have the same meaning, regardless of whether they are being used in a

⁵⁰⁷ See Swiss Federal Supreme Court Judgement of 12 November 1926 (BGE 52 I 280), cons. E. 2.

⁵⁰⁸ This was explicitly indicated in the Swiss Federal Supreme Court Judgement of 20 March 1920 (BGE 46 I 234).

⁵⁰⁹ BLUMENSTEIN, *Gegenseitige Beziehungen*, p. 211a.

⁵¹⁰ BLUMENSTEIN, *Gegenseitige Beziehungen*, p. 205a.

civil or a tax law provision⁵¹¹. Therefore, an artificial distinction in a civil law term's meaning for a tax law or a civil law provision based on the different regulatory goals of civil and tax law should be avoided⁵¹². Consequently, civil law terms dominated the interpretation of statutes in both civil law and tax law. In the author's view, economic terms in tax law provisions at that time were rendered meaningless by the adoption of this approach.

3.3.7.2.3.2.2 Interpretation According to the Economic Reality by Using Tax-Avoidance Criteria

A fundamental change in the Federal Tribunal's stance occurred in a judgment of 1 December 1933⁵¹³. Distancing itself from its previous position based on the principle of legal certainty⁵¹⁴, the Tribunal somewhat cautiously adopted Ernst Blumenstein's postulation for the necessity of a bond between civil law and tax law in regard to the interpretation of tax statutes. Blumenstein advocated the use of civil law methods when interpreting terms in tax statutes and the underlying facts of a concrete case, except for situations where the criteria of tax-avoidance ("*Steuerumgehungs doktrin*", "*théorie de l'évasion fiscale*") as described in detail below are fulfilled, thus following the economic reality. This change in the Federal Tribunal's stance was confirmed in future judgments⁵¹⁵.

3.3.7.2.3.2.3 Departure from Tax-Avoidance Doctrine

In later years, the Federal Tribunal distanced itself from the rigid tax-avoidance doctrine, although not abandoning it completely⁵¹⁶. Previously, the

⁵¹¹ BLUMENSTEIN, Auslegung der Steuergesetze in der schweizerischen Rechtsprechung, p. 233.

⁵¹² KOLLER, Privatrecht und Steuerrecht, p. 273.

⁵¹³ See Swiss Federal Supreme Court Judgement of 1 December 1933 (BGE 59 I 272).

⁵¹⁴ See Swiss Federal Supreme Court Judgement of 1 December 1933 (BGE 59 I 272), cons. E. 7.

⁵¹⁵ See Swiss Federal Supreme Court Judgement of 14 May 1976 (ATF 102 Ib 50), cons. 3; Swiss Federal Supreme Court Judgement of 6 June 1983 (BGE 109 Ib 110); Swiss Federal Supreme Court Judgement of 4 June 1987 = ASA 57, p.267/271, cons. 2b.

⁵¹⁶ See Swiss Federal Supreme Court Judgement of 14 March 1975 (BGE 101 Ib 44), cons. 2; Swiss Federal Supreme Court Judgement of 17 June 1983 (BGE 109 Ia 97),

court relied on the criteria for tax-avoidance in order to determine whether interpretation would follow an economic approach including objective, purpose driven and subjective elements⁵¹⁷. The court then found that, for the interpretation of provisions regulating the economic reality, interpretation of these provisions could be performed directly, without artificially testing first whether the criteria of the tax-avoidance doctrine were met⁵¹⁸. This means that the context of the term in a provision determines whether said term is to be understood from an economic or civil law perspective.

3.3.7.2.3.2.4 Development of a Dualistic Interpretive Approach
Based on Whether a Statute is Founded on Civil Law
or Stems from an Economic Context

More recently, in a decision of 19 November 2008⁵¹⁹, the Swiss Federal Supreme Court opted for a dualistic approach. In this decision, the Tribunal held that one had to determine in a first stage whether a statute was founded on civil law or whether it had its roots in an economic context. The Tribunal recognized the view of legal scholars such as Ernst Höhn and Peter Locher which is outlined in greater detail below. These scholars advocate the integration of the teleological method in the interpretation of tax law provisions⁵²⁰. If a statute is based on the pursuit of an economic goal, an economic approach should be applied⁵²¹ irrespective of whether the criteria postulated by Ernst Blumenstein's tax-avoidance doctrine are fulfilled or not. The tax-avoidance doctrine

cons. E. 2a; Swiss Federal Supreme Court Judgement of 19 December 1984 = ASA 54, p. 211, cons. 3.

⁵¹⁷ BLUMENSTEIN, *Auslegung der Steuergesetze in der schweizerischen Rechtsprechung*, p. 277.

⁵¹⁸ See Swiss Federal Supreme Court Judgement of 14 March 1975 (BGE 101 Ib 44), cons. 2; Swiss Federal Supreme Court Judgement of 19 December 1984 = ASA 54, p. 211, cons. 3.

⁵¹⁹ See Swiss Federal Supreme Court Judgement of 19 November 2008, not published (BGer 2C_393/2008).

⁵²⁰ See MATTIOTTI, *Wirtschaftliche Betrachtungsweise und Steuergerechtigkeit*, p. 239.

⁵²¹ See Swiss Federal Supreme Court Judgement of 6 April 1973 = ASA 42, p.393, cons. 2; Swiss Federal Supreme Court Judgement of 17 June 1983 (ATF 109 Ia 97), cons. 2; Swiss Federal Supreme Court Judgement of 28 May 2005, not published (1P.588/2004) =

becomes relevant for cases where a statute is not based on the pursuit of an economic goal. In fact, the economic approach is only applicable in cases where the criteria of tax-avoidance are fulfilled⁵²².

3.3.7.2.3.3 Historical Development of the Swiss Legal Doctrine

In his acclaimed essay in the “*Schweizerischer Juristentag*” of 1933, Ernst Blumenstein expressed his dissent towards the predominant tendency (at the time mainly in Germany, but also followed by the Swiss Federal Supreme Court as noted above) to completely segregate tax law from civil law which enabled an absolute economic approach in taxation matters⁵²³. By highlighting the importance of using civil law terms in tax statutes when interpreting the criteria for tax-avoidance (“*Steuerungsumgehungs doktrin*”; “*théorie de l’évasion fiscale*”)⁵²⁴, Ernst Blumenstein supported a selective use of the economic approach. According to this approach, when the legislator expressly uses a civil law term with no intent of departing from its legal definition, the same legal definition should directly be applicable to a tax law provision containing this term. Conversely, when a provision implies that the legislator intended to reflect economic circumstances, interpretation of the provision requires an economic approach. This economic approach is based on the criteria for tax-avoidance⁵²⁵, which includes objective (extraordinary legal structure), purpose driven (significant savings on tax) and subjective (intent of saving on tax) elements⁵²⁶. Using these strict tax-avoidance criteria allows

ZBL 107 365, p. 375; Swiss Federal Supreme Court Judgement of 19 November 2008 (BGer 2C_393/2008), cons. 2.1.

⁵²² MATTEOTTI, *Wirtschaftliche Betrachtungsweise und Steuergerechtigkeit*, p. 239.

⁵²³ This has been demonstrated by Peter Locher in: LOCHER, *Rechtsmissbrauchsüberlegungen*, p. 678; See also: BLUMENSTEIN, *Gegenseitige Beziehungen*, p. 240a.

⁵²⁴ This method, first proposed by Blumenstein, has since been referred to as “*Steuerungsumgehungs doktrin*” or “*théorie de l’évasion fiscale*” by Swiss legal scholars. See, e.g. MATTEOTTI, *Wirtschaftliche Betrachtungsweise und Steuergerechtigkeit*, p. 237.

⁵²⁵ BLUMENSTEIN, *Auslegung der Steuergesetze in der schweizerischen Rechtsprechung*, p. 277.

⁵²⁶ LOCHER, *Rechtsmissbrauchsüberlegungen*, p. 678 in connection with BLUMENSTEIN, *Gegenseitige Beziehungen*, p. 239 et seq. Peter Locher correctly points out that the approach as perpetuated by Ernst Blumenstein corresponds to today’s Art. 42 para. 1 of the “*Abgabenordnung der Bundesrepublik Deutschland*” as well as Art.

for the interpretation of tax provisions independently from a civil law perspective⁵²⁷. Therefore, the decision whether the interpretation of a tax law provision should be based on civil law or on other factors is at the discretion of the legislator and, to a smaller extent, of the court interpreting the relevant statutes in a specific case⁵²⁸.

According to Thomas Koller, Blumenstein's call for the inclusion of the subjective element (intent on saving on tax) in the criteria of tax-avoidance became the fundamental element upon which future legal doctrine and court judgments would base their considerations, albeit with modifications⁵²⁹. The "*tax-avoidance doctrine*" postulated by Ernst Blumenstein has since been considered as too restrictive by some scholars⁵³⁰. Additionally, his approach does not take into account the possible fiscal reasoning and justifications behind an entity's tax saving strategies.

It should be noted that Ernst Blumenstein's original conception is no longer of any immediate significance for contemporary Swiss tax law. However, certain authors such as Walter Ryser⁵³¹ and Jaques-André Reymond⁵³² still follow Blumenstein's approach, where the civil law interpretation dominates and the economic reality is only considered when the criteria of tax avoidance are fulfilled, despite the Federal Tribunal's case law having significantly evolved over time, as shown above. According to Thomas Koller, Ryser's and Reymond's criticism of the accepted interdependence between civil and tax law is without merit. Ryser and Reymond take a "*phenomenological*" stance

22 of the "*Österreichische Bundesabgabenordnung (BAO)*" and was followed in a leading case rendered by the Swiss Federal Supreme Court on 1 December 1933, cons. E. 8 (BGE 59 I 272) = Pra 23 nr. 39.

⁵²⁷ BLUMENSTEIN, *Auslegung der Steuergesetze in der schweizerischen Rechtsprechung*, p. 278. BLUMENSTEIN, *Gegenseitige Beziehungen*, p. 230a; PONCE, *L'évasion fiscale en droit interne*; GLAUSER, *Evasion fiscale et interprétation économique*, p. 131.

⁵²⁸ BLUMENSTEIN, *Gegenseitige Beziehungen*, p. 205a.

⁵²⁹ KOLLER, *Privatrecht und Steuerrecht*, p. 279.

⁵³⁰ Amongst others: MATTEOTTI, *Wirtschaftliche Betrachtungsweise und Steuergerechtigkeit*, p. 237.

⁵³¹ RYSER, *La fiscalisation par l'interprétation*, p. 263.

⁵³² REYMOND, *Moralische Betrachtungsweise*, p. 19.

(“*phänomenologischer Ansatz*”; “*position phénoméologique*”). These authors consider all influence of civil law on tax law, particularly in the area of commerce, to be categorically negative. They seem to refuse the recognition of any possible positive formative aspects that an interpretation according to civil law concepts could have on tax law⁵³³. Thomas Koller, on the other hand, argues that judicial authorities are bound to apply the law and cannot simply replace a missing tax statute. Therefore, the social phenomenon of tax-avoidance should not be countered with a cumbersome legal model like the tax-avoidance doctrine, but with an accurate interpretation of the relevant statutes⁵³⁴.

During the second half of the past century, a teleological method for the interpretation of tax statutes was developed in order to take into account possible justifications for tax saving strategies. By embracing an open approach based upon the purpose of a statute rather than its rigid wording, Ernst Höhn can be considered the leading voice of this movement⁵³⁵. The teleological interpretation of tax statutes has led to a better understanding of the economic approach, and paved the way for more extensive methodological work of authors such as Peter Locher⁵³⁶. According to Ernst Höhn and Peter Locher, who advocate a dualistic approach, a statute must generally be interpreted according to its purpose, i.e. in a civil law sense, or in order to describe economic circumstances⁵³⁷. The majority of Swiss legal doctrine⁵³⁸ and jurisprudence followed the view of Ernst Höhn. Thomas Koller considers that this teleological approach provides a promising framework for consistent adjudication, since the courts are freed from the overly schematic and formalistic interpretation required by the tax-avoidance doctrine for civil law terms in tax statutes⁵³⁹.

⁵³³ KOLLER, *Privatrecht und Steuerrecht*, p. 302.

⁵³⁴ KOLLER, *Privatrecht und Steuerrecht*, p. 299.

⁵³⁵ HÖHN, *Wirtschaftliche Betrachtungsweise im Steuerrecht*, p. 394.

⁵³⁶ KOLLER, *Privatrecht und Steuerrecht*, p. 296.

⁵³⁷ MATTEOTTI, *Wirtschaftliche Betrachtungsweise und Steuergerechtigkeit*, p. 238.

⁵³⁸ Amongst others: LOCHER, *Rechtsmissbrauchsüberlegungen*, p. 682; LOCHER, *Commentary LDFT*, nr. 145 ad. *Vorbemerkungen*; BÖCKLI, *Steuerumgehung: Qualifikation gegenläufiger Rechtsgeschäfte und normative Gegenprobe*, p. 311.

⁵³⁹ KOLLER, *Privatrecht und Steuerrecht*, p. 299.

3.3.7.2.4 Issues Raised by an Interpretation According to the Economic Reality

As in other areas of law, the traditional methods of interpretation (literal, historical, systematic and teleological) are used in tax law in order to interpret the applicable legal provision⁵⁴⁰. However, there are additional complications for matters concerning tax law, especially when a provision contains civil law concepts but regulates an economic transaction. In order to remedy this problem, it is necessary to determine the legislator's intent by applying the teleological interpretation method⁵⁴¹. This allows for determinations as to whether the legislator intended to abandon the chosen legal formalities in favour of an interpretation more in line with economic reality⁵⁴². According to Floran Ponce, it is therefore in the context of teleological interpretation where one must consider a possible interpretation pursuant to the economic reality⁵⁴³. As a reaction to the Federal Tribunal's change of stance in its judgment of 19 November 2008, which adopted an economic approach in the interpretation of tax law provisions, Swiss scholars have identified various problems in relation to this new approach. Firstly, the Federal Tribunal did not specify under which conditions a provision should be considered as based on an "*economic context*" ("*wirtschaftlicher Zusammenhang*"; "*rattachement économique*")⁵⁴⁴. Swiss scholars have provided possible solutions to this problem. Ernst Höhn suggests an interpretation on the merits of the individual case. In other words, he submits that, when the arguments in favor of imposing taxation outweigh the arguments for exemption, interpretation should follow the economic reality⁵⁴⁵. Peter Böckli, on the other hand, considers an interpretation based on the economic context only to be possible when a general, abstract formulation,

⁵⁴⁰ See Swiss Federal Supreme Court Judgment of 6 July 2005 (ATF 131 II 562), cons. 3.5; Swiss Federal Supreme Court Judgment of 26 October 2005 (ATF 131 II 697), cons. 4.1.

⁵⁴¹ PONCE, L'évasion fiscale en droite interne p.128.

⁵⁴² PONCE, L'évasion fiscale en droite interne p. 132.

⁵⁴³ PONCE, L'évasion fiscale en droite interne p. 134

⁵⁴⁴ PONCE, L'évasion fiscale en droite interne, p. 133.

⁵⁴⁵ HÖHN, Gesetzesauslegung, p. 396 et seq., cited in PONCE, L'évasion fiscale en droite interne, p. 135.

intended to be easily understandable for a layman, is present in the legal text⁵⁴⁶.

A second problem seems to be that the Federal Tribunal shows a preference for the teleological interpretation method. This results in a preferred interpretation according to the economic reality at the expense of other interpretative methods (literal, systematic and historical)⁵⁴⁷. Some authors find that this approach makes the court appear terminologically vague⁵⁴⁸. They criticize that the court does not draw a clear distinction between the four methods of interpretation, allowing it to arbitrarily choose a method based on the desired outcome⁵⁴⁹. Instead of discussing its interpretive methods, these authors argue that the court should provide more clarity on its specific criteria of interpretation⁵⁵⁰.

Finally, the Federal Tribunal has not defined clear limits for the economic approach. Therefore, one must be cautious not to allow broad usage of the economic approach, which could result in an interpretation contrary to the actual purpose of the statute (interpretation “*contra legem*”). This is problematic as such broad interpretation would allow integration of systematic tax elements, which would normally require a legal basis in tax provisions.

⁵⁴⁶ BÖCKLI, *Steuerumgehung: Qualifikation gegenläufiger Rechtsgeschäfte und normative Gegenprobe*, p. 311, cited in PONCE, *L'évasion fiscale en droite interne*, p. 135.

⁵⁴⁷ See Swiss Federal Supreme Court Judgement of 19 April 1985 = ASA 55, p. 206, cons. 4; Swiss Federal Supreme Court Judgement of 19 November 2008 = RF 2009, p. 110, cons. 2.3 and 2.4.

⁵⁴⁸ See HÖHN, *Wirtschaftliche Betrachtungsweise im Steuerrecht*, p. 467; DESAX, *Methodologie der Rechtsprechung*, p. 35, cited in PONCE, *L'évasion fiscale en droite interne*, p. 129.

⁵⁴⁹ HÖHN/WALDBURGER, *Steuerrecht*, Vol. 1, 9th edition, Bern 2001, p. 152; DESAX, *Methodologie der Rechtsprechung*, p. 34, cited in PONCE, *L'évasion fiscale en droite interne*, p. 4.

⁵⁵⁰ HÖHN, *Wirtschaftliche Betrachtungsweise im Steuerrecht*, p. 469, DESAX, *Methodologie der Rechtsprechung*, p. 35, cited in PONCE, *L'évasion fiscale en droite interne*, p. 130.

Another perspective on this problem is provided by René Matteotti. He considers that this methodology allows the courts to use the tax-avoidance doctrine in order to arbitrarily correct tax statutes (“*mutiert die Steuerumgehungsdoktrin zu einem Vehikel für die berüchtigte Normkorrektur*”; “*mutation de la doctrine de l’évasion fiscale en instrument de correction de la loi*”)⁵⁵¹. His dissent mainly stems from the argument that this approach does not include technical fiscal considerations or reasons of practicability in the statutory interpretation⁵⁵². Additionally, René Matteotti argues that the inherent problem with the Federal Tribunal’s dualistic approach is its assumption that statutes can be separated distinctly into economic terms and terms of civil law, which contradicts the general assumption that true understanding of a statute can only be achieved through its application on specific facts. Finally, he considers that this somewhat arbitrary correction of statutes at the expense of the taxpayer goes against the principle of legality, which is inherent to tax law⁵⁵³.

3.3.7.2.5 Justification of the Economic (Substance-Over-Form) Approach in Respect of Trust Taxation based on Swiss Constitutional and Legal Principles?

When considering issues of trust taxation, a thorough civil law analysis of the legal relationship at hand seems to be indispensable in order to answer the question of whether tax law diverges from private law in regard to the following three types of trusts: (i) revocable trust, (ii) irrevocable fixed interest trust and (iii) irrevocable discretionary trust, and whether an economic approach would be justified to apply based on Swiss constitutional and legal principles. The economic approach gives rise to controversies in Swiss legal doctrine, in particular amongst tax law scholars since it requires a valuation decision of the authority deemed to apply the law⁵⁵⁴. This inconsistency can also be seen in the case law⁵⁵⁵. In this valuation, a balancing of interests between, on the one hand, the interest for legal certainty and, on the other

⁵⁵¹ MATTEOTTI, *Wirtschaftliche Betrachtungsweise und Steuergerechtigkeit*, p. 239.

⁵⁵² MATTEOTTI, *Wirtschaftliche Betrachtungsweise und Steuergerechtigkeit*, p. 240.

⁵⁵³ MATTEOTTI, *Wirtschaftliche Betrachtungsweise und Steuergerechtigkeit*, p. 240.

⁵⁵⁴ See Chapter: 3.3.7.2.

⁵⁵⁵ See Chapter: 3.3.7.2.3.2.

hand, the interest for a fair taxation needs to be performed⁵⁵⁶. It should be noted that the Swiss constitutional and legal principles are not discussed in depth here due to time constraints.

In the author's view, the economic approach allows for economically equal sets of facts to be taxed independently of their respective form or organization. As correctly pointed out by René Matteotti, this approach effectively promotes tax fairness⁵⁵⁷. If, nevertheless, this were the case, one should assess in a second step whether the circular letters published by the Federal Tax Administration and the Swiss Tax Conference concerning the taxation of trusts, which partly diverge from private law, are justified in the light of the object and purpose of Swiss law.

The first question is difficult to answer due to the fact that Switzerland does not embrace in its legal system the duality of legal and equitable ownership⁵⁵⁸, but recognizes such dual ownership, resp. legal and equitable ownership. It can be seen in the figure below that in all three scenarios the equitable owner is not the legal owner, and for this reason the situation cannot fully be compared with the term of "*ownership*" as prevailing in Switzerland⁵⁵⁹. Switzerland being a civil law country, its legal system adheres to a concept of "*property*" based on Roman law. Accordingly, the concept of "*property*" is in principle unitary, absolute and exclusive⁵⁶⁰.

Due to this divergence of the term of "*ownership*", it cannot definitely be concluded that the Swiss tax laws deviate in respect of the taxation of trusts in Circular Letter 30/20 from the civil law characterization. The only observation which can be drawn is that the trust as the pure legal owner is not taxed according to Swiss tax laws.

⁵⁵⁶ MATTEOTTI, *Wirtschaftliche Betrachtungsweise und Steuergerechtigkeit*, p. 218.

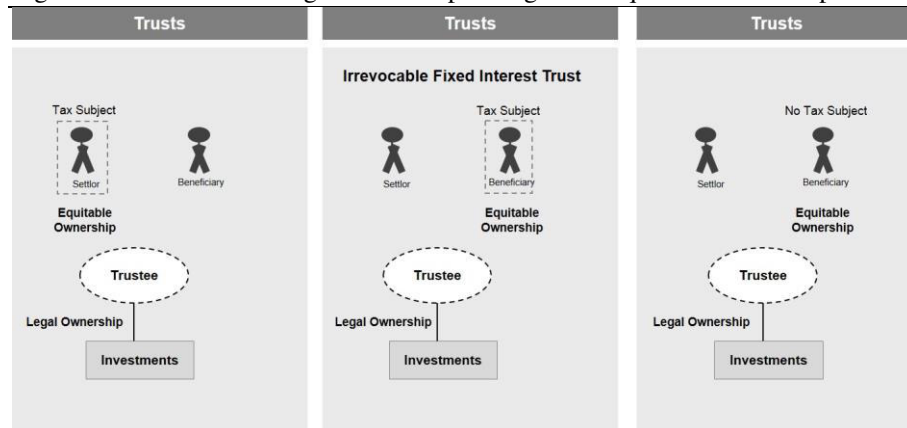
⁵⁵⁷ MATTEOTTI, *Wirtschaftliche Betrachtungsweise und Steuergerechtigkeit*, p. 223.

⁵⁵⁸ SMITH, *Trusts in Civil Law*, p. 665; PEYROT, thesis, p. 22-26.

⁵⁵⁹ PEYROT, thesis, p. 22-26.

⁵⁶⁰ BAUER-BALMELLI/WIDMER/HARBEKE, *Switzerland-Trusts*, p. 1. For more detailed information, see: PEYROT, thesis, p. 30 et seq.

Figure 3.4: Deviation of Legal Ownership in Regard to Equitable Ownership



Source: Own figure

The second question concerns the taxation principles applicable to trusts which diverge from civil law. These principles, codified in a Letter of Reference by the Swiss Tax Conference to the cantonal tax authorities and Circular Letter No. 30, need to be reviewed as to their legality and constitutionality. Moreover, it is necessary to assess whether they are in accordance with the prevailing rules of income and wealth taxation⁵⁶¹.

In particular, the assessment of the economic approach needs to respect the constitutional principles which will be briefly summarized in the following⁵⁶².

One of the most important principles of a democratic tax system is the principle of legality (*“Legalitätsprinzip”*; *“Principe de la légalité”*)⁵⁶³: The circle of tax payers (tax subjects), the object of the tax (tax object) and the basis

⁵⁶¹ NIEDERER, Neue Besteuerungspraxis, p. 1501.

⁵⁶² In the following summary, the guarantee of property under Art. 26 FC and the prohibition of intercantonal double-taxation under Art. 127 para. 3 FC will not explicitly be discussed. For further details: MATTEOTTI, Wirtschaftliche Betrachtungsweise und Steuergerechtigkeit, p. 225- 235.

⁵⁶³ Art. 5 of the Swiss Cnstitution, headed *“Rule of law”* reads: *“1. All activities of the state are based on and limited by law. 2.State activities must be conducted in the public interest and be proportionate to the ends sought. 3. State institutions and private persons*

for taxation need to be outlined in a formal statute⁵⁶⁴. This means that the basis for taxation needs to be regulated in a statute which has been decreed according to the procedure prescribed for the legislative process. In addition to this so-called reservation of law, the principle of legality also includes the so-called primacy of the law; this means that the State's organs need to respect the hierarchy of norms when perceiving taxes, and, in particular, that an ordinance or administrative order cannot contradict the law.

Another fundamental principle of an established modern tax system is the principle of universality of taxation (*"Grundsatz der Allgemeinheit der Besteuerung"*; *"Principe de la généralité de l'imposition"*)⁵⁶⁵. This principle wants that all persons or groups of persons must be taxed according to the same legal rules. Exceptions for which there is no factual reason are not admissible⁵⁶⁶. In particular, individual persons may not be tax-exempted without any factual reasons, and particularly wealthy or poor tax payers may not be privileged (prohibition of privileges). Moreover, it is not permissible, without any factual justification, to shift the burden of considerably higher taxes (in relation to their economic capacity) to a single group of tax payers (prohibition of discrimination)⁵⁶⁷. In summary, it can be said that the principle of universality of taxation refers to the tax subject and wants that the circle of tax payers is determined according to factual criteria. It thus includes a prohibition of privileges on the one hand, and a prohibition of discrimination on the other hand.

shall act in good faith. 4. The Confederation and the Cantons shall respect international law."

⁵⁶⁴ Art. 127 para. 1 FC.

⁵⁶⁵ Art. 127 of the Swiss Constitution, headed *"Principles of taxation"* reads: *"1. The main structural feature of any tax, in particular those liable to pay tax, the object of the tax and its assessment, are regulated by law. 2. Provided the nature of the tax permits it, the principles of universality and uniformity of taxation as well as the principle of taxation according to ability to pay are applied. 3. Intercantonal double taxation is prohibited. The Confederation shall take the measures required."*

⁵⁶⁶ Swiss Federal Supreme Court Judgment of 21 December 2010, cons. E.2.1 (BGE 137 I 145).

⁵⁶⁷ Art. 127 FC as well as Swiss Federal Supreme Court Judgment of 21 December 2010, cons. E.2.1 (BGE 137 I 145).

Further, the principle of uniformity of taxation (“*Gleichmässigkeit der Besteuerung*”; “*principe de l'égalité de l'imposition*”)⁵⁶⁸ is vital to a modern tax system. This principle refers to the objective side of the tax law relation, namely the tax object, the basis for taxation and the tax rate. Tax subjects in similar conditions are to be taxed similarly, whereas tax subjects in considerably different conditions are to be taxed differently⁵⁶⁹.

Another fundamental idea is that each tax payer should, within the extent of his financial and personal capacities, contribute to the funding of the State's budget⁵⁷⁰. Therefore, in the field of income tax, persons and groups of persons having a similar income, should have a similar income tax burden. The decisive factor in this regard is whether there are horizontally comparable sets of facts resulting from a comparison between persons with a similar economic capacity⁵⁷¹. However, the principle of economic capacity („*Grundsatz der wirtschaftlichen Leistungsfähigkeit*“; „*Principe de la capacité contributive*“)⁵⁷² in a horizontal comparison does not require absolutely identical taxation⁵⁷³.

⁵⁶⁸ Art. 127 of the Swiss Constitution, headed “*Principles of taxation*” reads: “1. The main structural feature of any tax, in particular those liable to pay tax, the object of the tax and its assessment, are regulated by law. 2. Provided the nature of the tax permits it, the principles of universality and uniformity of taxation as well as the principle of taxation according to ability to pay are applied. 3. Intercantonal double taxation is prohibited. The Confederation shall take the measures required.”

⁵⁶⁹ Swiss Federal Supreme Court Judgment of 1 June 2007, cons. E.6.1 (BGE 133 I 206).

⁵⁷⁰ Art. 127 FC, Swiss Federal Supreme Court Judgment of 5 Mai 2014 (2C_1011/2012) as well as Swiss Federal Supreme Court Judgment of 6 March 2014 (ATF 140 II 157) = StR 2014 69, p. 365.

⁵⁷¹ Swiss Federal Supreme Court Judgment of 1 June 2007, cons. E.7.2 (BGE 133 I 206).

⁵⁷² Art. 127 of the Swiss Constitution, headed “*Principles of taxation*” reads: “1. The main structural feature of any tax, in particular those liable to pay tax, the object of the tax and its assessment, are regulated by law. 2. Provided the nature of the tax permits it, the principles of universality and uniformity of taxation as well as the principle of taxation according to ability to pay are applied. 3. Intercantonal double taxation is prohibited. The Confederation shall take the measures required.”

⁵⁷³ Swiss Federal Supreme Court Judgment of 6 March 2014, cons. E. 7.3 (ATF 140 II 157) = StR 2014 69, p. 365, 368.

In regard to the taxation of trusts it can be said that there is no right to tax if no economic capacity exists, like it would be the case for the simple expectations of a beneficiary in an irrevocable discretionary trust. However, there is a right to tax under constitutional and legal principles if an economic capacity is given, like for example for a settlor or beneficiary holding either directly or indirectly trust assets or income.

If a formal approach leads to an interpretation which is in contradiction with constitutional principles, the authority applying the law is confronted with the question of whether an economic approach diverging from civil law should be taken⁵⁷⁴. Since Swiss laws are not familiar with tax rules specifically designed for the taxation of trusts, each individual trust needs to be assessed under general tax principles in order to ensure a correct taxation. In the author's view, any situation where neither the settlor nor the beneficiary have, either directly or indirectly, an economic benefit from the trust (such as the case of an irrevocable discretionary trust) cannot trigger taxation under the current framework of Swiss constitutional and legal tax principles.

3.3.7.3 *Tax Consequences of a Revocable Trust*

Under a “revocable trust” (“*widerruflicher Trust*”; “*trust révocable*”), the settlor does not definitively alienate the trust assets and income upon creation of the trust⁵⁷⁵. From an economic perspective, the settlor maintains (either directly or indirectly) legal and effective control over the trust assets and income⁵⁷⁶.

3.3.7.3.1 Creation

The creation of a revocable trust “*per se*” has no direct consequence on income and wealth taxes since for these purposes the assets and income of the trust remain fiscally attributed to the settlor⁵⁷⁷.

⁵⁷⁴ MATTEOTTI, *Wirtschaftliche Betrachtungsweise und Steuergerechtigkeit*, p. 218; TIPKE/LANG, *Steuerrecht*, para. 5 nr. 68.

⁵⁷⁵ RIVIER, *Droit Fiscal International*, p. 324; SCHMID, *Trust*, p. 294.

⁵⁷⁶ See Chapter 3.3.7.1.

⁵⁷⁷ Para. 5.2.1 Circular 30/20.

3.3.7.3.2 Ongoing Taxation

The settlor remains fully taxable on the trust assets and income⁵⁷⁸ until an effective distribution is made to a beneficiary⁵⁷⁹. The capital gains from private assets remain tax free⁵⁸⁰, so long as the settlor keeps them separate and does not qualify as a professional securities dealer⁵⁸¹.

3.3.7.3.3 Distributions

When distributions (“*Weiterleitungen*”; “*distributions*”)⁵⁸² of the assets and income of a revocable trust are executed by the trustee, one must determine whether the beneficiary is the settlor himself or a third party. Distributions to the settlor do not trigger any tax consequences because, from a fiscal point of view, no act of disposition has taken place. Distributions to a third party, however, are considered by most Swiss cantons as donations (which are expressly tax-exempted in regard to income taxes both on federal and cantonal/communal levels⁵⁸³), provided that the conditions to make a donation⁵⁸⁴ are satisfied. In such cases, a cantonal gift tax may be levied if the settlor, at the time of the distribution, is domiciled in a Swiss canton or if

⁵⁷⁸ Para. 5.1.1.2 Circular 30/20.

⁵⁷⁹ See Chapter 3.3.7.3.3.

⁵⁸⁰ Art. 16 para. 3 LDFT; Art. 7 para. 4 (b) LDHT.

⁵⁸¹ Circular 8.

⁵⁸² In the German version of the Circular, the term “*Ausschüttungen*” instead of “*Weiterleitungen*” is being used when referring to the distribution of trust assets and income or capital gains from private assets. The German terminology “*Ausschüttungen*” is not appropriate in this context as it relates more to dividend distributions by a legal person in Swiss law and not to the transfer of the trust assets and income from the trustee to the beneficiary. In this vein: BÖCKLI, *Angelsächsische Trust – Zivilrecht und Steuerrecht*, p. 41.

⁵⁸³ Art. 24 lit. a LDFT; Art. 7 para. 4 lit. a LDHT.

⁵⁸⁴ Para. 5.1 Circular 30/20. The definition of “*donation*” varies from one canton to another. However, it is fair to say that between most cantons a broad consensus exists with regard to the interpretation of the term “*donation*” which has the meaning given by civil law according to Art. 239 CO, namely an “*inter vivos*” transfer of wealth (“*Vermögenszuwendung*”; “*acte d’attribution*”) from the donor to the donee in the absence of payment (“*Unentgeltlichkeit*”; “*gratuité*”) from the latter. In this vein among others: OEHRLE, thesis, p. 68 et seq.; BLUMENSTEIN/LOCHER, *System des Schweizerischen*

Swiss-situs immovable property is the object of the transfer. On the other hand, if the settlor, at the time of the trust creation, is domiciled outside of Switzerland (or no Swiss-situs immovable property is brought into the trust), no gift tax will be levied in Switzerland, even if the beneficiary is domiciled in Switzerland⁵⁸⁵. The beneficiary is generally charged with payment of the gift tax. The determination of the tax rate between the settlor and the beneficiary will consequently be left to the canton, and to some extent to the commune in question⁵⁸⁶. It is clear that the decisive relationship is not the one between the settlor and the trustee, but that between the settlor and the beneficiary⁵⁸⁷. However, if the distribution is, for instance, not qualified for tax purposes as a gift, the distribution to the Swiss-resident beneficiary may be subject to Swiss income taxation⁵⁸⁸. It must be kept in mind that Circular 30 only includes a comprehensive set of non-binding recommendations on cantonal/communal levels and, therefore, raises fundamental concerns about legal certainty in the field of trust taxation.

The partial taxation procedure (“*Teilbesteuerungsverfahren*”; “*imposition partielle*”) may be applied to the settlor within a revocable trust as long as the income is attributed to him for Swiss tax purposes by reason of the trust relationship⁵⁸⁹. In the author’s view, this can be justified by relying on Art.

Steuerrechts, p. 205; RICHNER/FREI, Commentary on inheritance and donation tax, p. 140 ad. nr. 18; DANON, thesis, p. 220 et seq.

⁵⁸⁵ See for the Canton Zurich § 2 ESchG.

⁵⁸⁶ Para. 5.2.2 Circular 30/20.

⁵⁸⁷ The Circular 30/20 does not expressly address this subject. Cantonal practices do however vary in their calculation of the tax rate. In principle, the degree of relationship between the creator of the trust and the beneficiary is taken into account in order to determine the tax rate. In this vein: BÖCKLI, Angelsächsische Trust – Zivilrecht und Steuerrecht, p. 45; NIEDERER, Neue Besteuerungspraxis, p. 1504; AMONN, Trustbesteuerung, p. 501.

⁵⁸⁸ Art. 16 para. 1 LDFT; Art. 7 para. 1 LDHT.

⁵⁸⁹ This is the unwritten tax policy of the Zurich tax authority which has been orally confirmed. Further, Swiss Federal Supreme Court Judgment of 20 December 2012 (2C_711/2012 2C_712/2012) clearly states in its point 2.2 that revenues (in the present case, distributions from a Liechtenstein Foundation) which are distributed to a Swiss-resident beneficiary are fully taxable if partial taxation does not apply. In the present case, the Liechtenstein Foundation is a corporate taxpayer. Therefore, this situation cannot be compared with a revocable trust relationship which is subject to a look-through approach for tax purposes.

20 para. 1bis LDFT and, in particular, by the fact that today's version of the law does not explicitly address direct ownership of shares. Further, based on the meaning of the words (grammatical arguments) as well as the object and purpose of avoiding double taxation (teleological arguments), Art. 20 para. 1bis LDFT should be interpreted as meaning that qualified participations need not be held directly. If the requirements for partial taxation are fulfilled by a tax payer within a trust relationship, they should, in the author's view, be granted in a consistent manner and in compliance with constitutional principles⁵⁹⁰. However, this applies only to dividend distributions from qualifying participations held by trusts, in order to diminish the effects of economic double taxation at federal level⁵⁹¹. At cantonal/communal levels, either the partial taxation or the partial tax rate procedure ("*Teilsatzverfahren*"; "*procédure du taux partiel*") may apply.

3.3.7.3.4 Liquidation

The liquidation of a revocable trust has no tax consequences as long as the trust assets consist of capital gains from private assets and initial trust capital⁵⁹². If income is remaining after liquidation, tax consequences will only arise if this income is distributed to a third party and not to the settlor. It will be subject to the relevant cantonal gift tax if the cumulative conditions for a donation are met⁵⁹³.

3.3.7.4 Introduction to Irrevocable Trusts

Unlike under revocable trusts, under irrevocable trusts the settlor definitively divests himself of the trust assets and income and can no longer reclaim them⁵⁹⁴. In other words, the trust becomes a "*free-standing device with a life of its own*"⁵⁹⁵. Consequently, once the trust is created, its assets and income

⁵⁹⁰ Para. 2 Circular 22 on Partial Taxation and according to Art. 127 para. 2 FC, the tax legislator has to respect not only the principles of universality and uniformity of taxation, but also the principle of taxation according to the economic capacity. For further details, see Chapter 2.3.

⁵⁹¹ Art. 20 para. 1^{bis} LDFT; Art. 18 b LDFT.

⁵⁹² Para. 5.2.1 Circular 30/20.

⁵⁹³ See Chapter 3.3.7.3.3.

⁵⁹⁴ In this vein HAYTON/KORTMANN/VERHAGEN, p. 31.

⁵⁹⁵ HAYTON/KORTMANN/VERHAGEN, p. 31.

can no longer be attributed to the settlor, resulting in a definitive separation of the trust assets from the patrimony of the settlor⁵⁹⁶. The settlor may, therefore, no longer exercise direct or indirect control over the trust assets and income⁵⁹⁷.

A further distinction must also be drawn between irrevocable “*fixed interest trusts*” and irrevocable “*discretionary trusts*”.

In the case of an irrevocable fixed interest trust⁵⁹⁸, certain parts of the trust assets and income, referred to as “*fixed entitlements*”, are specifically differentiated in the trust deed and are accordingly attributed to the beneficiary⁵⁹⁹.

In case of an irrevocable discretionary trust, the trustee has an extensive power of discretion⁶⁰⁰ to determine the beneficiaries and to determine the amount of distributions. Thus, a potential beneficiary under an irrevocable discretionary trust has only an expectation, as opposed to a fixed pretention, to receive any distributions, whereas under an irrevocable fixed interest trust, the beneficiary holds a fixed legal claim against the trust⁶⁰¹. In practice, the distinction between an expectation and a fixed claim is crucial.

One must refer to the principle of economic reality in order to determine whether a trust is an irrevocable fixed interest trust or an irrevocable discretionary trust; in other words, one needs to take into account both the formal designation in the trust deed and the specific contextual circumstances⁶⁰².

⁵⁹⁶ Para. 3.7 Circular 30/20.

⁵⁹⁷ See Chapter 3.3.7.4.

⁵⁹⁸ Walter Ryser names this situation a “*life interest trust*”. See: RYSER, double taxation treaties, p. 312.

⁵⁹⁹ Para. 3.7.2 Circular 30/20.

⁶⁰⁰ Para. 3.7.3 Circular 30/20.

⁶⁰¹ Para. 3.7.2 Circular 30/20.

⁶⁰² See Chapter 3.3.7.1.

3.3.7.5 *Tax Consequences of an Irrevocable Fixed Interest Trust*

3.3.7.5.1 Creation

Upon the creation of an irrevocable fixed interest trust, the capital dedicated to the trust is characterized as a donation from the settlor to the beneficiary in the amount of the trust capital, and must therefore be assessed⁶⁰³ under the cantonal gift tax⁶⁰⁴. The determination of the tax rate between the settlor and the beneficiary will consequently be left to the canton, and to some extent to the commune in question⁶⁰⁵. From this point of view, it is understandable that the trust assets and income are not attributed to the settlor. Rather, trust assets and income are attributed to the beneficiary in the amount of the part or parts to which he has a fixed entitlement.

3.3.7.5.2 Ongoing Taxation

The beneficiary has a pre-determined fixed entitlement (*“fester Rechtsanspruch”*; *“droit ferme”*)⁶⁰⁶ to some or all of the trust assets and income, and is considered to be a usufructuary⁶⁰⁷. Thus, the distributed income represents taxable income for the beneficiary in accordance with the general income clause in Swiss tax law⁶⁰⁸, provided that the beneficiary is subject to Swiss tax liability or is the owner of Swiss-situs immovable property⁶⁰⁹. The

⁶⁰³ Para. 5.2.2 Circular 30/20.

⁶⁰⁴ The same applies here as what has been illustrated in Chapter 3.3.7.3.3, with the difference that the taxation of the donation takes place at the time of the creation and not at the time of the distribution.

⁶⁰⁵ Para. 5.2.2 Circular 30/20.

⁶⁰⁶ The term *“fixed interest”* is used in Circulars 30/20. In this vein: BÖCKLI, *Angelsächsische Trust – Zivilrecht und Steuerrecht*, p. 73. However, this term is not unanimously among various authors such as DANON, thesis, p. 214 *“fixed right”*; *“interest in possession”* and *“present right”*.

⁶⁰⁷ Para. 3.7.2 and para. 5.2.2 Circular 30/20; Decision of the Cantonal Administrative Court of 7 June 1983 = StE 1985 B 52.1 nr.1. Decision of the Swiss Federal Supreme Court Judgment of 5 September 1984 = ASA 55, p. 657.

⁶⁰⁸ Art. 16 para. 1 LDFT; Art. 7 para. 1 LDHT.

⁶⁰⁹ Para. 5.2.2 Circular 30/20 in connection with Art. 16 para. 1 LDFT and Art. 7 para. 1 LDHT.

beneficiary is not subject to taxation on the entirety of the trust assets and income, but only on the part or parts to which he has a fixed entitlement⁶¹⁰.

3.3.7.5.3 Distributions

The Circular states that distributions which a beneficiary receives in addition to his pre-determined fixed entitlement are also treated as taxable income⁶¹¹, in the sense of the general income clause⁶¹². Due to the “*principle of transparency*”, the income can be divided into three categories according to its origin: income, capital gain and initial trust capital. Capital gains from private assets⁶¹³ and initial trust capital⁶¹⁴ are not taxable, provided that the beneficiary is able to state the proof of their origin⁶¹⁵. The initial trust capital may only be paid out after distribution of the income and capital gains, following the principle of “*last in - first out*”. Thus, no distribution of initial trust capital may occur until the trust has distributed all of its accumulated income⁶¹⁶.

The partial taxation procedure (“*Teilbesteuerungsverfahren*”; “*imposition partielle*”) may be applied, from a systematic point of view, to the settlor within an irrevocable fixed interest trust as long as income is attributed to him by reason of the trust relationship⁶¹⁷. However, this applies only to dividend distributions from qualifying participations held by trusts, in order to diminish the effects of economic double taxation at federal level⁶¹⁸. At can-

⁶¹⁰ For income tax purposes, the trust is considered as quasi-transparent. Para. 5.2.2. Circular 30/20.

⁶¹¹ Para. 5.2.2 Circular 30/20.

⁶¹² Art. 16 para. 1 LDFT and Art. 7 para. 1 LDHT.

⁶¹³ Art. 16 para. 3 LDFT and Art. 7 para. 4 b LDHT.

⁶¹⁴ Art. 24 (a) LDFT and Art. 7 para. 1 LDHT.

⁶¹⁵ To prove the origin of the distribution (capital gain from private assets, income or initial trust capital), the beneficiary relies on the trustee’s information regarding the repartition of the trust’s income over the years, even when the income is undistributed.

⁶¹⁶ Para. 5.2.2 Circular 30/20. Among others: OBERSON, Trust, p. 487; VON AH, Trusts im Schweizer Steuerrecht, p. 6; DANON, Critique de la Circulaire du 22 août 2007, p. 456.

⁶¹⁷ See the author’s view in the chapter outlining the tax principles of a revocable trust (Chapter 3.3.7.3.3).

⁶¹⁸ Art. 20 para. 1^{bis} LDFT; Art. 18 b LDFT.

tonal/communal levels, either the partial taxation or the partial tax rate procedure (“*Teilsatzverfahren*”; “*procédure du taux partiel*”) may apply. In the case of an accumulation trust⁶¹⁹ in which there is a delayed distribution and/or no distribution at all, the trust income that has not been distributed cannot be attributed to the beneficiary, since the taxation of the beneficiary would not be fiscally justifiable according to the principles of financial capacity and equality of treatment⁶²⁰. What is relevant is the time of the attribution of income. The income may only be attributed to the beneficiary once the trustee has formally decided to distribute an additional part of the income to the beneficiary⁶²¹.

3.3.7.5.4 Liquidation

As long as the beneficiary does not receive capital gains from private assets, nor initial trust capital, upon liquidation of the trust, no tax consequences arise from such liquidation. If income remains after the liquidation, it will be treated as taxable income in the same way it would be during ongoing taxation⁶²².

3.3.7.6 *Tax Consequences of an Irrevocable Discretionary Trust*

In most tax systems, the tax treatment of an irrevocable discretionary trust is even more complex since the trust is technically “*non-existent*”. In this case, the settlor has definitively disposed of the trust assets and income, yet they cannot be attributed to the beneficiary since he only has an expectation as

⁶¹⁹ BÖCKLI, Angelsächsische Trust – Zivilrecht und Steuerrecht, p. 46 et seq: The term “*accumulation trust*” did not originate in English trust law, but originated in Swiss tax practices. The English mainly refer to the term “*accumulation period*”. According to BÖCKLI the maximum accumulation period can go up to 21 years.

⁶²⁰ Art. 127 para. 2 FC.

⁶²¹ Para. 5.2.3. Circular 30/20; DANON, thesis, p. 235; OBERSON, Trust, p. 489; BÖCKLI, Angelsächsische Trust – Zivilrecht und Steuerrecht, p. 47; RYSER, Rapports de trust, p. 752 et seq.; LANDOLF/GRAF, Trust im schweizerischen Steuerrecht, p. 14; CRETTEI, thesis 2007, p. 133.

⁶²² See Chapter 3.3.7.5.2.

opposed to a vested equitable interest⁶²³. In other words, the trustee may consider the beneficiary only a “*potential*” recipient of an ascertainable part of the trust assets and income⁶²⁴. Compared to the creation of an irrevocable fixed interest trust, the beneficiary does not hold an “*equitable interest*” (“*fester Rechtsanspruch*”; “*droit ferme*”)⁶²⁵, but rather an expectation right (“*Anwartschaft*”; “*droit expectatif*”), which is not yet attributable to it⁶²⁶. The trustee cannot be forced to make a distribution to a beneficiary holding only an expectation right. However, the beneficiary under such a trust has the right to require the trustee to exercise his powers of discretion fairly and reasonably following objective considerations in his decision-making.

3.3.7.6.1 Creation

The tax treatment depends on whether the settlor is a Swiss or non-Swiss resident as well as how the Swiss resident settlor is taxed at the time of the trust’s creation⁶²⁷. According to the Circulars, the tax consequences may be divided into three parts.

The first part relates to a Swiss resident settlor subject to Swiss unlimited tax liability at the time of the creation of the trust. The Swiss resident settlor, on the creation of an irrevocable discretionary trust, is not fiscally recognized as having definitely disposed of the trust assets and income, even if the trust is recognized under international private law. As a result, the tax consequences are the same as those for revocable trusts⁶²⁸, and so the trust assets and income are fully attributed to the settlor⁶²⁹. Foreigners living in Switzerland, who are subject to lump-sum taxation according to Art. 14 LDFT and 6 LDHT, constitute an exception to this rule of attribution.

⁶²³ Para. 7.2.3 Circular 30/20.

⁶²⁴ DANON, thesis, p. 28.

⁶²⁵ Para. 3.2 Circular 30/20; BÖCKLI, Angelsächsische Trust – Zivilrecht und Steuerrecht, p. 72. DANON uses the terminology “*fixed right*” in this regard, see DANON, thesis, p. 164.

⁶²⁶ Para. 3.7.2 Circular 30/20; BÖCKLI, Angelsächsische Trust – Zivilrecht und Steuerrecht, p. 71. DANON uses the terminology “*expectancy*” in this regard.

⁶²⁷ Para. 5.2.3 Circular 30/20.

⁶²⁸ See Chapter 3.3.7.3.

⁶²⁹ In comparison to a revocable trust, see thereto para. 5.2.3 Circular 30/20.

This mismatch between recognition of the trust in private law and non-recognition of the trust for fiscal purposes under tax law is widely criticized by leading practitioners and academics, and is chiefly explicable by political causes. Trusts provide a variety of optimized tax solutions⁶³⁰ - indeed “*it is likely that no ethereal invention has had a greater impact on tax minimisation in common law countries than that of the trusts*”⁶³¹. It is undoubtedly true that this flexible device offers many tax planning opportunities⁶³². However, it is fair to say that there are many other reasons for using trusts⁶³³ and, like other legal concepts, a trust should not necessarily be considered a means for tax avoidance through abuse of law⁶³⁴. In particular, it has been argued that the non-recognition of discretionary trusts created by Swiss resident settlors under the Circular is contrary to Art. 5 FC, the “*principle of legality*” (“*Prinzip der Gesetzmässigkeit*”; “*principe de la légalité*”) and Art. 127 para. 2 FC⁶³⁵, the “*principle of equality of treatment*” (“*Gleichmässigkeitsprinzip*”; “*principe de l’égalité de traitement*”). Express fiscal recognition of irrevocable discretionary trusts created by Swiss resident settlors, as published by the Federal Tax Administration in their draft version of Circular 30⁶³⁶, would have been preferable⁶³⁷.

The second part relates to a Swiss resident settlor subject to lump-sum taxation at the time of the creation of the trust. At the time of creation, such a settlor⁶³⁸ is fiscally recognized as having definitely disposed of the trust assets

⁶³⁰ EASSON/THURONYI, Fiscal Transparency, p. 970

⁶³¹ BURNS/KREVER, Interests in Non-resident Trust, p. vii.

⁶³² A trust may generally influence or give the opportunity to change the timing period of realization of income and assets, the characterization of income; the ownership of income and assets, the source of income or situs of assets and the character of income and assets.

⁶³³ VOLKART/GEIGER/WÜNSCH, Trusts in der Vermögensverwaltung, p. 5-6.

⁶³⁴ In this vein: DANON, thesis, p. 185.

⁶³⁵ In this vein: OBERSON, Trust, p. 490-491; DANON, Critique de la Circulaire du 22 août 2007, p. 453 et seq.; AMONN, General report on the fiscal treatment of international investment trusts and mutual funds, p. 6; VON AH, Trusts im Schweizer Steuerrecht, p. 8.

⁶³⁶ In para. 5.1.3 of the draft of 26 May 2005 for Circular 30.

⁶³⁷ Against: BÖCKLI, Angelsächsische Trust – Zivilrecht und Steuerrecht, p. 55-56.

⁶³⁸ Art. 14 LDFT and Art. 6 LDHT. The issued Ordinance based on Art. 14 LDFT clarifies the method of lump-sum taxation.

and income. Consequently, the trust is recognized and the trust assets and income are neither attributed to the beneficiary nor to the settlor⁶³⁹. Therefore, no taxation results from it.

The third part relates to a non-Swiss resident settlor, who is not liable to tax in Switzerland at the time of the creation of the trust. When creating an irrevocable discretionary trust, such a settlor is fiscally recognized as having definitely disposed of the trust assets and income. Consequently, the trust is recognized and the trust assets and income are neither attributed to the beneficiary nor to the settlor from a Swiss perspective, and therefore no taxation results from it. According to the Circular, the creation of the trust represents a donation by the settlor to the extent of the trust capital. The terminology “*im Umfang des Trustskapitals*” used in Circulars 30/20 is meaningless, because only Swiss-situs immovable property may be taxed at the time of the creation of the trust by a non-Swiss resident settlor. No cantonal gift tax may be levied in Switzerland if the settlor is domiciled outside of Switzerland and if no Swiss-situs immovable property is brought into the trust.

3.3.7.6.2 Ongoing Taxation

After creation of the trust, the trust assets and income may only be fiscally attributed to a “*no-man’s-land*” (“*Niemandland*”; “*zone neuter*”; in Peter Bockli’s words - to a “*terra nullius*”⁶⁴⁰; or in the language of the Circulars - to a “*trust cloud*” (“*Trustwolke*”; “*nuage de trust*”)⁶⁴¹). The trust assets and income are therefore outside the fiscal sphere of both the settlor and the beneficiary. Such no-man’s-land taxation will apply only if the settlor is subject to Swiss lump-sum taxation at the time of creation of the trust or if the settlor is a non-Swiss resident subject to foreign taxation at the time of the creation of the trust⁶⁴².

⁶³⁹ The Circulars 30/20 do not expressly refer to this subject. VON AH, Trusts im Schweizer Steuerrecht, p. 8.

⁶⁴⁰ BÖCKLI, Angelsächsische Trust – Zivilrecht und Steuerrecht, p. 55, 59 and 64.

⁶⁴¹ Para. 5.2.3 Circular 30/20.

⁶⁴² See Chapter 3.3.7.6.1.

3.3.7.6.3 Distribution

The fiscal non-attribution of the trust assets and income is caused by the fact that the donation is not yet completed. The trust assets and income are considered attributed to the Swiss resident beneficiary as soon as he obtains a fixed entitlement to the trust assets or income, which may be at the time of the effective distribution by the trustee⁶⁴³. Prior to this, the beneficiary simply possesses an expectation that is not subject to taxation.

The nature of the trust income should be determined according to its origin. However, in comparison to an irrevocable fixed interest trust, distributed capital gains from private assets are not tax-free but are instead transformed into taxable income for the beneficiary⁶⁴⁴. As previously noted, the trust has no legal personality, unlike a foundation or other legal entity. Due to the resulting transparency of the trust, one must refer to the original nature of the trust assets and income during its life span⁶⁴⁵, and therefore tax-free capital gains from private assets should consequently not be re-characterized into taxable income. The vast majority of authors rightfully supports this view⁶⁴⁶. Only Sibilla Cretti appears to be in favour of the taxation of the capital gains⁶⁴⁷.

The question regarding the time of the attribution of income is equally important here. The income is attributable to the beneficiary when he receives the income or a fixed entitlement⁶⁴⁸. Initial trust capital remains tax-free for the beneficiary as under an irrevocable fixed interest trust.

In the author's view, the partial taxation procedure (*"Teilbesteuerungsverfahren"*; *"imposition partielle"*) may not be applied, neither to the settlor

⁶⁴³ Para. 5.2.2 Circular 30/20.

⁶⁴⁴ Para. 5.2.3 Circular 30/20.

⁶⁴⁵ Para. 5.2.3 Circular 30/20.

⁶⁴⁶ DANON, thesis, p. 207 and 232; LANDOLF/GRAF, Trust im schweizerischen Steuerrecht, p. 19; BÖCKLI, Angelsächsische Trust – Zivilrecht und Steuerrecht, p. 54; BÖCKLI, Angelsächsische Trust, Part II, p. 787; VON AH, Trusts im Schweizer Steuerrecht, p. 9; DANON, Critique de la Circulaire du 22 août 2007, p. 457-458.

⁶⁴⁷ CRETTI, thesis 2007, p. 126 et seq.

⁶⁴⁸ The time of the attribution of income is identical to the mechanism used in an irrevocable fixed interest trust. However, in the latter, the income may be attributed at the time the beneficiary has a fixed pretention.

nor to the beneficiary of an irrevocable discretionary trust as no income is attributed to them by reason of the trust relationship⁶⁴⁹. The same view should be followed at cantonal/communal levels.

3.3.7.6.4 Liquidation

The treatment of distributions during the liquidation of the trust follows the considerations outlined above⁶⁵⁰.

3.3.8 Critique of Circular Letter 30/20

As mentioned above, the lack of consistency between Circular Letter 30/20 on trusts⁶⁵¹ and Swiss constitutional law has caused significant debate. In the following chapter critical arguments in relation to this inconsistency will be summarized, though some of these comments have already been mentioned above. This chapter only aims at providing a general critique on few selected issues without giving final conclusions or forming a new approach providing any recommendations “*de lege ferenda*” for Swiss domestic tax law. However, the ways in which the Circular Letters should, in the opinion of the author, be modified, may result from the following.

3.3.8.1 *Critical Thoughts on the Distinction between Revocable and Irrevocable Trusts*

The demarcation between revocable and irrevocable trusts is decisive, as it forms the basis of fiscal attribution⁶⁵². Generally, the tax consequences of trusts depend on whether the settlor and/or the beneficiary retain or obtain some sort of benefit or interest under the trust, and the extent to which the settlor keeps a degree of control over the trust assets. If the settlor retains control, and thus the trust is revocable, in Switzerland as in many other

⁶⁴⁹ Para. 5.2.3 Circular 30/20. It is therefore justified that the partial taxation procedure may not be applied as long as no income and wealth tax is paid by the settlor or the beneficiary.

⁶⁵⁰ See Chapter 3.3.7.6.3.

⁶⁵¹ See Chapter 3.3.2.

⁶⁵² See Chapter 3.3.7.1 to Chapter 3.3.7.6.

countries, this leads for Swiss tax consequences to the attribution of trust assets and income to the person who controls the trust – usually the settlor⁶⁵³.

In determining whether a trust is revocable or irrevocable, Circular Letter 30/20 correctly states that the economic reality of the situation shall be determinative, and that it is not just the formal designation indicated in the trust deed (“*Errichtungsurkunde*”; “*document de constitution*”) which is to be taken into account⁶⁵⁴. In view of the complexity prevailing in trust relationships, one finds it uneasy to draw a clear line between revocable and irrevocable trusts. The Circular lists nine factors, partly based on the case law relating to family foundations, which should be taken into account to determine whether a trust is revocable or irrevocable⁶⁵⁵. In doing so, it follows a restrictive approach since a trust will be treated as revocable if one of the nine designated powers remains with the settlor⁶⁵⁶. It is submitted that this goes too far. In the author’s opinion, there should only be one inquiry of relevance for determining the nature of a trust as revocable or irrevocable, namely whether the settlor has definitively alienated the trust assets and income.

In the following paragraph there will be an analysis of how the criteria listed in Circular Letter 30/20 should be redefined in order to draw a clearer line differentiating between revocable and irrevocable trusts. Among the nine powers listed in the Circular are those in which the settlor is able to: (i) benefit from capital distributions of the trust assets; (ii) benefit from distributions of the trust income; (iii) remove the trustee and appoint another; (iv) appoint or cause the appointment of new beneficiaries; (v) replace the protector (who in turn has powers comparable to those of a trustee); (vi) amend the trust deed or cause it to be amended; (vii) revoke the trust; (viii) require liquidation of the trust; and (ix) exercise a veto over the trustee’s decisions with respect to trust assets and income⁶⁵⁷. It is the author’s opinion that, in most of the outlined powers, the assets and income should not fiscally be attributed to the settlor. In situations, for instance, where the settlor is a member of the class of beneficiaries, replaces the protector or removes the trustee, this

⁶⁵³ See Chapter 3.3.7.3.

⁶⁵⁴ Para. 3.7 Circular 30/20.

⁶⁵⁵ Para. 3.7 Circular 30/20.

⁶⁵⁶ See Chapter 3.3.7.1.

⁶⁵⁷ Para. 3.7 Circular 30/20.

should not change the fact that he has definitively alienated the trust assets, as long as he has no right to revoke the trust itself or is restricted in his decision power⁶⁵⁸. Also, if the settlor demands the liquidation of the trust, this should not change the fact that he has definitively alienated the trust assets, as long as the liquidation strictly follows the trust deed. Similarly, if a trust holds an underlying company in an offshore jurisdiction but managed by a Swiss resident settlor who is a member of the company's board of directors, this should not automatically render the trust revocable, as long as the settlor has no access to the trust assets and cannot use them as personal assets, which might cause the attribution of the trust assets and income to the settlor⁶⁵⁹. However, the underlying company may itself be subject to unlimited tax liability in Switzerland based on the fact that its "*place of effective management*" is in Switzerland⁶⁶⁰.

In conclusion, it is submitted that the Circular's restrictive method in terms of alienation of ownership does not fully grasp the complexity of the subject matter⁶⁶¹. Proper attribution of the trust's assets and income cannot be dependent on one specific factor, and so it is crucial to consider the economic reality and the specific, contextual circumstances in order to establish whether a trust is revocable or irrevocable⁶⁶². Situations in which the settlor has definitively alienated trust assets and income, which remain attributed to him for fiscal purposes, are clearly unjustifiable. The nine factors listed in the Circular Letter 30/20 should therefore be reviewed and limited in their scope in order to be in line with the core principles of the Federal Constitution. Further, it should be noted that cantonal tax authorities, when confronted with well reasoned arguments, may deviate from these general principles in individual cases.

⁶⁵⁸ VON AH, Trusts im Schweizer Steuerrecht, p. 484 et seq. Against: NIEDERER, Neue Besteuerungspraxis, p. 1502; NABHOLZ, Besteuerung von irrevocable discretionary Trusts, p. 53.

⁶⁵⁹ Amongst others: NABHOLZ, Besteuerung von irrevocable discretionary Trusts, p. 53.

⁶⁶⁰ See for more details Chapter 3.3.4.

⁶⁶¹ In the same vein: BÖCKLI, Angelsächsische Trust – Zivilrecht und Steuerrecht, p. 50; AMONN, Trustbesteuerung, p. 498.

⁶⁶² In the same vein: BÖCKLI, Angelsächsische Trust – Zivilrecht und Steuerrecht, p. 48 et seq. and, in particular, p. 50.

3.3.8.2 *Taxation of the Creation of an Irrevocable Discretionary Trust*

Upon the creation of an irrevocable discretionary trust, Circular Letters 30 and 20 detail different tax consequences depending on whether the settlor is a Swiss resident or a non-Swiss resident⁶⁶³. Only non-Swiss residents and foreigners living in Switzerland subject to lump-sum taxation under Arts 14 LDFT and 6 LDHT may create a fiscally recognized irrevocable discretionary trust⁶⁶⁴. The ensuing mismatch between express recognition under private law on one hand, and non-recognition for tax purposes on the other hand, is widely criticized by practitioners and academics, and is chiefly explicable by political causes. In particular, the non-recognition by the Circular of irrevocable discretionary trusts created by Swiss resident settlors is considered to be contrary to Art. 5 FC, the “*principle of legality*” (“*Prinzip der Gesetzmässigkeit*”; “*principe de la légalité*”) and Art. 127 para. 2 FC⁶⁶⁵, the “*principle of equality of treatment*” (“*Gleichmässigkeitsprinzip*”; “*principe de l’égalité de traitement*”)⁶⁶⁶. In these cases, the Swiss resident settlor no longer has the opportunity to use or exercise influence over the trust assets, but for tax purposes, these assets remain attributed to him. This violates Art. 127 para. 2 FC, which sets out the principle of financial capacity (“*Leistungsfähigkeitsprinzip*”; “*principe de l’imposition selon la capacité contributive*”). Under Swiss tax law there is no legal basis to tax a settlor in respect of assets for which he has neither legal ownership nor beneficial economic ownership⁶⁶⁷. It is clear that, as a result of the tax principles under the Constitution, there is only one correct solution - the settlor should not be subject-to-tax under an irrevocable discretionary trust. The fiscal recognition of an

⁶⁶³ See Chapter 3.3.7.6.1 in connection with para. 5.2.3. Circular 30/20.

⁶⁶⁴ Circular Letter 30/20 does not take a position on the issue of where the trust assets and income come from (and so whether this also applies to Swiss source income or only to foreign source income).

⁶⁶⁵ In this vein: OBERSON, Trust, p. 490-491; DANON, Critique de la Circulaire du 22 août 2007, p. 453 et seq.; AMONN, General report on the fiscal treatment of international investment trusts and mutual funds, p. 6; VON AH, Trusts im Schweizer Steuerrecht, p. 8; NABHOLZ, Besteuerung von irrevocable discretionary Trusts, p. 54.

⁶⁶⁶ DANON, Critique de la Circulaire du 22 août 2007, p. 472.

⁶⁶⁷ Note that the gift tax issue is not explored in this chapter. See on this issue: NABHOLZ, Besteuerung von irrevocable discretionary Trusts, p. 57-59.

irrevocable discretionary trust created by a Swiss resident settlor, as published by the Federal Tax Administration in the draft version of Circular 30⁶⁶⁸, would have been preferable and in line with the correct systematic solution⁶⁶⁹.

3.3.8.3 *Distribution of an Irrevocable Discretionary Trust*

The first issue to be noted concerns the term “*Ausschüttungen*” in the German version of the Circular. The term “*Weiterleitungen*” would have been more appropriate in the context of the distribution of trust assets and income or capital gains from private assets. In fact, “*Ausschüttungen*” is inappropriate in this context as it relates to dividend distributions by legal persons in Swiss law and not to the transfer of trust assets and income from trustees to beneficiaries⁶⁷⁰.

The fiscal non-attribution of trust assets and income to beneficiaries under an irrevocable discretionary trust is explicable by the fact that the donation is not yet completed. The trust assets and income are only attributed to the Swiss resident beneficiary as soon as he obtains a fixed entitlement on the trust assets and income or, if different, at the time of the effective distribution by the trustee⁶⁷¹. Prior to this, the beneficiary simply possesses an expectation that is not subject to taxation according to Swiss tax law. The nature of trust income should be determined according to its origin. Under an irrevocable discretionary interest trust, distributed capital gains from private assets are not considered tax-free but are, for fiscal purposes, transformed into taxable income of the beneficiary⁶⁷². Given that the trust has no legal personality and is therefore tax-transparent, one must refer to the original nature of the trust assets and income during its life span⁶⁷³, causing the recharacterization of tax-free capital gains from private assets into taxable income. The vast majority

⁶⁶⁸ In para. 5.1.3 of the draft of 26 May 2005 of Circular 30.

⁶⁶⁹ Contrary to BÖCKLI, *Angelsächsische Trust – Zivilrecht und Steuerrecht*, p. 55-56.

⁶⁷⁰ See BÖCKLI, *Angelsächsische Trust – Zivilrecht und Steuerrecht*, p. 41.

⁶⁷¹ Para. 5.2.2. Circular 30/20.

⁶⁷² Para. 5.2.3. Circular 30/20. In this vein also: CRETTI, thesis 2007, p. 126 et seq.

⁶⁷³ Para. 5.2.3. Circular 30/20.

of authors rightfully criticizes this practice⁶⁷⁴, since the attribution of income of the trust assets clearly should not have any influence on the tax characterization of the capital gains. Only Sibilla Cretti appears to be in favor of taxation of the capital gains⁶⁷⁵.

3.3.9 Taxation of Investments Made by the Trust

This chapter deals with the tax consequences of investments made by trusts from both a domestic and an international tax perspective. Chapter 3.3.9.1 deals exclusively with investments made in Switzerland, where all the parties involved (settlor, trustee and beneficiary) are located in Switzerland that is, a fully domestic scenario. Under these situations, only Swiss domestic tax law has to be taken into consideration, and DTC provisions do not need to be analyzed or applied. Accordingly, this Chapter analyzes the impact of the Swiss withholding tax at the level of the parties involved in the trust first, and then at the level of the trust and outlines which person (either the settlor, beneficiary, trustee or the trust itself), can claim a refund of the Swiss withholding tax and under what conditions such a refund can be claimed.

The analysis separately deals with the case of revocable trusts, irrevocable fixed interest trusts, and irrevocable discretionary trusts. Finally, the chapter contains a brief critique of the current Swiss withholding tax refund procedure, and suggests possible solutions to this issue.

The subsequent chapter 3.3.9.2 serves as an introduction to the relevant problems arising from “*cross-border scenarios*”. These situations are discussed in greater detail in Chapter 6 and Chapter 7. The analysis outlined in this chapter reveals that there are currently no mechanisms in place regarding the tax treatment of trusts in a “*cross-border*” scenario, which may result in double taxation or double non-taxation of trusts. As will be seen, this stems from the fact that virtually no attention is paid to trusts by Swiss

⁶⁷⁴ DANON, thesis, p. 207 and 232; LANDOLF/GRAF, Trust im schweizerischen Steuerrecht, p. 19; BÖCKLI, Angelsächsische Trust – Zivilrecht und Steuerrecht, p. 54; BÖCKLI, Angelsächsische Trust, Part II, p. 787; VON AH, Trusts im Schweizer Steuerrecht, p. 9; DANON, Critique de la Circulaire du 22 août 2007, p. 457-458 and 472-473.

⁶⁷⁵ CRETTI, thesis 2007, p. 126 et seq.

DTCs, the OECD Model Tax Convention and its Commentaries⁶⁷⁶ as well as lack of mechanisms at a worldwide level to harmonize the tax treatment of trusts.

3.3.9.1 *Investments Made in the Residence State: The “Domestic Scenario”*

This chapter deals with fully domestic cases. This means that taxation of income at source arising in a “domestic scenario”, comprising an internal trust (“*Binnentrust*”; “*trust interne*”)⁶⁷⁷ in which all parties (settlor, trustee and

⁶⁷⁶ Neither the OECD Commentary nor the OECD Model contains specific provisions with regards to the application of DTCs to trusts, trustees, settlors or beneficiaries.

⁶⁷⁷ After long discussions in Switzerland during the preparation of the Hague Trust Convention, the internal trust was finally accepted by the Swiss legislator. See: WOLF/JORDI, *Trust und schweizerisches Zivilrecht*, p. 51. As in Italy, the election of the applicable law can not be limited due to an internal trust in which all parties (settlor, trustee and beneficiaries) are domiciled within the country. The only international element is the election of the applicable law, which can, according to Art. 6 of the Hague Trust Convention in relation with Art. 149c para. 2 SPILA, be chosen from any jurisdiction that has regulated the concept of the Anglo-Saxon trust. See thereto: THÉVENOZ, *Convention de la Haye sur les trusts*, p. 66 et seq.; GUILLAUME, *Incompatibilité du trust avec le droit suisse*, p. 14 et seq.; GUILLAUME, *Incompatibilité du trust avec le droit suisse*, p. 19-20. Moreover, GUTZWILLER, *Schweizerisches Internationales Trustrecht*, p. 14 states more precisely: “*Konkret bedeutet dies, dass keine ‘enge Beziehung’ (‘close connection’ oder auch ‘substantial relation’) des Sachverhaltes zum gewählten Recht bestehen muss, und die Errichtung des Trusts nach dem vom Settlor bestimmten Recht auch zulässig ist, wenn alle wesentlichen Sachverhaltselemente auf das Inland weisen. Nur ist nicht möglich: Den Trust dem Schweizerischen materiellen Recht zu unterstellen (...).*” PÉLICHET, *Trust*, p. 147 summarizes the fact that the settlor is totally free in electing the applicable law and may choose the one offering him the most suitable rules and institutions “*liberté totale*”; LUPOI, *Development of Protected Trust Structures*, p. 92; LUPOI/ARRIGO, *National Report for Italy*, p. 129.

beneficiaries)⁶⁷⁸ and the investments⁶⁷⁹ are domiciled or located in Switzerland⁶⁸⁰ and where the only international element is the election of the applicable law. From a tax point of view, this should not create any particular issues regarding the possibility to claim a refund of the Swiss withholding tax of 35%⁶⁸¹ which may be levied on Swiss-source trust income. This withholding tax and the possible refund occur mainly in the estate planning context in relation to movable capital property (*“bewegliches Kapitalvermögen”*; *“revenu de capitaux mobiliers”*)⁶⁸². In particular, the trust assets may take the form of interest from bonds and debentures issued by domestic debtors and other similar negotiable instruments⁶⁸³, shares and other participation rights⁶⁸⁴, profits deriving from units in Swiss CISs⁶⁸⁵ and interest on savings with Swiss banks and other similar institutions⁶⁸⁶. Since the parties involved in this scenario are all Swiss resident, only Swiss domestic tax law has to be taken into consideration. The question of when the tax must be withheld by the debtor of the item and paid to the Federal Tax Administration does not arise⁶⁸⁷. The claim has to be made when the income falls due (*“im Zeitpunkt, in dem die steuerbare Leistung fällig wird”*; *“au moment où échoit la prestation imposable”*)⁶⁸⁸. However, questions do arise regarding to the person who acts (the settlor, beneficiary, trustee or the trust itself⁶⁸⁹), and under what

⁶⁷⁸ BÖCKLI, Angelsächsische Trust – Zivilrecht und Steuerrecht, p. 56: *“Der engste Inlandbezug liegt sicherlich vor, wenn das ‘ganze Dreieck’ des Trusts, d.h. der Settlor, der Trustee und alle Begünstigten, in der Schweiz liegt”*.

⁶⁷⁹ LUPOI, Comparative study, p. 92 adds to the parties as mentioned by BÖCKLI the investment itself.

⁶⁸⁰ Even Swiss Law may be applicable as Art. 5 of the Hague Trust Convention does not limit the choice of applicable law governing a trust.

⁶⁸¹ Art. 13 para. 1 (a) WTL.

⁶⁸² Art. 4 WTL. The withholding tax on lottery gains (Art. 6 WTL) and on insurance benefits (Art. 7-8 WTL) is out of the scope of this analysis.

⁶⁸³ Art. 4 para. 1 (a) WTL; Art. 14 and 15 WTO.

⁶⁸⁴ Art. 4 para. 1 (b) WTL; Art. 20 para. 1 and 2 WTO.

⁶⁸⁵ Art. 4 para. 1 (c) WTL; Art. 28 para. 1 WTO.

⁶⁸⁶ Art. 4 para. 1 (d) WTL.

⁶⁸⁷ Art. 10 WTL.

⁶⁸⁸ Art. 12 WTL.

⁶⁸⁹ The trustee cannot claim a refund of the deducted withholding tax. As shown in Chapter 3.3, the trustee cannot be taxed on the trust assets and income; thus, the trustee has (according to Art. 21 para. 1 (a) WTL) no refund claim on the deducted withholding tax

conditions the actor is finally entitled to obtain a refund of the Swiss withholding tax. The following conditions must be fulfilled by the settlor or beneficiary in order to claim a refund of the Swiss withholding tax. The first condition is satisfaction of the Swiss “*beneficial ownership*” concept, also known as the “*right to use*” requirement⁶⁹⁰. The other conditions, such as the “*absence of tax avoidance*” (“*keine Steuerumgehung*”; “*absence d’évasion fiscale*”)⁶⁹¹, reimbursement within a timeframe (“*Rückerstattungsanspruch innerhalb einer Zeitfrist*”; “*remboursement dans un certain délai*”)⁶⁹², “*domicile*” (“*Wohnsitz*”; “*domicile*”)⁶⁹³ and “*reporting*” (“*Deklaration*”; “*déclaration*”)⁶⁹⁴ need not be considered in detail here, since their fulfillment does not “*per se*” depend on the existence of a trust relationship⁶⁹⁵.

Instead, this study focuses on the first requirement - the “*right to use*” (“*Recht zur Nutzung*”; “*droit de jouissance*”)⁶⁹⁶. This requirement is fulfilled, according to Art. 21 para. 1 (a) WTL, at the time when the income falls due (“*bei Fälligkeit der steuerbaren Leistung*”; “*au moment de l’échéance de la prestation imposable*”). The “*ratio legis*” from the “*right to use*”

deriving from the trust fund. This result is consistent with the fact that the person who is not taxed on the trust assets and income is necessarily the person who does not have the right to use and, therefore, cannot claim a refund of the deducted withholding tax. The same result can be reached, according to LANDOLF/GRAF, *Trust im schweizerischen Steuerrecht*, p. 22, by assimilating the trustee to a fiduciary according to Art. 61 WTO.

⁶⁹⁰ Art. 21 para. 1 (a) WTL.

⁶⁹¹ Art. 21 para. 2 WTL.

⁶⁹² Art. 32 para. 1 WTL.

⁶⁹³ Art. 22 para. 1 WTL.

⁶⁹⁴ Art. 23 WTL.

⁶⁹⁵ In this vein DANON, thesis, p. 241.

⁶⁹⁶ Art. 21 para. 1 (a) WTL. This term should in particular be construed by reference to the economic reality. In this vein: BAUER-BALMELLI, thesis, p. 118; STOCKAR/HOCHREUTENER, *Praxis WTL*, nr. 35 ad. Art. 21 para. 1 (a); Federal Court of Appeal for Taxation of 19 February 2001 (SRK 1999-130) = JAAC 65.112,2.b.bb. See in particular: DANON, thesis, p. 241-244 for a detailed analysis of the “*right to use*” requirement.

requirement in Swiss domestic tax law is comparable to the beneficial ownership requirement in international tax law. Furthermore, this Article is only applicable if there is no tax avoidance by abuse of the law⁶⁹⁷.

3.3.9.1.1 Revocable Trusts

According to Art. 21 para. 1 (a) WTL⁶⁹⁸, the Swiss resident settlor is regarded to be the beneficial owner of the income for the refund of Swiss withholding tax. Assuming fulfillment of the other conditions⁶⁹⁹, the Swiss resident settlor is entitled to relief from the Swiss withholding tax for as long as the trust assets and income are not fiscally attributed to the beneficiary.

3.3.9.1.2 Irrevocable Fixed Interest Trusts

Based on the analysis above, the Swiss resident beneficiary of an irrevocable fixed interest trust is considered to be the beneficial owner of the income. Consequently, he is entitled to relief from Swiss withholding tax⁷⁰⁰ by way of analogy to the regulations regarding fiduciary relationships⁷⁰¹, assuming of course that the other requirements are fulfilled⁷⁰².

In practice, irrevocable fixed interest trusts often feature an accumulation period⁷⁰³. Depending on the trust deed and potentially at the trustee's discretion, the trust assets and income may be retained for a period of time and may not be paid out to the beneficiary until certain conditions are met⁷⁰⁴. Following the reasoning of the Circular Letter 30/20, the trust assets and income that have not been paid out can consequently not be attributed to the

⁶⁹⁷ Art. 21 para. 2 WTL. Federal Court of Appeal for Taxation of 19 February 2001 (SRK 1999-130), published in JAAC 65.112,2.b.cc.

⁶⁹⁸ Para. 7.2.1 Circular 30/20.

⁶⁹⁹ Please refer to the second "*domicile requirement*" and third "*reporting requirement*" as stated in Chapter 3.3.9.1.

⁷⁰⁰ Para. 7.2.2 Circular 30/20.

⁷⁰¹ Art. 61 para. 2 WTO.

⁷⁰² See Footnote 699.

⁷⁰³ See Footnote 619.

⁷⁰⁴ GARBARINO, Trust, p. 399-400.

beneficiary on the principles of financial capacity⁷⁰⁵ and equality of treatment⁷⁰⁶. Under an irrevocable fixed interest trust, the trustee has the obligation to remit the designated income to the beneficiary at the moment when it arises, or said income belongs “*ipso facto*” to the beneficiary when it arises⁷⁰⁷. However, the trust income under an irrevocable fixed interest trust is attributed to the beneficiary as soon as he has a fixed interest or has received a distribution⁷⁰⁸. The same problem can arise within an irrevocable discretionary trust⁷⁰⁹ in which it is not at all clear when the income arises and to whom it will be distributed. In such situations, the trustee has in general a discretionary power under which he can decide to whom, among a plurality of beneficiaries, a distribution is to be made.

Swiss scholarly writing does not seem to pay much importance to this time difference⁷¹⁰ which is, however, of significance in practice in a tax-transparent world⁷¹¹. It is obvious that under a restrictive interpretation, the beneficiary would not be able to claim the Swiss withholding tax on the accumulated trust income because of the non-reporting of the relevant income under Art. 23 WTL. According to the practice under the issued Circular, the beneficiary fulfils the duty of declaration if he pays income taxes on the trust assets and income attributed to him. Based on the foregoing, it is obvious that the beneficiary is entitled to claim a refund of the Swiss withholding tax so long as the request is made within a timeframe of three years after the distribution has been made⁷¹².

⁷⁰⁵ Art. 127 para. 2 FC.

⁷⁰⁶ Art. 127 para. 2 FC.

⁷⁰⁷ RYSER, double taxation treaties, p. 312.

⁷⁰⁸ Para. 5.2.2 Circular 30/20.

⁷⁰⁹ KOELE, Trusts and the Application of the OECD Model Convention, p. 95.

⁷¹⁰ See DANON, thesis, p. 245-246; OBERSON, Trust, p. 489; LANDOLF/GRAF, Trust im schweizerischen Steuerrecht, p. 23; RYSER, double taxation treaties, p. 323 et seq. The Circulars even do not address this important issue.

⁷¹¹ In this vein BÖCKLI, Angelsächsische Trust – Zivilrecht und Steuerrecht, p. 46-47.

⁷¹² Art. 32 para. 1 WTL.

3.3.9.1.3 Irrevocable Discretionary Trusts

For relief of Swiss withholding tax under an irrevocable discretionary trust, the Swiss resident settlor must be regarded as the beneficial owner of the income, according to Art. 21 para. 1 (a) WTL⁷¹³. This depends on whether the settlor is a Swiss or non-Swiss resident as well as how the Swiss resident settlor is taxed. The tax consequences may, therefore, be divided into three hypotheses.

In the first hypothesis, a Swiss resident settlor who is subject to unlimited Swiss tax liability, is entitled to relief from the Swiss withholding tax⁷¹⁴ as the trust assets and income are attributed to him⁷¹⁵.

In the second hypothesis, a Swiss resident settlor subject to lump-sum taxation at the time of the creation of the trust, is entitled to relief from Swiss withholding tax⁷¹⁶.

In the third hypothesis, a Swiss resident settlor is resident outside of Switzerland at the time of the creation of the trust. Due to the trust's fiscal recognition, its assets and income are attributed to a "*no man's land*"⁷¹⁷. Since the settlor has definitely disposed of the trust assets and the beneficiary only has a pure expectation right and not a fixed entitlement, neither is considered to be the beneficial owner. Consequently, there is no possible claim for a refund of the Swiss withholding tax as long as the trust assets and income have not been distributed and can be attributed for tax purposes to the beneficiary within the timeframe of reimbursement imposed by the WTL⁷¹⁸.

An even rarer hypothesis leading to the same conclusion has been pointed out by Robert Danon. This hypothesis concerns situations in which the trustee's discretion is exercised before the income falls due⁷¹⁹. In such case, the beneficiary under an irrevocable discretionary trust has not, exceptionally, an

⁷¹³ Para. 7.2.1 Circular 30/20.

⁷¹⁴ Para. 5.1.1.2 Circular 30/20.

⁷¹⁵ See Chapter 3.3.9.1.1.

⁷¹⁶ Para. 7.2.3 Circular 30/20

⁷¹⁷ Circulars 30 and 20 do not expressly refer to this subject. See thereon Chapter 3.3.7.6.2.

⁷¹⁸ In this vein: RYSER, double taxation treaties, p. 323-324.

⁷¹⁹ DANON, Critique de la Circulaire du 22 août 2007, p. 434-435.

expectation, but has instead a fixed entitlement or, in other words, a fixed legal claim against the trust, which is comparable to that under an irrevocable fixed interest trust. For the relief of Swiss withholding tax under an irrevocable discretionary trust, the Swiss resident settlor must be regarded as the beneficial owner of the income, according to Art. 21 para. 1 (a) WTL. Consequently, there is no possible claim for a refund of the Swiss withholding tax as long as the trust assets and income have not been paid out and can be attributed for tax purposes to the beneficiary, assuming of course that the other requirements are fulfilled⁷²⁰.

3.3.9.1.4 Critique in Relation to Refund of the Swiss Withholding Tax

Neither the settlor nor the beneficiary can obtain a refund of Swiss withholding tax under an irrevocable discretionary trust or an irrevocable trust in which the beneficiary possesses a mere expectation right. With regards to Circular 20, the trustee is not mentioned under the title “*refund of the Swiss withholding tax*”, presumably because on an economic analysis the trustee is not entitled to the trust assets⁷²¹. The Circular goes on to expressly reject, in conformity with the direct taxation treatment, the possibility for the trust itself to reclaim the Swiss withholding tax as a company without legal personality, according to Art. 24 para. 2 WTL, or as an organized patrimony, according to Art. 55 (c) WTO⁷²². This conclusion is clearly incompatible with the objective of Swiss withholding tax since the primary “*ratio legis*” of Art. 55 (c) WTO is to ensure that Swiss withholding tax constitutes a final burden only in cases in which the Swiss direct tax reporting obligations have not been complied with⁷²³. Due to its significance for a financial center such as Switzerland, this question will be further addressed in the next chapter in comparison with the refund of Swiss Withholding Tax for the benefit of Swiss Collective Investment Schemes⁷²⁴. In the author’s view, a different approach in regard to the right to a refund of withholding tax should be elaborated, taking into account the spirit of the Swiss legal system and the interests of Switzerland as a financial center.

⁷²⁰ See Footnote 699.

⁷²¹ Para. 4.2 Circular 30/20.

⁷²² Para. 7.2 Circular 20. This possible solution has been suggested by Robert Danon in his thesis. See DANON, thesis, p. 248 et seq.

⁷²³ DANON, thesis, p. 248 et seq.

⁷²⁴ See Chapter 2.3.6.3.

3.3.9.1.5 Identification and Evaluation of Possible Conceptual Solutions in Relation to the Refund of Swiss Withholding Tax for the Benefit of an Irrevocable Discretionary Trust within the Current Legal Framework

It has been outlined in the previous chapters that neither the settlor nor the beneficiaries can obtain a refund of Swiss withholding tax under an irrevocable discretionary trust or an irrevocable trust in which the beneficiary possesses a mere expectational right, as long as no distribution is made under the current Swiss tax laws⁷²⁵. On the one hand, the settlor of an irrevocable discretionary trust has transferred both the legal and the economical power of disposition. For this reason, the right to a refund cannot exist. On the other hand, the beneficiaries of such a trust only have an expectational right to benefits until any distributions are effectively made. Thus, they do not have a right to a refund for retained profits, either. Moreover, the trustee does not have a right to a refund of the withholding tax “*de lege lata*”⁷²⁶. It can thus be concluded that, under the current practice, the trustee is not entitled to claim a refund of the withholding tax.

The author fully agrees with Robert Danon’s position that an irrevocable discretionary trust or an irrevocable trust should be entitled to obtain a full refund of the Swiss withholding tax levied on Swiss investments through the trust⁷²⁷. However, it is submitted that, compared to Robert Danon’s view, this right should not be conferred through a legislative act on the ordinance level.

The author is in favour of the acrobatic reasoning that an irrevocable discretionary trusts which is administred in Switzerland through a Swiss resident trustee should be entitled, either under a body of persons (“*Personenvereinigung*”; “*groupement de personnes*”) or a unit of assets (“*Vermögensmasse*”; “*masse de biens*”), to obtain a full refund of the Swiss withholding tax. However, with the introduction of Circulars 30/20 and for reasons of legal security, the federal tax authority expressly confirmed with Circular 20 its practice for Swiss withholding taxes. As a result, this proposition would

⁷²⁵ Para. 7.2.3. Circular 20.

⁷²⁶ Para. 7.2.3. Circular 20. According to BAUER-BALMELLI, Commentary WHT, nr. 12 ad. Art. 21, a trustee does not have a right to a refund of withholding taxes since he cannot freely dispose of the profits of the assets.

⁷²⁷ DANON, thesis, p. 248 et seq.

today clearly not be feasible, as it goes against the opinion of the Swiss tax authorities.

In the author's view, a less creative but more acceptable solution would be the creation of an explicit provision comparable to Art. 24 para. 2 WTL or Art. 26 WTL in respect of Collective Investment Schemes. With regard to Art. 26 WTL, the provision should be drafted differently in order for the foreign trust not to be subject to Swiss withholding tax at the trust level. The refund may be requested by the Swiss-resident trustee of an irrevocable discretionary trust according to the Circular Letters 30/20 for the Swiss withholding tax. In order to ensure that the Swiss withholding tax is not refunded twice, the Swiss-resident trustee would have to confirm that the income is, for tax reasons, not attributed and therefore taxed at the level of the settlor or beneficiary⁷²⁸. The "*ratio legis*" of such new norm would be in line with the objective of the Swiss withholding tax aiming at ensuring compliance with direct tax reporting requirements⁷²⁹. The reimbursement of the Swiss withholding tax to individual beneficiaries would be inefficient in practice, as it would be difficult, not to say impossible, for beneficiaries of an irrevocable discretionary trust to prove the required conditions for a refund.

To this purpose, the first theoretical condition to be met is that of Swiss "*beneficial ownership*", that is to say the "*right to use*" ("*Recht zur Nutzung*"; "*droit de jouissance*")⁷³⁰ of the trust/trustee comparable to a CIS. It is important to note that, in practice, this requirement should not be as decisive as for a CIS⁷³¹. Should this criterion nevertheless be decisive, a trustee of an irrevocable discretionary trust must, according to Marcel Jung, clearly

⁷²⁸ DANON, thesis, p. 254.

⁷²⁹ Swiss Federal Supreme Court Judgment of 26 March 1999 = ASA 68 = RDAF 2000, p. 65; Swiss Federal Supreme Court Judgment of 29 October 1992, ASA 62, p. 280 and p. 285; BAUER-BALMELLI, thesis, p. 115; BAUER-BALMELLI, Commentary WHT, nr. 7 ad. Art. 21.

⁷³⁰ Art. 21 para. 1 (a) WTL. For further details see: PFISTER, Rückerstattung der Verrechnungssteuer an inländische Investoren transparenter ausländischer kollektiver Kapitalanlagen, p. 22 and Chapter 6.5.2.1.2.

⁷³¹ OESTERHELT, Basler Kommentar, Kollektivanlagengesetz, nr. 274 ad. Art. 1; OESTERHELT/WINZAP, kollektive Kapitalanlagen, Part III, p. 131.

be seen as a person satisfying the “*right to use*” requirement as long as the trustee has the “*power to control*” the distribution of the trust assets⁷³².

However, it is submitted that taking into account the interpretation of the “*right to use*” requirement developed by various court decisions in Switzerland, the latter can easily be challenged since the trustee does not freely hold the power of disposition over the income of the trust assets. In fact, the trustee must distribute the trust income according to the trust deed; this limits, in principle, the power of disposition of the trustee⁷³³. When analyzing Art. 26 WTL it can be observed that, due to the flow-through character of Swiss CISs, neither the income should be attributed to the CIS, nor the CIS be considered a taxpayer for purposes of refunding Swiss withholding tax.

The other conditions, such as the “*absence of tax avoidance*” (“*Steuerumgehung*”; “*évasion fiscale*”)⁷³⁴, “*reimbursement within a timeframe*”⁷³⁵ (“*Rückerstattungsanspruch innerhalb einer Zeitfrist*”; “*remboursement dans un certain délai*”⁷³⁶, “*domicile*” (“*Wohnsitz*”; “*domicile*”)⁷³⁷ and “*reporting*” (“*Deklaration*”; “*déclaration*”)⁷³⁸, shall not be analyzed in detail since their fulfillment does not “*per se*” depend on the existence of a trust.

3.3.9.2 *Investments Made in the Source State: The “Cross-Border Scenario”*

“*Cross-border scenarios*” cases involve one or more jurisdictions and source income taxation arising in this context is far more complex and uncertain in comparison to the “*domestic scenario*” due to the lack of appropriate provisions addressing the issues surrounding trusts and DTCs⁷³⁹. However, it

⁷³² JUNG, Trusts im internationalen Steuerrecht, p. 418.

⁷³³ For a detailed analysis of the concept of “*right to use*” under Art. 21 para. 1 (a) WTL, see Chapter 6.5.2.1.2.

⁷³⁴ Art. 21 para. 2 WTL.

⁷³⁵ Art. 32 para. 1 WTL.

⁷³⁶ Art. 31 para. 1 WTL.

⁷³⁷ Art. 22 para. 1 WTL.

⁷³⁸ Art. 25 WTL.

⁷³⁹ See DANON, thesis, p. 2: “(...) no unified administrative practice has so far emerged (...)”. Moreover, “(...) there is no case law or official position as regards to the applica-

would be wrong to conclude that due to the lack of appropriate provisions, DTCs should not be applicable to trust relationships⁷⁴⁰. Part of the explanation must lie in the lack of attention paid to trusts by the applicable Swiss DTCs and by the OECD Model Tax Convention and its Commentary⁷⁴¹. Another part lies perhaps in the lack of worldwide harmonization, the complexity of the direct taxation of trusts, the absence of a taxable person⁷⁴² and the preference of countries to deal with the complexity on a pragmatic basis instead of attempting to develop a coherent worldwide tax system based on uniform principles.

Furthermore, there is no case law or official position expressed by the Federal Tax Administration with regard to the application of DTCs to trusts which could provide guidance. In this scenario, it is unavoidable that problems connected with the “*interference of tax jurisdictions*”⁷⁴³ will arise. The country in which investments are located may, as the source state of the dis-

tion of these agreements to trusts.”; CRETTE, thesis 2007, p. 170 et seq.; JUNG, International Taxation, p. 143; RYSER, double taxation treaties, p. 310: “(...) *that express references to trust relationships are practically missing in the tax treaties passed by Switzerland.*” However, in a later article in the International Guide to the Taxation of Trusts issued by the IBFD, RYSER observed in Section 8.1: “*The treaties concluded with states in which the trust is an institution under domestic law usually contain a definition of the term ‘person’ and extend this notion to ‘any other body of persons’.*” AVERY JONES, Trusts under the OECD Model, Part II: “(...) *the degree of uncertainty in applying treaties to trusts is not surprising, even in countries where trusts are frequently used.*” BAKER, The Application of the Convention to Partnership, trusts and other Non-Corporate Entities, p. 13-14: “(...) *there are no cases which provide any significant clarification of the application of double taxation conventions to trusts.*” MAISTO, Applicazione delle Convenzioni, p. 84-85. Against: LUPOI, Comparative study, p. 160 which states that a trust is a body of persons under the OECD Model and must therefore be included in the term of person in any event.

⁷⁴⁰ RYSER, double taxation treaties, p. 310.

⁷⁴¹ Neither the OECD Commentary nor the OECD Model contains specific provisions with regards to the application of DTCs to trusts, trustees, settlors or beneficiaries.

⁷⁴² In common law countries it is usually clear who is taxable in respect of the income of the trust assets. However, this does not mean that no controversial questions arise with regard to the application of DTCs to trusts. In Canada and the United States, for instance, a trust is deemed to be a taxable person according to its domestic law. In this vein: WHEELER, Taxation of Trusts in Common Law Jurisdictions, p. 49.

⁷⁴³ RYSER, double taxation treaties, p. 310.

tribution, intend under its domestic law to tax such dividend or interest payments at the level of the investment by a withholding tax (source taxation)⁷⁴⁴, whereas realized and distributed capital gains are usually not subject to taxation in the source state but may be taxed in the alienator's state of residence⁷⁴⁵. On the other hand, the beneficiary's or settlor's state of residence, in this case Switzerland, may, depending upon the arrangement of the trust under its governing law, be entitled to exercise its right to tax the income based on the principle of worldwide income through a yearly final assessment (residence taxation)⁷⁴⁶.

In such a scenario, cross-border double taxation⁷⁴⁷ (or double non-taxation⁷⁴⁸) is likely to arise. Concurring double or multiple tax charges may be eliminated by unilateral provisions in the corresponding domestic law of the involved country⁷⁴⁹, by the existence and application of DTCs⁷⁵⁰, or - even more rarely - by multilateral⁷⁵¹ or supranational⁷⁵² measures. The reality is that, in practice, unilateral provisions, DTCs, and multilateral/supranational measures are insufficient to eliminate such imbalances in the principle of tax neutrality arising from source taxation. Despite this fact, attention must be paid to the relevant DTC between the source state of income and the residence state, which may reduce the rate of the withholding tax payable on dividend or interest payments in the source state, and may provide relief in the residence state for taxes paid in the source state⁷⁵³.

⁷⁴⁴ As stated in Chapter 3.2, it is presumed in this analysis that the activity carried out by the trust in the source state does not constitute a permanent establishment, but a portfolio investment. In the case of a permanent establishment, the taxation would be made by an assessment and, therefore, would not be made by a withholding tax as in this analysis.

⁷⁴⁵ Art. 13 para. 5 OECD Model.

⁷⁴⁶ Art. 6 para. 1 resp. Art. 52 para. 1 LDTE.

⁷⁴⁷ See Chapter 4.

⁷⁴⁸ See Chapter 4.1.4.

⁷⁴⁹ See Chapter 4.2.1.1.

⁷⁵⁰ See Chapter 4.2.1.2.

⁷⁵¹ See Chapter 4.2.1.3.

⁷⁵² See Chapter 4.2.1.4.

⁷⁵³ Arts. 23 A and B OECD Model.

3.4 Summary Overview of the Tax Consequences of Trusts in Switzerland

Figure 3.5: Overview of the Tax Consequences of Trusts in Switzerland

Types of Private Express Trusts <i>which are held in private assets and do not hold immovable property</i>	Taxable income	Subject to Swiss withholding tax on trust/trustee level ¹	Fiscal attribution and realization of the taxable income	Eligibility to obtain the reimbursement of the withholding tax in the Domestic Scenario	Eligibility to obtain the reimbursement of the withholding tax in the Cross-Border Scenario
Revocable Trust					
Periodical Income distributed	Yes	No	Settlor	The Swiss resident settlor may claim the Swiss Withholding Tax deriving from the investments in Switzerland according to Art. 21 and seq. WTL.	This topic will be analysed in the following chapters
Periodical Income not distributed	Yes	No	Settlor until the beneficiary has acquired an equitable interest		
Capital Gains distributed	No, (tax free capital gain if declared by the settlor)	No	—		
Capital Gains not distributed	No, (tax free capital gain if declared by the settlor)	No	—		
Trust Fund	—	—	—	—	—
Irrevocable Fixed Interest Trust					
Periodical Income distributed	Yes	No	Beneficiary	The Swiss resident beneficiary may claim the Swiss Withholding Tax deriving from the investments in Switzerland according to Art. 21 and seq. WTL. ²	This topic will be analysed in the following chapters
Periodical Income not distributed	Yes (up to the part of the income which is attributable to the beneficiary)	No	Entitled beneficiary up to his attributable portion		
Capital Gains distributed	No, (tax free capital gain if forwarded and declared by the beneficiary)	No	—		
Capital Gains not distributed	No, (tax free capital gain if forwarded and declared by the beneficiary)	No	—		
Trust Fund	—	—	—	—	—
Irrevocable Discretionary Trust³					
Periodical Income distributed	Yes	No	Beneficiary	Neither the Swiss resident settlor nor beneficiary may claim the Swiss Withholding Tax from the investment level. ⁴	This topic will be analysed in the following chapters
Periodical Income not distributed	No	No	To nobody until the trustee has exercised its discretion or the beneficiary has acquired an equitable interest		
Capital Gains distributed	Yes	No	—		
Capital Gains not distributed	No, (capital gain becomes taxable if forwarded to the beneficiary)	No	—		
Trust Fund	—	—	—	—	—

¹ Without considering irrevocable fixed interest trusts with an accumulation period.

² This practice as to the Circular Letter is criticized among leading scholars and practitioners in tax law.

³ The tax consequences apply only if the trust is created by a Swiss-resident settlor who is subject to lump-sum taxation or by a non-Swiss resident.

⁴ This relates only to the Swiss withholding tax on the distribution or reinvestment of income on the level of the trust. This includes not the Swiss withholding tax on the investment level.

Source: Own figure

4 International Double Taxation

Although many people have an idea of what double taxation is, innumerable difficulties arise when an attempt is made to define it.
(Pires, 1989)

4.1 The Concept of International Double Taxation

4.1.1 Introduction

Due to the globalization of economic forces⁷⁵⁴, tax jurisdictions interfere with each other and therefore, conflicts affecting national economies unavoidably occur⁷⁵⁵. Such negative effects especially arise within CIS and trust structures and are mainly a consequence of differences in concepts, terms, and definitions between different legal systems⁷⁵⁶. These inconsistencies may, in a “*cross-border context*”, result in unintended taxation in the form of either over- or under-taxation, as each state may tax income and wealth without considering possible taxation levied in other states.

In international tax language, a distinction is generally made between international juridical and economic double taxation. Double taxation (and, for that matter, double non-taxation) is likely to be inefficient due to over-taxation and therefore undesirable from an economic perspective⁷⁵⁷. Moreover, it is questionable in terms of fairness and equality. However, it is established that such consequences are not forbidden by international law in today’s framework. As Victor Uckmar noted, international double taxation has a

⁷⁵⁴ PIRES, *Práticas Abusivas no Comércio Internacional*, p. 19 analyzes in detail the globalization of economics.

⁷⁵⁵ RYSER, *Double Taxation Treaties*, p. 310.

⁷⁵⁶ In this vein: HELMINEN, *The Dividend Concept*, p. 10.

⁷⁵⁷ CHOWN, *Eliminating Tax Obstacles for Cross-Border Operations*, p. 564.

negative impact on international trade and constitutes a considerable hindrance to international investments⁷⁵⁸. Manuel Pires goes even further and illustratively demonstrates the negative consequences at the financial, cultural, social and political levels resulting from international double taxation⁷⁵⁹.

The main goal of developed and progressive national tax systems is to try to achieve “*tax neutrality*”⁷⁶⁰, though in a global economy as the one existing today, this objective is difficult or even impossible to achieve⁷⁶¹. Many understand the idea of international double taxation, but innumerable difficulties arise when trying to establish a general definition encompassing all of its various aspects⁷⁶². The main objective of Swiss DTCs is usually referred to in their headings, such as, for instance, the “*Convention between the United States of America and the Swiss Confederation for the avoidance of double taxation with respect to taxes on income of October 2, 1996*”⁷⁶³ (emphasis added by the author), though interestingly, the term “*double taxation*” is not defined therein. In international tax planning, the concept of double taxation is very important, particularly when the structures used include CISs and trusts. The current situation, with the possibility of double taxation arising, is therefore highly unsatisfactory for clients and their tax advisers. For this reason, double taxation it is not merely a theoretical issue but rather poses an important series of practical challenges⁷⁶⁴.

⁷⁵⁸ UCKMAR, *Tratados Internacionales en Materia Tributaria*, p. 744.

⁷⁵⁹ PIRES, thesis, p. 86-89.

⁷⁶⁰ In detail: HELMINEN, *The Dividend Concept*, p. 11 et seq., HARRIS, p. 31 states “(...) *all taxes are non-neutral to some extent (...)*”. Moreover, he recognizes that: “(...) *all taxes affect in some manner the allocation of resources (...)*”.

⁷⁶¹ HELMINEN, *The Dividend Concept*, p. 12.

⁷⁶² RIVIER, *Droit Fiscal International*, p. 35; ARNOLD/MCINTYRE, *International Tax Primer*, p. 29.

⁷⁶³ DTC between Switzerland and the United States of October 2, 1996 published in *Systematic Collection of Federal Laws*: RS 0.672.933.61.

⁷⁶⁴ PIRES, thesis, p. 11.

4.1.2 Definition of “International Double Taxation”

The term “*international double taxation*” is characterized by a multitude of designations and interpretations⁷⁶⁵ and is subject to fierce academic debate⁷⁶⁶. Franz Wassermeyer notes that the term is unclear and is not a “*terminus technicus*”⁷⁶⁷, due to the difficulty in finding a general definition accounting for all of its aspects⁷⁶⁸. Such has also been stated by Manuel Pires: “*Difficulties occur not only on whether to establish a definition but also in the content*”⁷⁶⁹. Peter Locher describes it in an intercantonal context as “*Kollisionsrecht*” due to its various potential taxation conflicts⁷⁷⁰, though the term is equally apt at an international level. Double taxation can and has been classified in many different ways: in both narrow and broad senses⁷⁷¹, formal and material⁷⁷², subjective and objective⁷⁷³, real and unreal⁷⁷⁴, proper and improper⁷⁷⁵ as well as technical⁷⁷⁶, legal⁷⁷⁷, juridical⁷⁷⁸, economic⁷⁷⁹,

⁷⁶⁵ KLUGE, Das Internationale Steuerrecht, p. 25; RIVIER, Droit Fiscal International, p. 35.

⁷⁶⁶ For an overview: SCHAUMBURG, Internationales Steuerrecht, p. 585 et seq.

⁷⁶⁷ WASSERMEYER/LANG/SCHUCH, Commentary, nr. 1 ad. Introduction.

⁷⁶⁸ NIBOYET, Doubles impositions, p. 1; RIVIER, Droit Fiscal International, p. 35 ; ARNOLD/MCINTYRE, International Tax Primer, p. 29.

⁷⁶⁹ PIRES, thesis, p. 11.

⁷⁷⁰ LOCHER, Interkantonaes Steuerrecht, p. 6

⁷⁷¹ LOCHER, Einführung internationales Steuerrecht Schweiz, p. 49; OBERSON, Précis de droit fiscal international, p. 3.

⁷⁷² PIRES, thesis, p. 58.

⁷⁷³ PIRES, thesis, p. 60.

⁷⁷⁴ Dorn’s definition deriving from the year 1927 has been accepted by the majority of scholars, see: DORN, Doppelbesteuerung, p. 190; LOCHER, Einführung internationales Steuerrecht Schweiz, p. 49; OBERSON, Précis de droit fiscal international, p. 3; LOUKOTA, Aussensteuerrecht, p. 61-62.

⁷⁷⁵ SPITALER, Doppelbesteuerungsproblem, p. 58.

⁷⁷⁶ FLICK, Internationale Doppelbesteuerung, p. 86 et seq.

⁷⁷⁷ RÄDLER/RAUPACH, Auslandbeziehungen, p. 372.

⁷⁷⁸ OECD Commentary 2014, nr. 1 ad. Introduction.

⁷⁷⁹ OECD Commentary 2014, nr. 10, 40 ad. Art. 23A and 23B.

horizontal and vertical⁷⁸⁰, effective and virtual⁷⁸¹, direct and indirect⁷⁸². It is clear that a consistent and uniform definition is lacking⁷⁸³. Despite, and perhaps as a result of, this academic controversy, one common understanding of double taxation has emerged. Double taxation occurs when “*simultaneous taxation on the same item of income or capital (including capital gains)*”⁷⁸⁴ takes place in the “*same time period*”⁷⁸⁵ in “*two (or more) countries*” and affects “*the same tax subject*”⁷⁸⁶. The same criteria may be adapted to apply in an intercantonal context⁷⁸⁷. Although the literal interpretation of the term suggests that income is taxed only twice, double taxation also covers triple and any further multiple taxation fulfilling the aforementioned conditions⁷⁸⁸.

Certain authors, such as Bernhard Castagnède, also consider that juridical international double taxation must result in not only double (or multiple), but also excessive taxation⁷⁸⁹.

⁷⁸⁰ SPITALER, Doppelbesteuerungsproblem, p. 136; PIRES, thesis, p. 57 who adds to the classification between vertical and horizontal double taxation, the aspect of diagonal double taxation.

⁷⁸¹ DE VRIES REILINGH, thesis, p. 42 et seq..

⁷⁸² JUCH, National report on double taxation, p. 81; PIRES, thesis, p. 61-62.

⁷⁸³ In this vein: PIRES, thesis, p. 55. Additionally, he differentiates between the factual and potential, intentional and unintentional as well as simple and compound double taxation. JUNG, thesis, p. 60, arrives at the same conclusion for the economical double and multiple taxation.

⁷⁸⁴ Therefore, the income may be subject to income tax in one state and subject to a lottery tax in another. This situation gives rise to the same economic consequences as double taxation; however, it is not covered by the OECD Model. In this vein: STE 1997 A 31.1. Nr. 5.

⁷⁸⁵ SCHAUMBURG, Internationales Steuerrecht, p. 427. Against: DANON/SALOMÉ, double imposition internationale, p. 367 et seq. go even further and demonstrate that the criteria of the same time period is of no importance with regard to international double taxation.

⁷⁸⁶ In this vein: ARNOLD/MCINTYRE, International Tax Primer, p. 29. KNECHTLE, International Fiscal Law, p. 29; RIVIER, Droit Fiscal International, p. 38; OECD Commentary 2014, nr. 1 ad. Introduction.

⁷⁸⁷ Among others: DE VRIES REILINGH, thesis, p. 41.

⁷⁸⁸ JACOBS, Internationale Unternehmensbesteuerung, p. 3; SCHMIDT/SIGLOCH/HENSELMANN, Steuerlehre, p. 2.

⁷⁸⁹ CASTAGNÈDE, Précis de fiscalité internationale, p. 8.

The existence of each of the above conditions is not strictly required for there to be juridical international double taxation. In the literature⁷⁹⁰ as well as the OECD Commentary⁷⁹¹, a fundamental distinction is made between juridical double taxation (*“rechtliche Doppelbesteuerung”*; *“double imposition juridique”*)⁷⁹² and economic double taxation (*“wirtschaftliche Doppelbesteuerung”*; *“double imposition économique”*)⁷⁹³. The 2014 Model Convention and corresponding DTCs are primarily designed to eliminate juridical double taxation and not economic double taxation⁷⁹⁴. This has been expressly confirmed by Michael Lang, with the exception of Art. 9 OECD Model⁷⁹⁵. It should be noted that in this study, the intercantal context, i.e. juridical double taxation resulting from concurring fiscal jurisdictions within Switzerland, will not be analyzed⁷⁹⁶.

4.1.2.1 *Juridical Double Taxation*

International juridical double taxation is defined as the imposition of comparable taxes in two (or more) states on the same taxpayer in respect of the same subject matter and for identical periods⁷⁹⁷. In other words, juridical double taxation results in an international activity being taxed more heavily than an economically comparable domestic activity⁷⁹⁸. Juridical double taxation only occurs when the taxpayer is identical in both states, i.e. the same person (whether an individual or legal entity) is being taxed. In addition, the

⁷⁹⁰ RIVIER, *Droit Fiscal International*, p. 35.

⁷⁹¹ The OECD Commentary 2014, nr. 37 ad. Art. 10 uses these definitions expressly: *“In contrast to the notion of juridical double taxation, which has, generally, a quite precise meaning, the concept of economic double taxation is less certain”*.

⁷⁹² See Chapter 4.1.2.1.

⁷⁹³ See Chapter 4.1.2.2.

⁷⁹⁴ The only distributive rule that deals with economic double taxation is Art. 9 of the OECD Model regarding transfer pricing rules.

⁷⁹⁵ LANG, *Partnerships*, p. 29.

⁷⁹⁶ See the recent doctoral thesis published by Daniel De Vries Reilingh for a detailed analysis of the intercantal double taxation.

⁷⁹⁷ OECD Commentary 2014, nr. 1 ad. Introduction; OBERSON, *Précis de droit fiscal international*, p. 2 et seq.; LOCHER, *Einführung internationales Steuerrecht Schweiz*, p. 47 et seq.; MÖSSNER, *Steuerrecht international tätiger Unternehmen*, p. 197.

⁷⁹⁸ BRACEWELL-MILNES, *Economics of International Tax Avoidance*, p. 28.

same taxpayer must be subjected to homogeneous or essentially similar taxes in more than one country. What is relevant is the similarity of the tax's structure and not its literal designation⁷⁹⁹. Furthermore, the taxation must apply to identical tax periods. This criterion is often improperly disregarded⁸⁰⁰. If taxation takes place in two countries in respect of different periods, there is no double taxation.

4.1.2.2 *Economic Double Taxation*

Economic double taxation may generally be defined as the “*imposition of tax on the same income in the hands of different taxpayers*”⁸⁰¹. It is used to describe the situation which arises when the same economic transaction, item of income or capital is being taxed in two or more states by comparable taxes in the same period upon different taxpayers⁸⁰². This situation arises most often in cases in which affiliated or associated corporations have their legal seats in different countries. It differs from juridical double taxation with regard to the identity of the taxpayer⁸⁰³. Its significance is much broader and covers every situation in which an item of income or capital is being taxed more than once⁸⁰⁴. In this case, whether the taxation occurs in the same period, is in principle and according to some authors, irrelevant⁸⁰⁵. However, the main difference between juridical and economical double taxation is that the taxes are levied in the hands of different taxpayers⁸⁰⁶. In German literature it is, therefore, often referred to as “*fehlende Subjektidentität*”, which could be translated into English as the “*lack of person identity*”⁸⁰⁷. In order

⁷⁹⁹ FROTSCHER, Internationales Steuerrecht, p. 5.

⁸⁰⁰ BÄCHLE/RUPP, Internationales Steuerrecht, p. 26.

⁸⁰¹ VOGEL, Double Taxation Conventions, p. 10.

⁸⁰² VOGEL/LEHNER, Doppelbesteuerungsabkommen 2003, nr. 4 ad. Einleitung; OBERSON, Précis de droit fiscal international, p. 4 et seq.; LOCHER, Einführung internationales Steuerrecht Schweiz, p. 48 et seq.; BÜHLER, Internationales Steuerrecht, p. 33.

⁸⁰³ Among others: PIRES, thesis, p. 48;

⁸⁰⁴ MILLER/OATS, Principles of International Taxation, p. 57.

⁸⁰⁵ SCHMIDT/SIGLOCH/HENSELMANN, Steuerlehre, p. 6.

⁸⁰⁶ RIVIER, Droit Fiscal International, p. 36. SALOM, thesis, p. 153.

⁸⁰⁷ KOFLER, Doppelbesteuerungsabkommen, p. 874; BÜHLER, Internationales Steuerrecht, p. 33; KOFLER, Doppelbesteuerungsabkommen, p. 874.

to better understand the concept of economic double taxation, it is helpful to distinguish between economic double taxation on one side, and economic double tax burden on the other side⁸⁰⁸:

4.1.2.2.1 Economic Double Taxation in a Narrow Sense

“*Economic double taxation*” (“*wirtschaftliche Doppelbesteuerung*”; “*double imposition économique*”)⁸⁰⁹ occurs in an international context when an item of income or capital is attributed to different persons by their respective domestic laws⁸¹⁰. In Switzerland, economic double taxation deriving from conflicting rules regarding the inclusion or deduction of positive and negative elements of income and capital, for example, in case of transfer pricing, is expressly prevented by Swiss domestic law⁸¹¹.

4.1.2.2.2 Economic Double Tax Burden

The “*economic double tax burden*” (“*wirtschaftliche Doppelbelastung*”; “*double imposition économique*”) of the distribution of dividends must be clearly differentiated from economic double taxation and juridical double taxation, for a number of reasons⁸¹². First, in Switzerland, the legislator expressly provides for such a double tax burden. Second, it is not generally the result of a conflict between two jurisdictions but rather a purely national phenomenon⁸¹³. For example, in Switzerland, the most frequent case occurs when profits generated by a company are first subjected to corporate income

⁸⁰⁸ Against MÖSSNER, *Steuerrecht international tätiger Unternehmen*, p. 199.

⁸⁰⁹ According to SCHAUMBURG, *Internationale Steuerrecht, Aussensteuerrecht, Doppelbesteuerungsrecht*, p. 424 and BÜHLER, *Internationales Steuerrecht*, p. 32 it is more appropriate to use the terminology in German of “*wirtschaftliche Doppelbelastung*” instead of “*wirtschaftliche Doppelbesteuerung*” in German.

⁸¹⁰ VOGEL/LEHNER, *Doppelbesteuerungsabkommen 2003*, nr. 4 ad. Einleitung.

⁸¹¹ Art. 127 para. 3 FC.

⁸¹² RIVIER, *Droit Fiscal International*, p. 38.

⁸¹³ RIVIER, *Droit Fiscal International*, p. 36. SPITALER, *Doppelbesteuerungsproblem* argues that there is no economic double taxation when a corporation and shareholder are both taxed on distributed profits. SPITALER classifies this type of situation as a “*double tax burden*”, where no identity of object exists. First, the profit is being taxed at the level of the company, then the distributed profit (income) is being taxed at the level of the shareholder.

taxation (taxation at the corporate level), and then are being taxed as investment income when distributed to the company's shareholders (taxation at the investor level)⁸¹⁴. Switzerland, as many other countries, has adopted a system designed to minimize but not to eliminate cases of economic double or multiple tax burden⁸¹⁵.

4.1.3 Circumstances Giving Rise to International Double Taxation

International double taxation is caused by simultaneous taxation, triggered by different connecting criteria, imposed in different countries or "*fisci*"⁸¹⁶. As outlined below, these conflicts arise mainly due to the basic principles of international taxation (conflicts 1 to 3)⁸¹⁷, the diversity of definitions⁸¹⁸ and due to attribution and qualification conflicts (conflicts 4 to 6)⁸¹⁹. Sometimes this is a direct consequence of the express intention of legislators, for example the double tax burden on the distribution of accumulated corporate gains in Switzerland at both the company level and at the shareholders' level (conflict 7)⁸²⁰.

4.1.3.1 *Conflict of the Basic Principles of International Taxation*

Following the "*principle of residence*"⁸²¹ ("*Ansässigkeitsprinzip*"; "*principe de résidence*"), unlimited taxation rights are granted to the country of a tax subject's residence, due to their connection with the jurisdiction, and regardless of the origin or location of their income and wealth. Each country's

⁸¹⁴ BARENFELD, thesis, p. 86.

⁸¹⁵ BARENFELD, thesis, p. 86.

⁸¹⁶ There are a multitude of global connecting criteria such as nationality, domicile, residence, headquarters, management, permanent establishment, location of the property and source of income, each of which may trigger domestic tax liability.

⁸¹⁷ See Chapter 4.1.3.1.

⁸¹⁸ DAVIES, Principles of International Double Taxation Relief, p. 2.

⁸¹⁹ See Chapters 4.1.3.2 and 4.1.3.3.

⁸²⁰ See Chapter 4.1.2.2.2.

⁸²¹ For a general overview: VAN WEEGHEL, thesis, p. 12.

domestic tax law defines the criteria of residency differently⁸²². For instance, in Switzerland, an individual's residence is established according to the criteria of domicile⁸²³ and place of abode⁸²⁴. As for legal entities, their seat⁸²⁵ or the place of effective management⁸²⁶ must be in Switzerland in order to be Swiss tax resident. If the requirement is met, the individual or legal entity will potentially be subject to unlimited tax liability on its worldwide income in Switzerland. Several leading scholars have advanced various justifications to legitimize this principle⁸²⁷.

It should be noted that in a majority of countries, the "*principle of nationality*"⁸²⁸ ("*Nationalitätsprinzip*"; "*principe de la nationalité*") has over time been replaced as the principal ground for unlimited potential tax liability on worldwide income by the principle of residence. However, the former has not completely lost its significance. For instance, it is still used in the United States⁸²⁹, and thus all American citizens and Green-Card holders are subject to unlimited tax liability in the US⁸³⁰, regardless of whether they live in the US or not. The justification for this relates to the sovereignty that a State exerts over its citizens⁸³¹.

Taxation of income based upon the "*principle of source*"⁸³² ("*Quellenprinzip*"; "*principe de la source*") is also frequently used⁸³³. The country of source reserves the right to tax all income arising in or having an economic connection with its territory, generally irrespective of whether such income

⁸²² PANAYI, Double Taxation, p. 3; ARNOLD/MCINTYRE, International Tax Primer, p. 16-17.

⁸²³ Art. 3 para. 1 LDFT; Art. 3 para. 1 LDHT.

⁸²⁴ Art. 3 para. 1 LDFT; Art. 3 para. 1 LDHT.

⁸²⁵ Art. 50 LDFT; Art. 20 para. 1 LDHT.

⁸²⁶ Art. 50 LDFT; Art. 20 para. 1 LDHT.

⁸²⁷ PANAYI, Double Taxation, p. 3-4.

⁸²⁸ For a general overview see VAN WEEGEHL, thesis, p. 10-12.

⁸²⁹ ARNOLD/MCINTYRE, International Tax Primer, p. 15.

⁸³⁰ AULT/ARNOLD, Comparative Income Taxation, p. 347.

⁸³¹ MARTHA, thesis, p. 47.

⁸³² For a general overview see VAN WEEGEHL, thesis, op. cit. p. 12-13.

⁸³³ BRUINS/EINAUDI/SELIGMAN/STAMP, Report on Double Taxation, p. 19-20.

is generated by residents or non-residents⁸³⁴. The justifications for this principle rely on various theories, such as the benefit theory⁸³⁵ and the theory of territorial sovereignty⁸³⁶.

Due to time constraints and scope delimitation, the principle of territoriality (*“Belegenheitsprinzip”*; *“principe de territorialité”*) will not be discussed in this thesis⁸³⁷.

4.1.3.2 Notion of Conflicts of Qualification

Special problems regarding *“conflicts of qualification”*⁸³⁸ (*“Qualifikationskonflikte”*; *“conflits de qualification”*) may also arise⁸³⁹. Throughout the years, many have attempted to define this concept⁸⁴⁰, but the similarities between these definitions given are rare. In this vein, Daniel De Vries Reilingh states *“le terme conflit de qualification n’a pas reçu de définition claire”*⁸⁴¹. However, scholars generally agree that conflicts of qualification arise when two states fiscally treat the same circumstances differently⁸⁴², due to differences in their interpretation of the terms used in DTCs, leading to dissimilarities of treatment in their respective domestic tax laws. Just as the

⁸³⁴ PANAYI, Double Taxation, p. 2.

⁸³⁵ COLON, Financial Products and Source Basis Taxation, p. 780-781; VAN WEEGHEL, thesis, p. 12.

⁸³⁶ MUSGRAVE, Interjurisdictional Equity in Company Taxation, p. 52-53.

⁸³⁷ For further information: VOGEL/LEHNER, Doppelbesteuerungsabkommen 2003, nr. 2 ad. Einleitung.

⁸³⁸ Instead of the term *“qualification conflict”*, the terms *“characterization”* and *“categorization conflict”* are sometimes used synonymously.

⁸³⁹ PILTZ, Qualifikationskonflikte, p. 22.

⁸⁴⁰ HANNES, thesis, p. 88, 129.

⁸⁴¹ DE VRIES REILINGH, thesis, p. 58

⁸⁴² In this vein: PILTZ, Qualifikationskonflikte, p. 22.

concept of “*conflicts of qualification*” is not defined consistently in the literature⁸⁴³, there are also different terms such as “*classification conflicts*”⁸⁴⁴, “*categorization conflicts*” and “*characterization conflicts*”⁸⁴⁵ being used.

There is a close connection between qualification and interpretation. Marjaana Helminen illustrates this problem with the following example: “(...) where an item of income had been classified as a dividend for tax treaty purposes or for the domestic tax law purposes of a state it must not be taxed as a dividend under the domestic law of the other state involved and vice-versa”⁸⁴⁶. In Switzerland, qualification problems often arise in relation to distributions from CISs and trusts, as neither Swiss domestic tax law, the OECD Model and its Commentaries, nor any DTCs of which Switzerland is a party (with the exception of the DTC with Germany) explicitly address these issues, except for the issue of distributions from a CIS at “*cross-border*” level⁸⁴⁷.

Conflicts of qualification may also arise following the application of Art. 3 para. 2 OECD Model⁸⁴⁸. This Article allows a state to refer to its domestic law (“*lex fori*”) if the DTC does not expressly contain a legal definition of the term, and as long as the context does not require otherwise. Depending on the circumstances, a term follows either an autonomous DTC meaning or the meaning encompassed in the state’s domestic law. “*In abstracto*”, conflicts may arise due to differences in domestic legal systems as states generally prefer, for reasons of convenience and efficiency, the interpretation which follows the meaning in their respective domestic tax law (“*lex fori*”). Conflicts may, as has been demonstrated in relation to Art. 3 para. 2 OECD

⁸⁴³ VOGEL/LEHNER, VOGEL/LEHNER, Doppelbesteuerungsabkommen 2003, nr. 151 ad. Einleitung. Many authors recommend not using the term “*qualification conflict*” due to potential confusion with international private law. Among other international private law specialists: ESCHER, Doppelbesteuerung, p. 74-75.

⁸⁴⁴ HELMINEN, The Dividend Concept, p. 50 et seq.

⁸⁴⁵ PILTZ, Qualifikationskonflikte, p. 21-22; HANNES, thesis, p. 23.

⁸⁴⁶ HELMINEN, The Dividend Concept, p. 50.

⁸⁴⁷ In this vein also: OESTERHELT/WINZAP, kollektive Kapitalanlagen, Part III, p. 126. The DTC with Germany classifies distributions as dividends according to Art. 10 para. 4 DTC Germany without considering the source of the income. In this vein also: HESS, thesis, p. 524 and ALTENBURGER, Taxation of Swiss-based investment funds and certificate holders, p. 100.

⁸⁴⁸ For a methodological and systematic overview of Art. 3 para. 2, see Chapter 5.2.3.5.

Model arise due to different methods of interpretation causing different meanings to be given to the same term or phrase⁸⁴⁹. According to Jacques Sasseville, conflicts of qualification may also arise, “*in a narrower sense*”, when two contracting states, such as the residence and source state, characterize income differently on the basis of divergences in their domestic law⁸⁵⁰ and therefore apply, different articles of the relevant DTC to the same element of income⁸⁵¹, or, “*in a broader sense*”, due to different methods of interpretation⁸⁵² with regards to DTCs. These disparities are likely to, in the end, cause double taxation (in the case of a positive qualification conflict) or double non-taxation (in the case of a negative qualification conflict)⁸⁵³.

4.1.3.2.1 Qualification Conflicts due to Differences in Domestic Laws

Following the conclusions of the Working Party Nr. 1 of the Committee on Fiscal Affairs of the OECD in its Report, “*The Application of the OECD Model Tax Convention to Partnerships*” (20 January 1999), conflicts of qualification may arise in a “*narrower sense*” due to differences in the domestic laws of the contracting states⁸⁵⁴. Each state may characterize income differently and therefore apply different articles of the DTC to the same income.

4.1.3.2.2 Qualification Conflicts due to Different Interpretation Methods of DTCs

In a “*broader sense*”, conflicts of qualification may arise when two contracting states characterize income differently on the basis of different methods of interpretation, consequently applying different articles of the DTC to the

⁸⁴⁹ HUERTA, Conflicts of qualification, p. 27 et seq.

⁸⁵⁰ See Chapter 4.1.3.2.1.

⁸⁵¹ SASSEVILLE, Lecture on Qualifications Conflicts in Tax Treaty Law.

⁸⁵² SASSEVILLE, Lecture on Qualifications Conflicts in Tax Treaty Law.

⁸⁵³ SASSEVILLE, Lecture on Qualifications Conflicts in Tax Treaty Law. The terms of positive and negative qualification conflicts are often referred to, among others RYSER, Introduction au droit fiscal international de la Suisse, p. 68.

⁸⁵⁴ OECD, Partnership Report, para. 94-123.

same income⁸⁵⁵. In the famous “*Pierre Boulez*” case, the term “*remuneration*” was qualified as a “*royalty*” (under Art. 12 of the OECD Model) by Germany and as “*compensation*” (under Art. 14 of the OECD Model) by the United States, because the definition had been interpreted differently by their respective tax authorities⁸⁵⁶. Even application of the relevant DTC could not solve such conflicts of qualification, arising due to the different characterization of income by each of the residence and source states.

4.1.3.3 *Notion of Conflicts of Attribution*

Another problematic situation arises in the case of “*conflicts of attribution*” (“*Zurechnungskonflikte*”; “*conflits d’attribution*”), which occur when two countries attribute income to different persons. At a global level almost no attention is paid to this fundamental and complex principle⁸⁵⁷ nor is it addressed in the OECD Model⁸⁵⁸, its Commentaries⁸⁵⁹ (except the Partnership Report⁸⁶⁰) or recent literature⁸⁶¹. However, at an early stage various schools of thought have emerged in Switzerland identifying this issue under Swiss

⁸⁵⁵ SASSEVILLE, Lecture on Qualifications Conflicts in Tax Treaty Law; PILTZ, Qualifikationskonflikte, p. 23.

⁸⁵⁶ US Case of *Pierre Boulez*, 83 TC 584 (1984).

⁸⁵⁷ WHEELER, The Attribution of Income in the Netherlands and the United Kingdom, p. 39-175 concluded that attribution of income is a complex issue according to her analysis.

⁸⁵⁸ Most DTCs also do not refer to this subject.

⁸⁵⁹ OECD Commentary 2014, nr. 6.9 ad. Art. 1 does not refer to this condition; LANG, CFC Regulations and Double Taxation Treaties, p. 51, 54; WHEELER, Attribution of Income, p. 477. Few statements can be found to the attribution of income in OECD Commentary 2014, nr. 29 and 30 ad. Art. 10; nr. 22.1 ad. Art. 1 and nr. 8 ad. Art. 17. See: WHEELER, The Missing Keystone of Income Tax Treaties, p. 256.

⁸⁶⁰ The Partnership Report outlines the most obvious mismatches of attribution, or in the word of the Partnership Report “*conflicts of income allocation*”. The OECD Partnership Report was then incorporated in the 2000 update of the OECD Commentary.

⁸⁶¹ Recently, however, in 2010 a doctoral thesis was published by Jessica Salom on: “*L’attribution du revenu en droit fiscal Suisse et international*”. Moreover, Beat Baumgartner has compared the concept of beneficial ownership to the concept of attribution of income in his doctoral thesis in 2010 on: “*Das Konzept des beneficial owner im internationalen Steuerrecht der Schweiz*”.

law⁸⁶², including papers by Marc Rivier in 1998⁸⁶³, Hugues Salomé in 2002⁸⁶⁴, Robert Danon in 2003⁸⁶⁵ and 2004⁸⁶⁶ and Henri Torrión in 2005⁸⁶⁷. However, it has only become more frequently discussed following the publication of the 1999 Partnership Report by the Committee on Fiscal Affairs of the OECD. Most countries lack legislative provisions to solve the pitfalls caused by attribution conflicts⁸⁶⁸. This type of conflict becomes relevant in Switzerland, since, if income cannot be generally attributed to a person, this person usually cannot claim DTC benefits because he would not fulfill the “*attribution of income*” requirement. In a cross-border situation, therefore, attribution of income represents a *de facto* additional condition - which is linked, and is sometimes included within, the beneficial ownership requirement - which must be satisfied in order to benefit from a DTC⁸⁶⁹.

However, under Swiss tax law, the taxpayer need not necessarily be the person who has legal entitlement to the income, respectively to whom the income is attributed. That would be the case, for example, a Swiss resident settlor creating an irrevocable discretionary trust⁸⁷⁰, a usufruct⁸⁷¹, the parents of a minor and partners in a partnership⁸⁷². In these examples, legal entitlement to the income is separated from the taxpayer. The majority of conflicts

⁸⁶² The principle of the attribution of income appears to derive from the articles published by Franz Wassermeyer in 1983 (see: WASSERMEYER, Die Hinzurechnungsbesteuerung als Qualifikationsproblem des nationalen und des internationalen Steuerrechts), Kees Van Raad in 1984 (see: VAN RAAD, Het Nationale Recht bij de Uitlegging van Belastingverdragen) and Klaus Vogel in 1986 (VOGEL, Double Tax Treaties and Their Interpretation).

⁸⁶³ RIVIER, Droit fiscal Suisse, p. 318 et seq.

⁸⁶⁴ SALOMÉ, Partnerships.

⁸⁶⁵ DANON, thesis, p. 296-326.

⁸⁶⁶ DANON, Conflicts of Attribution, p. 210 et seq.; DANON/SALOMÉ, double imposition international, p. 337 et seq.; DANON/SALOMÉ, Avoidance of Double Non-Taxation, p. 381 et seq.; DANON/SALOMÉ, National report on double non-imposition, p. 660 et seq.

⁸⁶⁷ TORRIÓN, Sociétés de personnes, p. 227 et seq.

⁸⁶⁸ WHEELER, General report on conflicts in the attribution of income, p. 20.

⁸⁶⁹ See Chapter 6.4.

⁸⁷⁰ Para. 5.2.3 in comparison to para. 5.1.1.2 Circular 30/20.

⁸⁷¹ In this vein also: DE VRIES REILINGH, thesis, p. 56, Footnote 227.

⁸⁷² In this vein: BOYER/HILDEBRANT, National report on attribution of income, p. 623.

of attribution arise in cases where both countries attribute the same item of income to different residents, under their domestic tax laws. These conflicts do not result from the application of the DTC itself, but from the application of the domestic laws of the contracting states. Unlike conflicts of qualification, conflicts of attribution may arise even where no DTC exists between the two states.

Figure 4.1: Circumstances Giving Rise to International Double Taxation

	Country A	Country B	
Conflict 1	General principle taxation of worldwide income (principle of residence or citizenship)	taxation of worldwide income (principle of residence or citizenship)	Conflict of the basic principles of international taxation
Conflict 2	General principle taxation of worldwide income (principle of residence)	taxation of country related income (principle of source)	
Conflict 3	General principle taxation of country related income (principle of source)	taxation of country related income (principle of source)	
Conflict 4	General principle Different qualification of the same circumstances in two involved States due to different fiscal meanings		Qualification Conflict
Conflict 5	General principle Different attribution of income to different tax subjects in the recognition („recognition“)		Attribution Conflict „recognition“
Conflict 6	General principle Different attribution of income to different tax subjects in the measurement („measurement“)		Attribution Conflict „measurement“
Conflict 7	General principle Taxation of the obtained gains on the company's level as well as taxation on the distribution of dividends on the shareholder's level		Economic double tax burden

Source: Own figure

4.1.4 Definition of “International Double Non-Taxation”

The League of Nations considered, in its 1923 Report on Double Taxation⁸⁷³, the principle of single taxation, on the premise that income should not be

⁸⁷³ See in general: BRUINS/EINAUDI/SELIGMAN/STAMP, Report on Double Taxation.

taxed more than once. The concept of international double non-taxation (*“Doppelte Nichtbesteuerung”*⁸⁷⁴; *“Double non-imposition”*) is clearly not in line with the principle of single taxation. However, it has only become more frequently discussed following the publication of the 1999 Partnership Report by the Committee on Fiscal Affairs of the OECD. In the Partnership Report, the objective of DTCs was specified to be: *“(...) to eliminate double taxation and to prevent **double non-taxation** (emphasis added by the author)”*⁸⁷⁵. The OECD Model does not recognize the avoidance of double non-taxation as a purpose or object of DTCs. The IFA Congress in 2004 on the subject of double non-taxation disagreed as to whether double non-taxation is covered by DTCs.

There are different ways of interpreting DTCs in relation to double non-taxation. On one side, the German⁸⁷⁶ and Austrian⁸⁷⁷ courts’ interpretation avoids double non-taxation, whereas on the other side, the Indian⁸⁷⁸ courts’ approach follows a more literal interpretation, which does not avoid double non-taxation. According to the latter approach, double non-taxation should be permitted and cannot be avoided by DTCs. It is submitted that this liberal view should be followed by Switzerland. As a result of the OECD’s new approach, double non-taxation is considered just as harmful as double taxation and will consequently be combated with the newly released Action Plan on Base Erosion and Profit Shifting (*“BEPS Action Plan”*), adopted by the OECD in July 2013. The OECD has developed a new set of standards to prevent double non-taxation based on closer international cooperation. These new standards aim at closing gaps for tax purposes by allowing multiple

⁸⁷⁴ LÜDICKE, DBA-Politik, p. 63 uses the terminology of *“Keinmalbesteuerung”* in German.

⁸⁷⁵ Partnership Report 2003, para. 52.

⁸⁷⁶ FG München IStR 1999, p. 569 as reported by RUST, Avoidance of Double Non-Taxation, p. 113.

⁸⁷⁷ Austrian Supreme Administrative Court case of 25 September 2001, 99/14/0217 as reported by HERDIN/SCHILCHER, Avoidance of Double Non-Taxation, p. 15.

⁸⁷⁸ Azadi Bachao Andolan, judgment of Indian Supreme Court dated 7 October 2003, as reported in 6 ITLR 233.

deductions for the same expense. Further, the BEPS Action Plan also proposes stricter rules for companies controlled by foreigners. In this present study, particular attention is paid to Action Nr. 2 which most clearly reflects this approach. In the DTC context, withholding taxes can only be reduced if the State of Residence sees and taxes the income as such, which the State of Source later reduces⁸⁷⁹.

Interestingly, double non-taxation has neither been defined nor described in the OECD Model, its Commentaries⁸⁸⁰ or in any of the DTCs concluded by Switzerland⁸⁸¹. The BEPS Action Plan nr. 2 (Treaty Issues) provides examples of situations where double non-taxation arises. The Report states that double non taxation can be achieved by, for instance, creating two deductions for one borrowing, generating deductions without corresponding income inclusions, or misusing foreign tax credit and participation exemption regimes. The Report continues by saying that double non-taxation involves loss of tax revenue, but not illegal tax avoidance since the tax laws of each country involved have been followed. There is, however, a reduction of the overall tax paid by all parties involved as a whole, which harms competition, economic efficiency, transparency and fairness⁸⁸². At best, it may be expressed by way of a negative definition⁸⁸³, or by referring to the opposite⁸⁸⁴ of “*juridical double taxation*”⁸⁸⁵. Authors have described this concept somewhat too broadly. It therefore lacks precision and is subject to wide interpretation. Consequently, it remains complex, uncertain and controversial and must necessarily be subject to extensive and serious analysis. The figure below provides an overview of five different definitions.

⁸⁷⁹ OECD, Final Report on BEPS Action 2.

⁸⁸⁰ In this vein among others: ARNOLD/SASSEVILLE/ZOLT, Tax Treaties, p. 70; HAHN, Double-Non-Taxation, p. 446-447; GROTHERR, DBA-Kommentar, nr. 55.

⁸⁸¹ DANON/SALOMÉ, Avoidance of Double Non-Taxation, p. 383.

⁸⁸² BEPS Report Action Plan nr. 2 (Treaty Issues), p. 4.

⁸⁸³ HAHN, Double-Non-Taxation, p. 447 has negatively defined double non-taxation: “*von zwei oder mehr Steuerhoheitsträgern nicht besteuert wird*”.

⁸⁸⁴ MÖSSNER, Steuerrecht international tätiger Unternehmen, p. 199.

⁸⁸⁵ Among others: OECD Commentary 2014, nr. 1 ad. Introduction.

Figure 4.2: Definitions of Double Non-Taxation

<i>Source</i>	<i>Definition</i>
HAHN ⁸⁸⁶	“(1) ein und derselbe Steuerpflichtige; (2) wegen ein und desselben Steuergegenstandes; (3) für ein und denselben Besteuerungszeitraum; (4) von zwei oder mehr Steuerhoheitsträgern; (5) nicht besteuert wird (emphasis added by the author), obschon die Vertragsstaaten eine Besteuerung in einem von ihnen wollten, und wenn (6) die Nichtbesteuerung unmittelbar auf der Anwendung des Abkommens beruht. ”
DANON / SALOMÉ ⁸⁸⁷	“(...) that is the non-taxation of any item of income or capital (emphasis added by the author) by neither of the two Contracting States (...).”
ARNOLD / SASSEVILLE / ZOLT ⁸⁸⁸	“The term double non-taxation can mean many things. In some cases, the source and residence countries may both decide not to tax a particular amount for legitimate policy reasons (emphasis added by the author). (...) the term should be restricted to situations in which the absence of taxation by either the residence or the source country is considered to be inappropriate or abusive. ”
BAKER ⁸⁸⁹	“(...) situations where a taxpayer faces no taxation in one state , yet still seeks the protection of the convention against taxation in the other state (emphasis added by the author). If he is entitled to the protection, the result will be double non-taxation.”

⁸⁸⁶ HAHN, Double-Non-Taxation, p. 447.

⁸⁸⁷ DANON/SALOMÉ, Avoidance of Double Non-Taxation, p. 383.

⁸⁸⁸ ARNOLD/SASSEVILLE/ZOLT, Tax Treaties, p. 235.

⁸⁸⁹ BAKER, Double Taxation Conventions, Section B ad. Introduction.

<i>Source</i>	<i>Definition</i>
WOLF ⁸⁹⁰	<i>“(...) wenn bestimmte Einkünfte (oder Vermögenswerte) auf Grund des Zusammenwirkens von Abkommensrecht und innerstaatlichem Recht in beiden Vertragsstaaten nicht besteuert werden, also völlig unbesteuert (emphasis added by the author) bleiben.”</i>

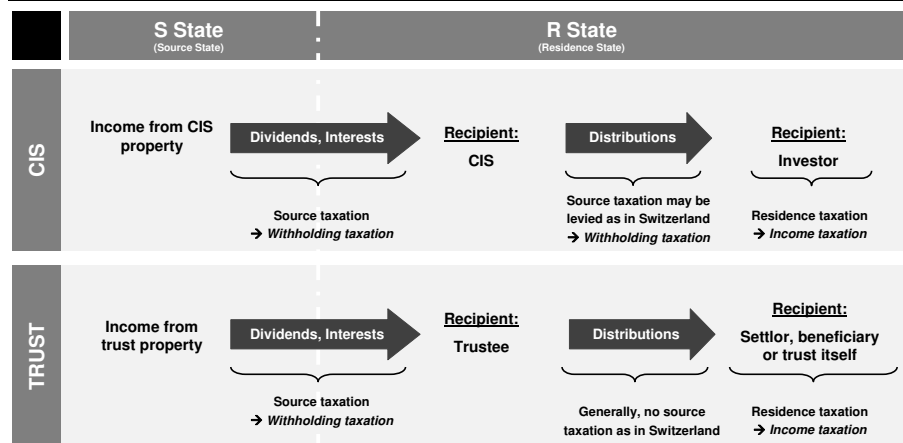
In the following chapters, a more detailed analysis of the concept of double non-taxation in relation to CISs and trusts in international tax law is provided, in order to foster a better understanding of this concept and its consequences. At this stage, the analysis will not refer to one specific country.

4.1.5 International Double Taxation of Collective Investment Schemes and Trusts

International double taxation of CISs and trusts may occur in a “*bilateral situation*” due to the levying of a withholding tax on distributed investment income in the state of source (source taxation) and the taxation of the recipient’s worldwide income in the state of residence (residence taxation). Additionally, some jurisdictions, such as Switzerland, levy (as long as the affidavit procedure is not applied) a withholding tax on the distribution of income from a CIS to an investor (though not from a trust to its beneficiaries). The recipient of income from CIS property may therefore be subject to double or multiple taxation. In a bilateral situation, international double taxation may be schematized as follows:

⁸⁹⁰ WOLF, Doppelte Nicht-Besteuerung, p. 542.

Figure 4.3: Source Taxation versus Residence Taxation - Bilateral Situation

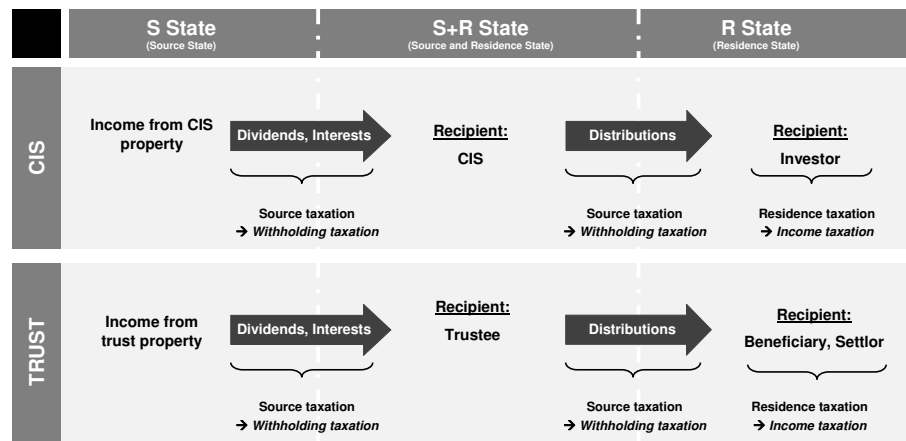


Source: Own figure

International double taxation in this context may more often result in a “*triangular situation*” than in a “*bilateral situation*”; this is mainly due to the fact that the investor, the investment and the CIS itself (or, respectively the trustee, settlor, beneficiary, investment and the trust itself), may not be located in the same State. The State of source may levy a withholding tax on distributed investment income (source taxation), whereas the residence State may tax the recipient’s worldwide income (residence taxation). Additionally, both states may treat the distribution of income from CIS (or trust) property as distributions that are subject to withholding tax (source taxation). However, in some jurisdictions, such as Switzerland, no withholding tax on the forwarding of income from the CIS to the investor is levied as long as the affidavit procedure is applied⁸⁹¹. The distributed income may also be taxed in the state of residence of the investor (or beneficiary). The recipient of income may therefore potentially be subject to double or multiple taxation. Such possibilities for international double taxation may be schematized as follows:

⁸⁹¹ See Chapter 2.3.6.5.1.

Figure 4.4: Source Taxation versus Residence Taxation - Triangular Situation



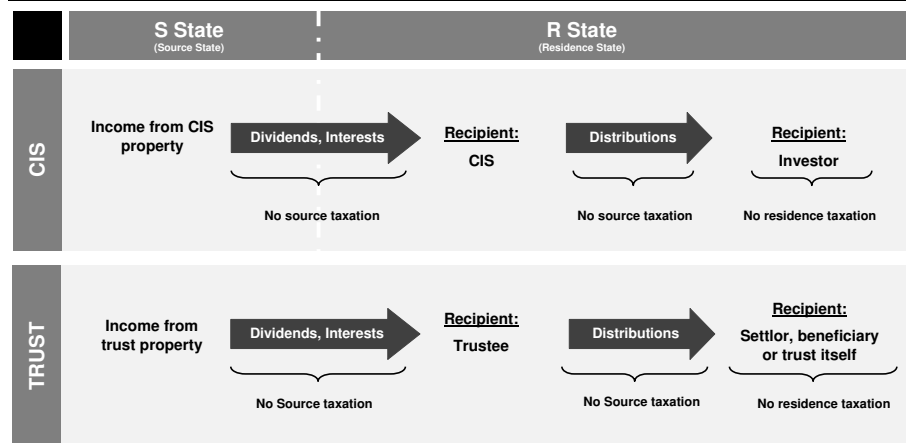
Source: Own figure

4.1.6 International Double Non-Taxation of Collective Investment Schemes and Trusts

International double non-taxation of CISs and trusts may arise in a “*bilateral situation*” due to divergences in the personal attribution of income or due to conflicts of qualification deriving from the interaction between national laws and DTCs⁸⁹². As a consequence, no taxation may result. No withholding tax is levied on distributed investment income (source taxation) and no taxation arises in the state of residence (residence taxation). The recipient of income from CIS property or trust property will not be taxed. International double non-taxation in a bilateral situation may be schematized as follows:

⁸⁹² MÖSSNER, Steuerrecht international tätiger Unternehmen, p. 199-200

Figure 4.5: Double Non-Taxation - Bilateral Situation



Source: Own figure

4.2 Avoidance of International Double Taxation

4.2.1 Avoidance of Double Taxation

Although there does not exist any international law provision requiring the avoidance of double taxation⁸⁹³, there is a general consensus that the avoidance of international double taxation facilitates international trade and investment by removing tax obstacles. Charles Constantin has posited that the state has a natural or moral obligation to ensure that double taxation is avoided⁸⁹⁴. Double taxation in the international exchange of goods and services and the movement of capital and persons can⁸⁹⁵ be avoided by unilateral, bilateral, multilateral or supranational measures. Depending on the tax

⁸⁹³ BÄCHLE/RUPP, Internationales Steuerrecht, p. 16 et seq.; JACOBS, Internationale Unternehmensbesteuerung, p. 4; FISCHER/KLEINEIDAM/WARNEKE, p. 32 - 34; PFITZER, thesis, p. 55 et seq.

⁸⁹⁴ CONSTANTIN, Entreprises internationales, p. 154.

⁸⁹⁵ MÖSSNER, Steuerrecht international tätiger Unternehmen, p. 201 adds that "(...) keinen dahingehenden Grundsatz gibt, dass eine erkannte juristische Doppelbesteuerung durch Massnahmen des internationalen Steuerrechts beseitigt werden **müsse** (emphasis added by the author)".

policy of a state, capital export neutrality (CEN) or, alternatively, capital import neutrality (CIN) may be preferred⁸⁹⁶. Switzerland eliminates or attenuates double taxation primarily by unilateral as well as bilateral measures. However, it should be noted that double taxation is, where remedied by unilateral measures, only eliminated to the extent of the scope of their application in relation to the persons and the taxes covered. Unilateral and bilateral measures should not, therefore, be considered as generic means in order to prevent double taxation⁸⁹⁷. Zvi Altman has suggested that, since an efficient way to resolve the conflicts arising from double taxation is lacking, there should be a *“new set of dispute settlement procedures for resolving international tax disputes, to be agreed upon in a multilateral treaty. This procedure would include a combination of negotiation, arbitration, and adjudication mechanisms applied by a new international institution”*⁸⁹⁸.

4.2.1.1 Avoidance by Unilateral Measures

The majority of national tax jurisdictions contain their own rules regarding the taxation of cross-border situations and offer - independently of other states' procedures - unilateral measures in order to avoid double taxation if one of the states involved gives up its taxing rights according to its domestic tax law⁸⁹⁹. Unilateral measures apply to foreign-source income and offer two methods in order to avoid double taxation: the *“credit method”*⁹⁰⁰ (*“Anrechnungsmethode”*; *“méthode d'imputation”*) or the tax *“exemption method”*⁹⁰¹ (*“Befreiungsmethode”*; *“méthode d'exemption”*).

Such is the case in Switzerland which, for example, unilaterally exempts income attributed to a foreign place of business (either a foreign company or a

⁸⁹⁶ TERRA/WATTEL, European Tax Law, p. 250 et seq.

⁸⁹⁷ See: ROCHA, Interpretation Double Taxation Conventions, p. xix.

⁸⁹⁸ ALTMAN, Dispute Resolution, p. 6.

⁸⁹⁹ VOGEL/LEHNER, Doppelbesteuerungsabkommen 2003, nr. 32 ad. Einleitung.

⁹⁰⁰ Please refer to HUNDT, Aussensteuerrecht, nr. 17 for an overview of the credit system in different jurisdictions.

⁹⁰¹ Please refer to VOGEL, Double taxation conventions, nr. 32 ad. Art. Einleitung for an overview of the exemption system in different jurisdictions.

foreign permanent establishment) or real property located abroad⁹⁰² through the “*exemption system with progression*”⁹⁰³ (“*Befreiung mit Progressionsvorbehalt*”; “*exemption avec réserve de progressivité*”); with the objective of encouraging foreign investments. The Swiss tax laws as well as the Federal Supreme Court’s case law do not require proof of effective taxation of the real property located abroad⁹⁰⁴. Instead, the exemption system with progression goes further than these requirements. It is unconditional and exists independently of the effective taxation of the company, permanent establishment or real property located abroad. The elements of income which are exempted are taken into account to determine the tax rate - in other words, they are subject to progression⁹⁰⁵. Special attention must be paid to bilateral measures as unilateral measures are in many cases insufficient to avoid international double taxation because of their lack of mutual consistency. Moreover, unilateral measures do not allow for an exchange of information between tax administrations, and thus, do not avoid double non-taxation⁹⁰⁶. However, in spite of their flaws, unilateral measures have the advantage of warding off the administrative burden of negotiating (as well as maintaining and re-negotiating) dozens of treaties⁹⁰⁷.

4.2.1.2 Avoidance by Bilateral Measures

As at 2013, Switzerland had concluded 85 DTCs covering either income or income and capital. Intergovernmental agreements are Switzerland’s most frequently used method to avoid international double taxation, as these interstate conventions are best suited to settle the difficulties arising from the divergences in internal tax legislations⁹⁰⁸. These agreements provide for a reallocation (or redistribution) of the taxing rights between two States in order to

⁹⁰² Art. 6 para. 3 LDFT and Art. 52 para. 3 LDFT. Most cantons have a similar legislation even though not expressly required by the LDFT. CONSTANTIN, *Interprétation*, p. 449 et seq; OBERSON, *Précis de droit fiscal international*, p. 6, 43.

⁹⁰³ OBERSON, *Précis de droit fiscal international*, p. 7; LOCHER, *Einführung internationales Steuerrecht Schweiz*, p. 58.

⁹⁰⁴ LOCHER, *Einführung internationales Steuerrecht Schweiz*, p. 58.

⁹⁰⁵ Art. 7 para. 1 LDFT; Art. 52 para. 3 LDFT.

⁹⁰⁶ EASSON, *Tax Treaties*, p. 624.

⁹⁰⁷ EASSON, *Tax Treaties*, p. 620 et seq.

⁹⁰⁸ KNECHTLE, *International Fiscal Law*, p. 161.

try to eliminate the most common problems that arise in the field of international double taxation⁹⁰⁹ by so called distributive rules (*“Verteilungsnormen”*; *“règles distributives”*)⁹¹⁰. More specifically, DTCs establish an independent mechanism to avoid double taxation, either through the exemption method, by which the income or capital can only be taxed in one of the contracting states, or through the credit method, by which the state of residence gives credit for taxes paid in the source state.

4.2.1.3 Avoidance by Multilateral Measures

Due to the plurality of interests of different countries, international multilateral agreements to avoid double taxation have rarely been concluded⁹¹¹, since each Contracting State is, especially in financial matters, independent. In the past, numerous attempts to create multi-lateral double taxation agreements have failed. Among them, three weighty attempts are worth mentioning. First, in 1931, a project led by the financial committee of the League of Nations, *“Plurilateral Conventions for the Prevention of Double taxation of certain categories of income”*, proved itself to be unsuccessful⁹¹². Second, the European Economic Community abandoned its project for a multilateral double taxation convention in 1968. Finally, in 1969 the AELE withdrew a project similar to the attempt made by the EU.

However, it is not inconceivable that multilateralism could further develop in the future, particularly within the EU⁹¹³. Multilateral agreements could be foreseen as a replacement for the existing network of bilateral agreements. They would have the advantage of creating uniformity in the application of

⁹⁰⁹ OECD Commentary 2014, nr. 3 ad. Introduction.

⁹¹⁰ Taxation of income: Art. 6 to 21; Taxation of capital: Art. 22. Often these rules are referred to as *“classification”*, *“assignment rules”*, *“allocating taxing rights”* or *“allocating tax claims”*. Among others: VOGEL, Double Taxation Conventions, p. 39; DANON/SALOMÉ, Avoidance of Double Non-Taxation, p. 385.

⁹¹¹ An example of a multilateral agreement is the Nordic Convention on income and capital between Denmark, Finland, Sweden, Norway, Iceland and since 1989, the Faroe Islands. For further details see: SALOM, thesis, p. 167.

⁹¹² Series of League of Nations Publications, II. Economic and financial, 1931 II. A. 22 (official Nr. C. 415. M. 171).

⁹¹³ OBERSON, Précis de droit fiscal international, p. 9; SASSEVILLE, Tax Treaties, p. 247.

international tax law between the contracting states, and could also help to resolve particular problems resulting from triangular cases⁹¹⁴. The EU Treaty simply states that Member States will, if needed, engage in negotiations in order to eliminate double taxation within the EU; however, it does not expressly prohibit double taxation⁹¹⁵. Subsequently, the Member States have adopted a multilateral convention⁹¹⁶, which came into force on 1st January 1995, with the objective of establishing an arbitral resolution procedure in order to eliminate double taxation arising from transfer pricing adjustments⁹¹⁷. However, this convention has not entered into effect since 2000 due to the fact that the contracting Member States have not ratified the protocol yet⁹¹⁸. For Switzerland, currently not a member of the EU, bilateral double tax conventions play a crucial role in its relations with other European countries.

4.2.1.4 Avoidance by Supranational Measures

Measures for avoiding international double taxation may also be prescribed by supranational organizations such as the EU. In such a case, measures could be binding on all of the organization's Member States. Examples illustrating this include the Parent-Subsidiary Directive⁹¹⁹ and the Interests and Royalties Directive⁹²⁰, which also apply to Switzerland on a treaty basis.

4.2.2 Avoidance of Double Non-Taxation

It seems that the OECD Fiscal Committee already considered in the past the prevention of double non-taxation to become an objective of the OECD

⁹¹⁴ In this vein: SALOM, thesis, p. 167.

⁹¹⁵ Art. 293 of the EC Treaty.

⁹¹⁶ Convention 90/436/CEE on the elimination of double taxation in connection with the adjustment of profits between associated undertakings.

⁹¹⁷ Art. 25 OECD Model (1995). In this vein among others: MARKHAM, Transfer Pricing, p. 215 et seq.

⁹¹⁸ DE HOSSON, Arbitration Convention, p. 482 et seq.

⁹¹⁹ Council Directive 90/435/EEC of 23 July 1990, which entered into force on 1 January 1992.

⁹²⁰ Council Directive of 3 June 2003, which entered into force on 1 January 2004.

Model, along with the avoidance of double taxation⁹²¹. However, the elimination of double non-taxation is not expressly mentioned in either the OECD Model or its Commentaries. Therefore, it cannot technically be considered to be an objective of the OECD Model or of any of the DTCs concluded by Switzerland⁹²². This conclusion has also been drawn by Michael Lang in his General Report for the 2004 IFA Congress in Vienna⁹²³. Nowadays, following the new OECD approach, double non-taxation is considered to be as harmful as double taxation and will consequently be combated with the newly released Action Plan on Base Erosion and Profit Shifting (“*BEPS Action Plan*”), adopted by the OECD in July 2013. The Action Nr. 2 most clearly reflects this approach. According to Action Nr. 2 and with regard to DTCs, withholding taxes cannot be reduced in the State of Source in principle if the income is not attributed and fulfill the residence requirement under the first sentence of Art. 4 para. 1 in its State of Residence⁹²⁴.

The main purpose of the OECD Model as well as the DTCs signed by Switzerland therefore seems to be clear: the elimination of double taxation⁹²⁵. This can be concluded directly from the title of the OECD Model as well as from the titles of the said DTCs⁹²⁶. This opinion is also shared by the majority of leading foreign scholars and practitioners⁹²⁷. It is thus established that a DTC applies even if the Contracting State to which taxing rights have been allocated does not make use of it⁹²⁸. This would only lead to a poor outcome in which both Member States would, in future, choose not to conclude any

⁹²¹ Amongst others: OECD Report on Hybrid Mismatch Arrangements dated on March 2012.

⁹²² DANON/SALOMÉ, Avoidance of Double Non-Taxation, p. 385, 418.

⁹²³ LANG, General report on double non-taxation, p. 81.

⁹²⁴ See Chapter 6.1.1.4 and Chapter 6.1.2.3.6.3.

⁹²⁵ OECD Commentary 2014, Introduction para. 3.

⁹²⁶ For instance, the Convention between the Swiss Confederation and Austria for the avoidance of double taxation with respect to taxes on income and wealth of 30 January 1974, published in Systematic Collection of Federal Laws RS 0.672.916.31.

⁹²⁷ For Switzerland: DANON/SALOMÉ, Avoidance of Double Non-Taxation, p. 419; for Austria: HERDIN/SCHILCHER, Avoidance of Double Non Taxation, p. 31; LOUKOTA, Ausländische Besteuerungsnachweise, p. 113; LANG, Partnerships, p. 29-30; LANG, Vermeidung der Doppelbesteuerung und der doppleten Nichtbesteuerung, p. 611.

⁹²⁸ LANG, Introduction to the Law of Double Taxation Conventions, p. 31.

DTCs, given that they could create taxation where the domestic laws of both states were precisely trying to avoid it.

Nevertheless, the OECD Model contains concepts, for instance the residence clause in Art. 4 OECD, which indirectly prevent double non-taxation. According to Michael Lang this mechanism is, however, not itself suitable to ensure single taxation⁹²⁹. The most effective mechanism to avoid double non-taxation is achieved by the credit-method, provided for by Art. 23A OECD Model (without entering into analyses of switch over clauses, remittance clauses, subject-to-tax clauses and limitation of benefits clauses).

A further question is whether double non-taxation should be tolerated when it is due to an abusive application of DTCs (treaty shopping)⁹³⁰, to divergences in different domestic tax laws (divergences in the personal attribution of income)⁹³¹ or to conflicts of qualification. As expressed in various National Reports following the Conference on Double Non-Taxation held in Hernstein, Austria, in June 2002, double non-taxation resulting from the application of DTCs is tolerated in Switzerland, as in most other OECD Member States. However, one must bear in mind that the overall idea and purpose of DTCs is to avoid double taxation and not “*e contrario*” double non-taxation. In other words, the result in terms of double taxation or double non-taxation deriving from the abusive and inconsistent application of DTCs⁹³² should not be confused with their object and purpose. It is clear that double non-taxation should not be tolerated when it derives from an abusive application of DTCs. If Switzerland wishes to avoid double non-taxation, this cannot be achieved by giving a wide interpretation to today’s existing conventions that are specifically meant to deal with double taxation. Robert Danon and Hugues Salomé argue that the basic purpose of the OECD Model is the avoidance of double taxation and not the avoidance of double non-taxation⁹³³. Although obviously unwanted, double non-taxation must therefore be

⁹²⁹ LANG, General report on double non-taxation, p. 90.

⁹³⁰ For an analysis of this term see DANON/SALOMÉ, Avoidance of Double Non-Taxation, p. 386-387.

⁹³¹ For an analysis of this term see DANON/SALOMÉ, Avoidance of Double Non-Taxation, p. 388-390.

⁹³² Amongst others: JUNG, National report on tax treaties and tax avoidance.

⁹³³ DANON/SALOMÉ, Avoidance of Double Non-Taxation, p. 419.

legal under the currently enacted laws⁹³⁴. However, following the OECD's new approach, double non-taxation is considered to be as harmful as double taxation and will consequently be combated with the newly released Action Plan on Base Erosion and Profit Shifting ("*BEPS Action Plan*"), adopted by the OECD in July 2013.

⁹³⁴ In this vein also, from a German perspective: KESSLER/EICHKE, Legal, But Unwanted, p. 582.

5 Introduction to Double Tax Conventions

The objective of tax treaties, broadly stated, is to facilitate cross-border trade and investment by eliminating the tax impediments to these cross-border flows
(Arnold / McIntyre, 2002)

5.1 Basic Principles

5.1.1 Objective

The core objective of DTCs is the avoidance of double taxation⁹³⁵. Such avoidance contributes to remove inappropriate barriers and obstacles in international commerce, in order to encourage the exchange of goods and services as well as the movement of persons and capital across national borders⁹³⁶. However, there is no supra-legal principle requiring a nation to give up its taxing rights to benefit another country with the aim of eliminating international double taxation⁹³⁷. Tax sovereignty is not, however, unlimited as a contracting state can only impose its taxing rights in situations where there is a close connection to that state⁹³⁸.

Despite the general avoidance of double taxation purpose, DTCs are not identical and they account for the interests of the contracting states and the interests of individual taxpayers in a different manner. Most provisions simply aim at avoiding double taxation by a set of distributive rules⁹³⁹

⁹³⁵ DTCs have limited capacity to triangular cases as they are concluded only by two contracting states as well as to company-shareholder double taxation.

⁹³⁶ OECD Commentary 2014, nr. 1 ad. Introduction. Among others: WARREN, Income Tax Discrimination Against International Commerce, p. 147.

⁹³⁷ This is a consequence of the state's territorial sovereignty which can be derived from the well-known Lotus-Case. See therewith: Permanent Court of International Justice, Decision of September 7, 1927, "Collection of the Court's Case-Law", series A, nr. 10.

⁹³⁸ LANG, Introduction to the Law of Double Taxation Conventions, p. 23.

⁹³⁹ Taxation of income: Art. 6 to 21; Taxation of capital: Art. 22. In literature, these rules are also referred to as "classification rules", "assignment rules", "allocation of taxing

(“*Verteilungsnormen*”; “*règles distributives*”), allocating taxing rights between the contracting states in order to eliminate the most common problems that arise in the field of international double taxation⁹⁴⁰. Therefore, the question is not whether a DTC contains rules creating taxing rights, but whether it contains any provision that limits or prohibits the exercise of the taxing competence deriving from internal tax legislation. The mechanism in place today in Switzerland, for example, neither systematically nor effectively avoids international double taxation. This is evident if one considers the effects of the tie-breaker rule on individuals’ and corporations’ residence status. The application of this rule generates controversy when compared with, for example, Canada and the United Kingdom⁹⁴¹. Such ineffectiveness is a direct consequence of the lack of specific provisions in Swiss law dealing with fundamental and controversial questions. In this sense, Swiss tax law does not indicate whether after the application of the tie-breaker rule the unlimited taxation of the individual or corporation remains the same or becomes limited taxation. Furthermore, at a cross-border level, there are no indications as to whether the dual resident is entitled to DTC access in Switzerland, regardless of whether it is considered the “winner” or “loser” state. The only efficient way to avoid this double taxation is the arbitration procedure⁹⁴². Since the beginning of 2008, the OECD Model includes an arbitration clause⁹⁴³. Of all the DTCs concluded or agreed to by Switzerland, only

rights” or “*allocation of tax claims*”. Among others: DANON/SALOMÉ, *Avoidance of Double Non-Taxation*, p. 385; UCKMAR, *Double Taxation Conventions*, p. 163.

⁹⁴⁰ OECD Commentary 2014, nr. 3 ad. Introduction. Most countries already have provisions in their domestic tax laws designated to eliminate double taxation, as for example in Switzerland, Art. 6 para. 3 and 52 para. 1 LDFT. These rules also apply to non-contracting states, in other words States with which Switzerland has not concluded a DTC.

⁹⁴¹ AVERY JONES/BOBBET, *Triangular Treaty Problems*, p. 20. Canada and the United Kingdom have introduced in their tax systems provisions according to which a person who loses unlimited tax liability in that state, following the consequences of the application of the tie-breaker rule may consequently not be entitled to the application of a DTC.

⁹⁴² LOCHER, *Einführung internationales Steuerrecht Schweiz*, p. 539.

⁹⁴³ See Art. 25 al. 5 OECD Model. AULT/SASSEVILLE, *Arbitration Provision*, p. 208.

three have included alternative arbitration clauses with different conditions to the ones set out in the OECD Model⁹⁴⁴.

Although not expressly referred to in the heading of Swiss DTCs, they do serve other important goals, such as: the prevention of fiscal evasion⁹⁴⁵, the elimination of discriminatory taxation, the attraction of foreign investment (or, in the words of Alexander Easson, “*the removal of administrative obstacles to international business and investment*”), the allocation of taxing rights between the contracting states, as well as the encouragement of cooperation between tax authorities⁹⁴⁶. Additionally, according to Brian Arnold and Michael McIntyre, an important aspect of DTCs is that they provide certainty for taxpayers. In this sense, certainty regarding the tax consequences of a cross-border investment is an important factor in facilitating such investments⁹⁴⁷.

This analysis aims at establishing whether the objectives mentioned above are equally important for trust and CIS structures in cross-border contexts.

⁹⁴⁴ As per August 2015, amongst others the following DTCs on income and capital contain an arbitration clause: Kazakhstan (1999); United States (1996); United Kingdom (2009); Norway (2015); Albania (2015) and South Africa (2007).

⁹⁴⁵ The importance of the prevention of tax evasion has recently increased in Switzerland. In March 2009, in a tense political climate, Switzerland agreed to accept the standard of the Organisation for Economic Cooperation and Development (OECD) on administrative assistance in tax matters for non-Swiss residents in accordance with Art. 26 OECD Model without abolishing the banks’ customer secrecy, as set forth in Art. 47 SBA. This conventional standard simply requires the communication of information upon request and can be seen as a mechanism for the prevention of tax evasion. BÖSCH, *The Swiss Banking Secrecy Myths and Facts*, p. 2 clearly points out that Switzerland did not agree to any automatic information exchange. In fact, foreign authorities have the right to obtain information from Swiss tax authorities in situations of alleged tax evasion upon sufficient request meaning that the request must specify a sufficiently founded suspicion of evasion, the names of the taxpayers involved, and must include a description of the circumstances.

⁹⁴⁶ OECD Commentary 2014, nr. 16 ad. Introduction; OBERSON, *Précis de droit fiscal international*, p. 10 differentiates the objective of DTCs in more detail. In this vein also: PIRES, thesis, p. 214; VAN WEEGHEL, thesis, p. 33-36; EASSON, *Taxation of Foreign Direct Investment*, p. 28; UCKMAR, *Double Taxation Conventions*, p. 152-154; GRAVELLE, *Tax Treaties*, p. 522.

⁹⁴⁷ ARNOLD/MCINTYRE, *International Tax Primer*, p. 106.

Therefore, the author will attempt to answer the question raised by Alexander Easson in his 2000 article: “*Do We Still Need Tax Treaties?*”⁹⁴⁸.

5.1.2 Historical Developments of DTCs

The concept of avoidance of double taxation was initially developed in the late nineteenth century⁹⁴⁹. The first structured analysis of the economic consequences of double taxation was issued by four economists - Prof. Einaudi Bruins (Commercial University of Rotterdam), Prof. Luigi Einaudi (Turin University), Prof. Seligman (Columbia University) and Prof. Josiah Stamp (London University) - in a report on double taxation submitted to the financial committee of the League of Nations in 1923⁹⁵⁰. The League analyzed the elimination of international double taxation, i.e. the most appropriate allocation of taxing rights between contracting states and developed various models⁹⁵¹.

It should be noted that the concept of tax residence was also discussed at this time. However, in the final report on double taxation submitted to the financial committee of the League of Nations in 1946 (the so-called “*London and Mexico Model*”), the concept of tax residence does not play a major role⁹⁵². In 1925 and 1926, Germany, Hungary, Austria and Italy wished to conclude

⁹⁴⁸ EASSON, *Tax Treaties*, p. 619 et seq.

⁹⁴⁹ Some of the leading bilateral agreements were, among others, the agreement between Prussia and Saxony regarding direct taxes of 16 April 1869, the agreement between Austria and Hungary regarding the taxation of business companies of 18 December 1869 and the agreement between Austria and Prussia regarding the avoidance of double taxation of 21 June 1899. In this vein: VOGEL/LEHNER, *Commentary* 2008, nr. 33 ad. Einleitung. The bilateral agreement between Prussia and Saxony of 16 April 1869 is generally referred to as the first DTC. See among others: DAVIES, *Principles of International Double Taxation Relief*, p. 28; ROHATGI, *Basic International Taxation*, p. 64; EASSON, *Tax Treaties*, p. 619.

⁹⁵⁰ See Report on Double Taxation Submitted to the Financial Committee of the League of Nations prepared by Professors Bruins, Einaudi, Seligman and Sir Josiah Stamp, Geneva, 5 April 1923, League of Nations, Doc., cons. F.S.73.F.19. Information retrieved from <http://www.setis.library.usyd.edu.au/oztexts/parsons.html>, under item 3.

⁹⁵¹ Information retrieved from <http://www.setis.library.usyd.edu.au/oztexts/parsons.html>, under item 3. In this vein also: LUKKIEN, nr. 2.2.

⁹⁵² Information retrieved from <http://www.setis.library.usyd.edu.au/oztexts/parsons.html>, under item 3. In this vein also: LUKKIEN, nr. 2.2.

DTCs with Switzerland⁹⁵³. In 1931, Switzerland signed its first DTC with Germany⁹⁵⁴, followed in 1937 by a DTC with France⁹⁵⁵. After World War II, an extensive DTC network developed all over Europe, trying to stimulate foreign trade and investment⁹⁵⁶ and to reduce double taxation arising from the income taxes introduced after World War I⁹⁵⁷. Switzerland currently has, as of August 2013, an important network comprising 85 DTCs covering either income or income and capital.

5.1.3 Legal Nature

One of the major questions in connection with the interpretation of DTCs concerns their legal nature. Theoretically, a DTC can be considered either a legislative enactment or an international agreement. This characterization determines whether DTCs should be subject to the ordinary rules of interpretation contained in domestic tax law or whether they should be interpreted following the principles of international law codified in the Vienna Convention on the Law of Treaties. According to Philip Baker, the difficulty is that DTCs are both: *“Double taxation conventions can be regarded as having a dual nature. On the one hand, they are international agreements entered into between governments under which those governments agree to limit the exercise of their fiscal jurisdiction. On the other hand they become part of the tax law of each contracting state, whether automatically or by incorporation through enactment into that law. One aspect of this dual nature (...) is the approach to interpreting such treaties: should they be interpreted as treaties,*

⁹⁵³ DE VRIES REILINGH, thesis, p. 9.

⁹⁵⁴ See: Technical Explanation of 19 January 1932, FF 1932 I 42, p. 41-42.

⁹⁵⁵ LOCHER, Einführung internationales Steuerrecht Schweiz, p. 74. Interestingly, a French speaking Canton of Switzerland, the Canton of Vaud had already concluded an agreement with the United Kingdom in 1872 on the avoidance of the double taxation of inheritance taxes.

⁹⁵⁶ PIRES, thesis, p. 217.

⁹⁵⁷ EASSON, Taxation of Foreign Direct Investment, p. 27 et seq. has analyzed in detail the evolution of DTCs. In this vein with a detailed analysis for Switzerland, see DE VRIES REILINGH, thesis, p. 10.

or as tax legislations?”⁹⁵⁸ It may be noted from this statement that DTCs have a “two-dimensional nature”⁹⁵⁹.

5.1.4 Monistic and Dualistic Enactment

The incorporation process of DTCs into domestic legal systems depends on each state’s internal law⁹⁶⁰. However, two traditions of incorporation are generally applied: the “monistic tradition”⁹⁶¹ or the “dualistic tradition”⁹⁶².

The monistic tradition is additionally divided into the “radical” and “moderate” theories of application. According to the former, an internal provision contrary to a DTC will be automatically considered null and void. In the latter case, the provision will merely be deemed ineffective⁹⁶³.

No particular provision in Swiss internal law clearly defines the relationship between Swiss domestic and international law, and following a literal interpretation of Art. 190 FC⁹⁶⁴ no definitive answer can be given. Other countries have express rules established in their constitutional law⁹⁶⁵. However, Switzerland follows the monistic tradition according to which, internal law, regardless of when it was enacted, does not prevail over international law⁹⁶⁶ even though, surprisingly, it is not expressly provided for in the Swiss Constitution⁹⁶⁷. Consequently, there is in principle no possibility to override an

⁹⁵⁸ BAKER, Double Taxation Conventions, ad. B-1.

⁹⁵⁹ BECKER, Treaty Shopping, p. 383.

⁹⁶⁰ Among others: BECKER, thesis, p. 98 et seq.

⁹⁶¹ Among others: Switzerland, Austria, France, Japan, the Netherlands and the United States. In Italy and Ireland, a parliamentary approval is required.

⁹⁶² Among others: Canada, India and the United Kingdom.

⁹⁶³ In this vein: ROCHA, Interpretation Double Taxation Conventions, p. 21.

⁹⁶⁴ Art. 190 FC reads: “*The Federal Supreme Court and the other judicial authorities shall apply the federal acts and international law*”.

⁹⁶⁵ For example, Argentina (Art. 75 of the Argentinean Constitution), Paraguay (Art. 137 and 141 of the Paraguayan Constitution), Italy (Art. 10 of the Italian Constitution), France (Art. 55 of the French Constitution), the Netherlands (Art. 94 of the Constitution of the Netherlands) and Germany (Art. 25 of the German Constitution).

⁹⁶⁶ PERRIN, Droit international public, p. 810; BECKER, thesis, p. 330 et seq.; JACQUOT-GUILLARMOD, p. 277. EPINEY, Völkerrecht, p. 537.

⁹⁶⁷ KELLER, p. 225 et seq.

international agreement by a domestic provision. The principle of good faith also forbids this⁹⁶⁸.

This system is widely accepted by leading scholars and by international courts. The International Court of Justice stated that: “*It is a generally recognized principle of international law that, in the relations between contracting powers of a treaty, the provisions of a law may not prevail over those of the treaty*”⁹⁶⁹. The primacy of international law has also been confirmed by Art. 27 VCLT which states that: “*one party may not invoke the provisions of its internal law to justify breach of a treaty*”. The main characteristic of a monistic system is that international bilateral agreements, such as DTCs⁹⁷⁰, become directly and immediately part of the Swiss legal system at the time (or 30 days after) of their ratification, without any implementation through parliamentary approval⁹⁷¹. According to Hans Kelsen⁹⁷², international law and domestic law are part of a uniform system with the priority of international law (monistic theory). Therefore, international agreements directly integrate into federal law and become immediately valid sources as soon as they are ratified by the contracting state as well as the Confederation⁹⁷³. However, to be directly applicable, they must be “*self-executing*”, i.e., they must be sufficiently precise⁹⁷⁴.

⁹⁶⁸ An exception to this principle is demonstrated by the “*Schubert-Praxis*” in Swiss Federal Supreme Court Judgment of 2 March 1973 (“*Schubert-Praxis*”, ATF 99 Ib 39)

⁹⁶⁹ BARROSO, p. 16.

⁹⁷⁰ Art. 2 (a) VCLT, headed “*Use of terms*” reads: “*treaty means an international agreement concluded between States in written form and governed by international law, whether embodied in a single instrument or in two or more related instruments and whatever its particular designation*”.

⁹⁷¹ Swiss Federal Supreme Court Judgment of 6 June 2005, cons. 4d (ATF 117 Ib 248) = ASA 60, p. 610; HÄFELIN/HALLER/KELLER, Schweizerische Bundesstaatsrecht, p. 570 in connection with Swiss Federal Supreme Court Judgment of 25 January 1979, p. 57 et seq. (BGE 105 II 49). HÄFELIN/HALLER/KELLER, Schweizerische Bundesstaatsrecht, p. 570; GANI, thesis, p. 97; WALDBURGER, Die Auslegung von Doppelbesteuerungsabkommen, p. 57. However, some States such as England, Germany and the Scandinavian States follow the dualistic system.

⁹⁷² KELSEN, Principles of International Law, pp. 290-294, 551-558.

⁹⁷³ Art. 190 FC.

⁹⁷⁴ HÄFELIN/HALLER/KELLER, Schweizerische Bundesstaatsrecht, p. 571; LOCHER, Einführung internationales Steuerrecht Schweiz, p. 92; WALDBURGER, Die Auslegung

5.1.5 Composition

Among the various model conventions⁹⁷⁵, the OECD Model is the most widely followed, not only by member countries in their bilateral negotiations but also by non-member countries, on the basis of which several thousands of bilateral DTCs on income and on income and capital have been negotiated worldwide⁹⁷⁶.

Moreover, both the UN Model⁹⁷⁷ and the US Model⁹⁷⁸ use the OECD Model as a basic instrument of reference⁹⁷⁹, and the majority of Swiss DTCs are based upon it⁹⁸⁰. Its increasing importance can be illustrated by the fact that today nearly all newly concluded DTCs are based on the OECD Model⁹⁸¹.

Switzerland currently has, as of August 2013 an important network comprising 85 DTCs either on income⁹⁸² or on income and capital⁹⁸³. These DTCs

von Doppelbesteuerungsabkommen, p. 54; Swiss Federal Supreme Court Judgment of 27 September 1991, cons. 4 (ATF 117 Ib 248); RIVIER, *Interprétation des conventions*, p. 116.

⁹⁷⁵ The OECD Model, UN Model, US Model and the Andean Model.

⁹⁷⁶ LOCHER, *Einführung internationales Steuerrecht Schweiz*, p. 67 et seq.

⁹⁷⁷ United Nations Model Double Taxation Convention between Developed and Developing Countries, New York: United Nations Publications, 1980.

⁹⁷⁸ United States Model Income Tax Treaty of 1981.

⁹⁷⁹ In this vein: RIBES, *Courts and Tax Treaty Law*, p. 342.

⁹⁸⁰ In this vein: THURONYI, *International Tax Cooperation and a Multilateral Treaty*, p. 26.

⁹⁸¹ HEINRICH/MORITZ, *Interpretation of Tax Treaties*, p. 148.

⁹⁸² As per August 2013, the following DTCs on income have been concluded: Australia (1980); Bangladesh (2007); Côte d'Ivoire (1987); Egypt (1987); Greece (1983); Hong Kong (2011); India (1994); Indonesia (1988); Jamaica (1994); Japan (1971); Korea, Rep. (1980); Malaysia (1974); Malta (2011); Mexico (1993); Morocco (1993); New Zealand (1980); Pakistan (2005); Philippines (1998); Qatar (2009); South Africa (2007); Thailand (1996); Trinidad and Tobago (1973); Tunisia (1994); Turkey (2010); United Arab Emirates (2011); United Kingdom and Barbados (1977); United Kingdom and Northern Ireland (1954); United States (1996).

⁹⁸³ As per August 2013, the following DTCs on income and capital have been concluded: Albania (1999); Algeria (2006); Argentina (1997); Armenia (2006); Austria (1974); Azerbaijan (2006); Belarus (1999); Belgium (1978); Bulgaria (1991); Canada (1997); Chile (2008); China, People's Rep. (1990); Columbia (2007); Croatia (1999); Czech Republic

generally follow the structure, system and content of the standard set by the “*Swiss Model Tax Convention*”⁹⁸⁴. The majority of these agreements follow the structure, system and content of the OECD Models of 1963⁹⁸⁵, 1977⁹⁸⁶ and 1992⁹⁸⁷, which have been revised in 1994, 1995, 1997, 2000, 2002⁹⁸⁸, 2005⁹⁸⁹, 2008⁹⁹⁰, 2010, and 2014, as well as the Commentaries⁹⁹¹. It should be noted that the most recent update released in 2014 reflects work on the Model Tax Convention that was carried out between 2010 and the end of 2013; but it does not include any results from the ongoing work on the BEPS Action Plan.

For this reason, the question regarding the treatment of trusts and CISs must be examined in light of the current OECD Model and Commentaries⁹⁹².

Where the OECD Model’s rules are different from those of the Swiss DTCs, they will be analyzed separately, and the divergences will be discussed if

(1995); Denmark (1973); Ecuador (1994); Estonia (2002); Finland (1991); France (1966); Georgian Republic (2010); Germany (1971); Ghana (2008); Hungary (1981); Iceland (1988); Iran (2002); Ireland (1966); Israel (2003); Italy (1976); Kazakhstan (1999); Kuwait (1999); Kyrgyzstan (2001); Latvia (2002); Lithuania (2002); Luxembourg (1993); Macedonia (2000); Moldova (1999); Mongolia (1999); Netherlands (1951); Norway (1987); Poland (1991); Portugal (1974); Romania (1993); Russia (1995); Serbia and Montenegro (2005); Singapore (1975); Slovak Republic (1997); Slovenia (1996); Spain (1966); Sri Lanka (1983); Sweden (1965); Tadjikistan (2010); Ukraine (2000); Uruguay (2010); Uzbekistan (2002); Venezuela (1996) and Vietnam (1996).

⁹⁸⁴ CADOSCH, *Relevance of the OECD MC and Commentary*, p. 304.

⁹⁸⁵ *Draft Double Taxation Convention on Income and Capital*, OECD, Paris, 1963.

⁹⁸⁶ *Model Double Taxation Convention on Income and on Capital*, OECD, Paris, 1977.

⁹⁸⁷ OECD Commentary 2014, nr. 11 ad. Introduction.

⁹⁸⁸ KOLB, *Überblick über das Update 2002 des OECD-Musterabkommens*, p. 1655 et seq.

⁹⁸⁹ KOLB, *Überblick über das Update 2005 des OECD-Musterabkommens*, p. 1911 et seq.

⁹⁹⁰ KOLB, *Überblick über das Update 2008 des OECD-Musterabkommens*, p. 2049 et seq.

⁹⁹¹ LOCHER, *Einführung internationales Steuerrecht Schweiz*, p. 80; OBERSON, *Précis de droit fiscal international*, p. 21, 645; DANON/SALOMÉ, *Avoidance of Double Non-Taxation*, p. 339. For a detailed analysis of Swiss DTC policy, see LÜTHI, *Die Abkommenspolitik im internationalen Steuerrecht der Schweiz*, p. 183 et seq.

⁹⁹² See Chapter 6.

they are of importance. This makes the analysis somewhat more complex given the large amount of DTCs concluded by Switzerland.

5.2 Interpretation of Double Tax Conventions

5.2.1 General Introduction

In order to understand whether hybrid entities such as CISs and trusts may have access to DTCs, the interpretation of DTCs is of great importance. The relevant conditions to access DTC benefits (person, residence, attribution of income and beneficial ownership) are detailly analyzed for CISs and trusts in light of the current OECD Model and Commentaries as well as under Swiss DTCs⁹⁹³. Because there is still considerable uncertainty regarding the tax treatment of CISs and trusts, the methods of interpretation of DTCs are especially relevant⁹⁹⁴. The aim of this section is to create the basis for a methodologically and systematically correct interpretation.

5.2.2 Interpretation Rule of Domestic Law versus Interpretation Rule of International Law

Treaty interpretation has been the focus of considerable attention throughout the nineteenth and twentieth centuries. As explored by Sergio Rocha⁹⁹⁵, various schools of thoughts have emerged in this regard, such as the interpretation theory of Hans Kelsen⁹⁹⁶, the theory of the open texture of language by Herbert Hart⁹⁹⁷ and the hermeneutic philosophy by Hans-Georg Gadamer⁹⁹⁸.

⁹⁹³ See Chapter 6.

⁹⁹⁴ See Chapter 2.3.6.5 for CIS and Chapter 3.3.9.2 for trust structures.

⁹⁹⁵ In this vein: ROCHA, Interpretation Double Taxation Conventions.

⁹⁹⁶ KELSEN, Pure Theory of Law.

⁹⁹⁷ HART, The Concept of Law.

⁹⁹⁸ GADAMER, Philosophical Hermeneutics.

Even today, and despite the existence of certain similarities with the interpretation of purely domestic tax legislation, the interpretation of DTCs remains one of the most controversial and debated areas in international tax law⁹⁹⁹.

This controversy essentially derives from the fact that legal systems have different views as to how to interpret undefined terms. Even a purely domestic legal text does not, “*per se*”, lend itself to only one correct interpretation. The resulting potential for inconsistency is strengthened by the national courts’ general lack of understanding of the rules and principles governing the interpretation of DTCs. They are also faced with peculiar issues due to the dual character of DTCs under international and domestic law¹⁰⁰⁰. In particular, national courts are challenged by DTCs’ dual status, and whether they should be interpreted following the ordinary rules of domestic interpretation or those relating to international agreements.

It seems clear that the VCLT prevails over the provisions of domestic law on issues of interpretation regarding DTCs. From a systematic point of view, the methods of interpretation are identical, but the selection of the means of interpretation, however, differs. In order to promote uniformity in their application, the VCLT aims at developing a common and autonomous meaning of DTCs. Therefore, domestic influences that are inconsistent with international practice should be avoided¹⁰⁰¹. As Klaus Vogel and Rainer Prokisch suggested in their General Report for the 1993 IFA Congress in Florence, a “*lingua franca*” - a sort of “*internationale Steuersprache*” (international tax language) that is understood worldwide - should be developed¹⁰⁰². Kees Van

⁹⁹⁹ The literature on the interpretation of DTCs is very extensive, see among others: AVERY JONES, Interpretation of Tax Treaties, Part I & II; WATTEL/MARRES, Legal Status of the OECD Commentary, p. 233; VAN RAAD, Interpretation and Application of Tax Treaties by Tax Courts, p. 3; VAN RAAD, Coordination of Tax Treaty Interpretation, p. 212; LANG, Amendments of the OECD Commentary, p. 2; AVERY JONES, The effect of changes in the OECD Commentary, p. 102; AVERY JONES, The One True Meaning of a Tax Treaty, p. 221; ELLIS, The Influence of the OECD Commentaries on Treaty Interpretation, p. 618; VOGEL, The Influence of the OECD Commentaries on Treaty Interpretation, p. 612.

¹⁰⁰⁰ Among others: CADERON/DOLORES, Interpretation of Tax Treaties, p. 379.

¹⁰⁰¹ VAN RAAD, Interpretation and Application of Tax Treaties by Tax Courts, p. 7.

¹⁰⁰² VOGEL/PROKISCH, General report on the interpretation of double taxation, p. 27.

In this vein also: VAN RAAD, Coordination of Tax Treaty Interpretation, p. 224; PROKISCH, International Tax Language, p. 103-110.

Raad has also stated that the interpretation of DTCs is not governed by ordinary domestic rules: “*many national Courts look upon tax treaty provisions as somewhat exotically clothed rules which nevertheless could be interpreted like domestic law (...). Interpretation follows customary international law and Courts are often not well versed in this area of the law*”¹⁰⁰³.

It is fair to say that today it is internationally accepted and recognized that DTC interpretation should be done in light of the VCLT, and the different OECD materials. It is not clear, however, which should be the methodological standard for selection (“*Reihenfolge*”; “*séquence*”) amongst the interpretative rules enumerated in the VCLT¹⁰⁰⁴. In other words, what remains unanswered is which of those rules should be applied primarily when interpreting a DTC, resulting in uncertainty as to the influence of OECD materials in the DTC final interpretation. In this sense, the question becomes whether the OECD materials should be regarded either as a “*supplementary means of interpretation*” in the sense of Art. 32 VCLT (taking the OECD into account only under certain circumstances); as the “*special meaning*” in the sense of Art. 31 para. 4 VCLT; as the “*ordinary meaning*” in the sense of Art. 31 para. 1 VCLT; or as constituting “*the context*” of the DTC in the sense of Art. 31 para. 2 and 3 VCLT (the material of the OECD is taken into account). Regarding the interpretation of OECD materials themselves, it is not clear whether the most recent Commentary should be applied (dynamic approach) or the Commentary in force at the time of the conclusion of the DTC (static approach). Lastly, as for the recourse to the domestic tax legislation for interpretation of DTCs, it is in principle accepted that such recourse is of last resort when interpreting DTCs, and should only be referred to if the application of the general principles of interpretation of Arts. 31 to 33 of the VCLT do not result in a clear meaning of the relevant term or phrase. There is a common understanding only on the point that DTC provisions should be sufficiently clear so that no interpretation is necessary. In the words of Emer De Vattel, “*la première maxime générale sur l’interprétation*

¹⁰⁰³ VAN RAAD, Interpretation and Application of Tax Treaties by Tax Courts, p. 7.

¹⁰⁰⁴ Among others: RIVIER, Interprétation des conventions, p. 113; RYSER, Introduction au droit fiscal international de la Suisse, p. 126; OBERSON, Précis de droit fiscal international, p. 29; DANON, thesis, p. 262; SCHWARZ, Tax treaties, p. 42; AVERY JONES, Interpretation of Tax Treaties, Part I, p. 14, 90; PROKISCH, Auslegung von Doppelbesteuerungsabkommen, p. 52; VIITALA, thesis, p. 73.

est qu'il n'est pas permis d'interpréter ce qui n'a pas besoin d'interprétation"¹⁰⁰⁵. Certainly, a supranational tribunal could decrease the uncertainties and resolve issues of interpretation¹⁰⁰⁶.

The lack of general principles and the ambiguity in understanding DTCs is illustrated by the confusion in case law. Clearly, *"interpretation is an art, not an exact science"*¹⁰⁰⁷. Zvi Daniel Altman demonstrated, in his impressive study of over 4,000 recorded US court cases interpreting tax treaties, that a *"coordination mechanism"* is required¹⁰⁰⁸. The same can be concluded for Switzerland. Robert Waldburger analyzed 51 federal court decisions rendered between 1934 and 1996, concluding that *"das schweizerische Bundesgericht das 51-teilige Puzzle seiner Entscheidungen zu den Doppelbesteuerungsabkommen nicht nur sehr bunt, sondern weitgehend methodenlos zusammengestellt hat"*¹⁰⁰⁹. The Swiss Federal Court arranged its 51 pieces decision puzzle in a *"methodless"* manner. Again, this demonstrates the non-uniformity among today's methods and reinforces the importance of the sources of interpretation followed by the judge. However, since the *"Denmark case"* court decision¹⁰¹⁰, the Swiss methodology of interpretation follows more and more the interpretative principles deriving from the VCLT¹⁰¹¹. Hopefully, the Federal Supreme Court will, in the future, maintain this interpretative method and abandon the *"methodless"* practice applied until this date. In the following chapters, the legal sources of interpretation

¹⁰⁰⁵ DE VATTEL, Le droit des gens ou principes de loi naturelle, para. 263.

¹⁰⁰⁶ In this vein also: SCHWARZ, Tax treaties, p. 57.

¹⁰⁰⁷ Yearbook of the International Law Commission, 1966, Vol. II, p. 218.

¹⁰⁰⁸ ALTMAN, thesis, p. 425.

¹⁰⁰⁹ WALDBURGER, Die Auslegung von Doppelbesteuerungsabkommen, p. 66. In this vein: REYMOND, Fiscalité en désarroi ou les chênes qu'on abat, p. 288; BÖCKLI, Kritik der indirekten Teilliquidation, p. 123; DESAX, Methodologie der Rechtsprechung, p. 51.

¹⁰¹⁰ Swiss Federal Supreme Court Judgment of 28 November 2005 (*"Dänemark-Entscheid"*, 2A.239/2005) = StR 2006, p. 217 = RDAF 2006 II, p. 239.

¹⁰¹¹ OESTERHELT, Bedeutung des OECD-Kommentars, p. 383 et seq. Stefan Oesterheld correctly points out that the OECD commentary becomes more and more relevant as a legal source for interpretation of DTCs. See: OESTERHELT, Bedeutung des OECD-Kommentars, p. 374.

of DTCs, namely the VCLT¹⁰¹², the OECD Model, its Commentaries¹⁰¹³ and Reports¹⁰¹⁴, domestic tax legislation¹⁰¹⁵, parallel treaties¹⁰¹⁶ and foreign legislation¹⁰¹⁷ will briefly be analyzed from a Swiss perspective.

5.2.3 Interpretation of Double Tax Conventions by the State of Source and the State of Residence

The interpretation of DTC terms by contracting states that apply the general “*renvoi*” provision, encompassed in Art. 3 para. 2 OECD Model¹⁰¹⁸ raises fundamental questions. The main issue here is to determine which of the contracting states’ rules - state of source, state of residence or both (autonomous interpretation) – applies and therefore, who interprets the DTC. Following the view of John Avery Jones, only the source state rules applies and interprets the DTC, the residence state having to accept it¹⁰¹⁹: *“The internal law categorization of the type of income in the residence state is irrelevant. That state is required by Article 23 to exempt, or give credit for tax on, income which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State. Assume that there is income which, under Article 15, the source state may tax, a golden handshake for example. Under Article 3(2) it is, in the first instance, for the source state to decide if this falls within the definition of income which may under the treaty be taxed in that state. If it does fall within the definition of income which it may tax under the treaty, this is income which in accordance with the Convention may be taxed in the source State; if it does not fall within such definition of income, then it is not. That is the only question which the residence state asks, and exemption (or credit) or taxation (if permitted under internal law)*

¹⁰¹² See Chapter 5.2.3.1.

¹⁰¹³ See Chapter 5.2.3.2.

¹⁰¹⁴ See Chapter 5.2.3.3.

¹⁰¹⁵ See Chapter 5.2.3.5.

¹⁰¹⁶ See Chapter 5.2.3.6.

¹⁰¹⁷ See Chapter 5.2.3.6.

¹⁰¹⁸ For a methodological and systematic overview of Art. 3 para. 2 see Chapter 5.2.3.5.

¹⁰¹⁹ AVERY JONES, Tax Treaty Problems Relating to Source, p. 78; AVERY JONES, Treaty interpretation, p. 252; AVERY JONES, Interpretation of Tax Treaties, Part I, p. 14 et seq.; AVERY JONES, Interpretation of Tax Treaties, Part II, p. 90 et seq.

automatically follows”¹⁰²⁰. On the contrary, Kees van Raad argues that both the source and residence states must apply and interpret the DTC¹⁰²¹.

The view supported by John Avery Jones obviously reduces the possibilities for interpretative divergences between the residence and source state as no “*organ of application*”¹⁰²² exists in the field of international law. According to John Avery Jones, this method would resolve the issue at hand, at least with regards to the categorization of income. The source state would have an exclusive competence to interpret the DTC and the residence state would have to accept the interpretation of the former. This mechanism would efficiently avoid any divergence in the interpretation of DTC terms arising from the differences in the contracting states’ domestic provisions. However, the grounds on which John Avery Jones’ solution is based are controversial. Following a literal interpretation, in the author’s view no substantive and convincing arguments supporting the fact that Art. 3 para. 2 OECD Model is based on the source state’s approach, “*except the need for a common interpretation*”¹⁰²³ and as to why the state of residence should follow the interpretation of the state of source.

John Avery Jones’ recommendation is preferable in order to avoid double taxation and double non-taxation arising from divergences in the interpretation of DTCs. For the purpose of avoiding divergences in the interpretation of DTC terms arising from the differences in the contracting states’ domestic provisions and, in particular, the resulting double taxation, the OECD makes use of Art. 23A and 23B OECD Model. The formulation contained in these provisions according to which “*können diese Einkünfte nach diesem Abkommen im anderen Vertragsstaat besteuert werden*”, should be interpreted in the sense that the residence state is obliged to follow the qualification of the source state and has to avoid double taxation¹⁰²⁴. According to the OECD, the above-mentioned articles provide for an indirect reference to the domestic laws of the source state¹⁰²⁵. However, it must be stated that in the author’s

¹⁰²⁰ AVERY JONES, The One True Meaning of a Tax Treaty, p. 220.

¹⁰²¹ VAN RAAD, Coordination of Tax Treaty Interpretation, p. 217.

¹⁰²² ROCHA, Interpretation Double Taxation Conventions, p. 141.

¹⁰²³ HELMINEN, Tax Treaty Interpretation in Finland, p. 85.

¹⁰²⁴ AVERY JONES, Credit and exemption under tax treaties, p. 126 et seq.; LANG, Einführung in das Recht der Doppelbesteuerungsabkommen, nr. 146 et seq.

¹⁰²⁵ OECD Commentary 2014, nr. 32.3 ad. 23.

view this approach is not commonly accepted because the residence state also applies the DTC¹⁰²⁶. The residence country has to determine which methods – exemption or credit – will be granted in order to avoid double taxation¹⁰²⁷. However, the exemption and credit articles do not require the residence state to follow the interpretation of the source state. Thus, the author suggests that the residence state should also interpret the DTC in a way that ensures that the source state does not interpret or apply the DTC improperly or only in its own interest. Michael Lang states that the residence state is not obliged to credit withholding tax already charged if it arrives to a different legal consequence under a treaty-autonomous interpretation of the DTC provisions¹⁰²⁸.

Interestingly, the Partnership Report implements a different mechanism according to which the qualification made by the source state is not decisive for deciding over DTC benefits, contrary to the one made by the other contracting state (residence state)¹⁰²⁹. The other contracting state is obliged to reduce the withholding tax based on a person's residency in the residence state.

5.2.3.1 *The Relevance of the Vienna Convention on the Law of Treaties*

In Switzerland, international agreements, including DTCs, are interpreted in light of general principles of international public law, such as reciprocity and territorial sovereignty. Also, they follow one of the most influential instruments of international law, the Vienna Convention on the Law of Treaties

¹⁰²⁶ LANG, Introduction to the Law of Double Taxation Conventions, p. 53;

WASSERMEYER/LANG/SCHUCH, Commentary; nr. 73 ad. 3.

¹⁰²⁷ ENGELN/PÖTGENS, Report on the Application of the OECD Model Tax Convention to Partnerships, p. 257. However, according to WASSERMEYER/LANG/SCHUCH, Commentary, nr. 73 ad. 3, the exemption and credit articles do not require that the residence State is obliged to follow the interpretation of the source State.

¹⁰²⁸ LANG, Einführung in das Recht der Doppelbesteuerungsabkommen, nr. 146 et seq.

¹⁰²⁹ OECD Commentary 2014, nr. 6.3 ad. Art. 1, as well as OECD, Partnership Report, para. 53 et seq.

(VCLT)¹⁰³⁰, which came into force in Switzerland on 6th June 1990¹⁰³¹. Leading scholars describe the VCLT as a “*treaty on treaties*”¹⁰³².

Reuven Avi-Yonah confirms that “*international tax law is part of international law*”¹⁰³³, an opinion shared by other leading scholars¹⁰³⁴. Thus international tax law, such as DTCs, falls (by implication) under the application of the VCLT¹⁰³⁵. A literal interpretation of Art. 4 VCLT suggests that the interpretative methods deriving from the VCLT only apply to DTCs concluded after its entry into force, that is, the VCLT does not have a retroactive effect¹⁰³⁶. However, even if the VCLT had not been ratified by Switzerland, its rules would independently have applied to both past and future DTCs, as they were accepted as part of customary international law and thus were already considered binding before being codified in the VCLT. This binding effect has been expressly confirmed by the Federal Council in the Technical

¹⁰³⁰ This has been established by court decisions: see, *inter alia*, decision of the Federal Court of Appeal for Taxation of 28 February 2001 = StR 2002 30, 35; Swiss Federal Supreme Court Judgment of 6 December 1996; Swiss Federal Supreme Court Judgment of 17 February 1971, p. 363 (ATF 97 I 359) = ASA 41, p. 470 as well as by leading scholars: RIVIER, *Interprétation des conventions*, p. 120; RIVIER, *Droit Fiscal International*, p. 99; OBERSON/HULL, p. 91; OBERSON, *Précis de droit fiscal international*, p. 22; LOCHER, *Einführung internationales Steuerrecht Schweiz*, p. 102; WALDBURGER, *Die Auslegung von Doppelbesteuerungsabkommen*, p. 54; DANON, *thesis*, p. 263. WOUTERS/VIDAL, *Tax Treaties*, p. 21.

¹⁰³¹ Vienna Convention of 23 May 1969 on The Law of Treaties (RS 0.111).

¹⁰³² TENORE, *Timing Issues*, p. 475.

¹⁰³³ AVI YONAH, p. 1-2.

¹⁰³⁴ Among others: GOUTHIERE, *Les impôts dans les affaires internationales*, p. 125; HEINRICH/MORITZ, *Interpretation of Tax Treaties*, p. 147; REIMER, *Tax Treaty Interpretation*, p. 122; HOFBAUER, *Tax Treaty Interpretation*, p. 22-23; PIRES, *thesis*, p. 229-230; AULT, *The role of the OECD commentaries*, p. 144; LEHNER, *Interpretation of Tax Treaties According to German Theory and Practice*, p. 90.

¹⁰³⁵ DTCs are subsumed within the term “*contract*” in Art. 2 para. 1 VCLT and therefore DTCs are within the scope of the VCLT.

¹⁰³⁶ Art. 4 VCLT.

Explanation to the VCLT¹⁰³⁷ as well as in doctrine¹⁰³⁸ and case law¹⁰³⁹. Besides Switzerland, several other countries such as Australia, Canada, Germany, the Netherlands, New Zealand and the United Kingdom have also recognized this to be the case. If a country has not ratified the VCLT, this does not mean that the principles of Articles 31 to 33 on the interpretation of treaties are not applicable. This may be observed in the case of France, which voted against the convention, yet remains subject to the VCLT since “*the principles contained in the VCLT are considered customary rules*” - a fact which has not been criticized within that country¹⁰⁴⁰. Frank Engelen even concludes that the principles contained in the VCLT are today recognized by the International Court of Justice¹⁰⁴¹. However, the Federal Supreme Court hardly ever consults these rules for the interpretation of international agreements concluded before the entry in force of the VCLT in Switzerland¹⁰⁴².

It may be concluded that despite the theoretical application of the VCLT only to DTCs enacted after the ratification of the VCLT, the general principles of interpretation codified in Arts. 31 to 33 of the VCLT apply to all DTCs in accordance with Art. 2 para. 1 (a) VCLT. These principles are regarded as general concepts. They are of great importance in Switzerland since they include relevant concepts for the purposes of interpretation. For instance, Art. 31 VCLT¹⁰⁴³ sets forth the general rule of interpretation that “*a treaty shall be*

¹⁰³⁷ TECHNICAL EXPLANATION VCLT, p. 777.

¹⁰³⁸ ROHATGI, Basic International Taxation, p. 27; WATTEL/MARRES, Legal Status of the OECD Commentary, p. 226; AULT, The role of the OECD commentaries, p. 144; DANON, Bénéficiaire effectif, p. 39; DANON, thesis, p. 263; OBERSON, Bénéficiaire effectif, p. 216; BAUMGARTNER, thesis, p. 6.

¹⁰³⁹ Swiss Federal Supreme Court Judgment of 28 November 2005, cons. 3.4.1

(“*Dänemark-Entscheid*”, 2A.239/2005) = StR 2006, 217 = RDAF 2006 II, p. 239. Swiss Federal Supreme Court Judgment of 12 Mai 2011, cons. 5.4.1 (A.4677/2010). See for more details Chapter 5.2.3.1.1.

¹⁰⁴⁰ GUTMANN, Tax Treaty Interpretation in France, p. 107.

¹⁰⁴¹ ENGELLEN, thesis, p. 54-57.

¹⁰⁴² Swiss Federal Supreme Court Judgment of 9 November 1984, cons. 3 (BGE 110 1b 291); Swiss Federal Supreme Court Judgment of 5 October 1965, cons. 4 (ATF 91 I 363).

¹⁰⁴³ Art. 31 VCLT, headed “*General rule of interpretation*” reads: “*1. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose. 2. The context for*

*interpreted in good faith*¹⁰⁴⁴ in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose”¹⁰⁴⁵. Art. 32 VCLT¹⁰⁴⁶ establishes the situation in which additional means of interpretation can be applied. Art. 33 VCLT¹⁰⁴⁷ concerns the interpretation of DTCs written in two or more languages. These four methods of interpretation generally follow those in domestic law¹⁰⁴⁸, although

the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes: (a) any agreement relating to the treaty which was made between all the parties in connexion with the conclusion of the treaty; (b) any instrument which was made by one or more parties in connexion with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty. 3. There shall be taken into account, together with the context: (a) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions; (b) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation; (c) any relevant rules of international law applicable in the relations between the parties. 4. A special meaning shall be given to a term if it is established that the parties so intended”.

¹⁰⁴⁴ VAN DER BRUGGEN, *Good Faith*, p. 25, 28.

¹⁰⁴⁵ ENGELÉN, *thesis*, p. 85, 108-109; HACCIUS, *Ireland in International Tax Planning*, p. 237-238.

¹⁰⁴⁶ Art. 32 VCLT, headed “*Supplementary means of interpretation*” reads: “*Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of article 31, or to determine the meaning when the interpretation according to article 31: (a) leaves the meaning ambiguous or obscure; or (b) leads to a result which is manifestly absurd or unreasonable.*”

¹⁰⁴⁷ Art. 33 VCLT, headed “*Interpretation of treaties authenticated in two or more languages*” reads: “*1. When a treaty has been authenticated in two or more languages, the text is equally authoritative in each language, unless the treaty provides or the parties agree that, in case of divergence, a particular text shall prevail. 2. A version of the treaty in a language other than one of those in which the text was authenticated shall be considered an authentic text only if the treaty so provides or the parties so agree. 3. The terms of the treaty are presumed to have the same meaning in each authentic text. 4. Except where a particular text prevails in accordance with paragraph 1, when a comparison of the authentic texts discloses a difference of meaning which the application of articles 31 and 32 does not remove, the meaning which best reconciles the texts, having regard to the object and purpose of the treaty, shall be adopted.*”

¹⁰⁴⁸ This basic rule can be derived from Art. 31 para. 1 VCLT. ÖHLINGER, *Der völkerrechtliche Vertrag im staatlichen Recht*, p. 103 et seq.; MELIN, *Gesetzesauslegung in den USA und in Deutschland*, p. 369 et seq.; IPSEN/VON HEINEGG, *Völkerrecht*, p.

they apply a different hierarchy¹⁰⁴⁹. Peter Hongler compared domestic interpretation methods with the methods of interpretation deriving from the VCLT and correctly concluded that the decisive difference with domestic interpretation is that the historical method of interpretation can only be considered “*subsidiarily*” to the other methods of interpretation¹⁰⁵⁰. The particularity of the interpretation of international law lies “*ab initio*” in the autonomous nature of such interpretation¹⁰⁵¹. A DTC must, therefore, be interpreted following the methods of the VCLT, which provides for literal and grammatical arguments (based on the meaning of the words), systematic arguments (based on the contract as a whole), teleological arguments (based on the object and purpose of avoiding double taxation) and historical arguments (based on materials from negotiations)¹⁰⁵². The interpretation of a provision is, therefore, not limited to its literal or grammatical meaning¹⁰⁵³. Interpretation according to context, object and purpose plays an important role.

Frank Engelen stated, more precisely, that “*the ordinary meaning of the terms of a treaty is not to be determined in isolation, but in the context of the*

117 et seq.; SHAW, *International Law*, p. 583 et seq.; BLECKMANN, *Grundprobleme und Methoden des Völkerrechts*, p. 89.

¹⁰⁴⁹ According to the Federal Supreme Courts’ principle of “*pluralisme des methods*” (in German: “*Methodenpluralismus*”), the hierarchy of the four different interpretative methods is not stated. See Swiss Federal Supreme Court Judgment of 6 June 2005, cons. 3.5 (ATF 131 II 562); Swiss Federal Supreme Court Judgment of 26 October 2005, cons. 4.1 (ATF 131 II 697). The historic arguments have much less significance with respect to the VCLT than to domestic law and so may not be considered general rules of interpretation. A contracting party should not be able to question an international agreement solely based on historic arguments. Therefore, recourse to arguments such as “*preparatory work of the treaty and the circumstances of its conclusion*” according to Art. 32 VCLT, may only be permissible under limited conditions. Among others: LOCHER, *Einführung internationales Steuerrecht Schweiz*, p. 576; OBERSON, *Bénéficiaire effectif*, p. 217.

¹⁰⁵⁰ HONGLER, *Hybride Finanzierungsinstrumente*, p. 200. The Swiss Federal Court has attached too much weight to the historical method of interpretation in its older court decisions. See Swiss Federal Supreme Court Judgment of 22 June 1990, cons. 3a (BGE 116 Ib 217). See among others: RIVIER, *Interprétation des conventions*, p. 133.

¹⁰⁵¹ OBERSON, *Précis de droit fiscal international*, p. 32; RIVIER, *Interprétation des conventions*, p. 99.

¹⁰⁵² Art. 31 and 32 VCLT.

¹⁰⁵³ CADOSCH, *Relevance of the OECD MC and Commentary*, p. 313.

treaty and in the light of its object and purpose”¹⁰⁵⁴. The VCLT specifies that the “context” includes not only the text of the DTC itself but also any agreement or instrument of the parties relating to the DTC in connection with its conclusion¹⁰⁵⁵. The “ordinary meaning” can be deducted from the context of the DTC in light of its object and purpose. A “special meaning” can be given to a term only if it is established that the parties intended such meaning to prevail¹⁰⁵⁶. However, the literal and grammatical arguments have priority over systematic and teleological arguments¹⁰⁵⁷. With regards to the literal arguments, the interpretation of a contract term cannot go further than its literal interpretation (“*praeter verba legis, sed secundum rationem legis*”), and it may not fundamentally differ from the specific wording either (“*contra verba legis, sed secundum rationem legis*”). Therefore, when applying this method, the terminology of the DTC is not only the starting point but also defines the limits of the interpretation.

Even if the result of an interpretation based on grammatical, systematic or teleological arguments would be absurd¹⁰⁵⁸, it should still be taken into account. Apart from these methods, a DTC must be interpreted in line with the basic principle of international law - good faith (“*Treu und Glauben*”; “*bonne foi*”) - honestly, reasonably¹⁰⁵⁹ and in accordance with the common intention of the parties. According to the Swiss Federal Administrative Tribunal the application of international treaties cannot violate the prohibition against “*venire contra factum proprium*” and cannot constitute an abuse of rights¹⁰⁶⁰. The principle and meaning of “good faith” follows the principles of effectiveness and “*pacta sunt servanda*”¹⁰⁶¹, which importance is also

¹⁰⁵⁴ ENGELN, thesis, p. 141.

¹⁰⁵⁵ Art. 31 para. 2 VCLT. In this vein: RIVIER, *Interprétation des conventions*, p. 100.

¹⁰⁵⁶ Art. 31 para. 4 VCLT.

¹⁰⁵⁷ SINCLAIR, *The Vienna Convention*, p. 118.

¹⁰⁵⁸ The historical argument is excluded, as it is under the wording of “*subsidiarity*” in the VCLT.

¹⁰⁵⁹ In this vein see the 2001 resolution of the International Whaling Commission. Information retrieved from <http://www.iwcoffice.org/meetings/resolutions/resolution2001.htm> on 6 July 2010. Furthermore, this principle can be seen among others in: AUST, p. 187; SINCLAIR, *The Vienna Convention*, p. 120; EVANS, p. 199.

¹⁰⁶⁰ Federal Administrative Court of 21 January 2010, cons. 3.5.3., (A-2163/2007).

¹⁰⁶¹ ENGELN, thesis, p. 125. The VCLT refers to the principle of good faith on five occasions: In its Preamble (Universal recognition of the principle); in Art. 26 VCLT (*Pacta*

confirmed by the VCLT¹⁰⁶². The VCLT refers to the principle of good faith in five different provisions¹⁰⁶³ and its role becomes considerably important as it represents the only possibility to avoid a manifestly absurd or unreasonable result¹⁰⁶⁴. Moreover, Anthony Aust has stated that: “*Even if the words of the treaty are clear, if applying them would lead to a result which would be manifestly absurd or unreasonable (...), the parties must seek another interpretation*”¹⁰⁶⁵. However, as Ned Shelton has correctly stated, it is sometimes difficult to differentiate between good and bad faith since the nature of the distinction is purely subjective¹⁰⁶⁶.

In this sense, the meaning of “*good faith*” cannot clearly be defined. Since no definition can be found in the VCLT, one can refer to Swiss domestic tax law to find an interpretation. This recourse to domestic terms, however, is only admissible if it is expressly agreed and must be an “*ultima ratio*”¹⁰⁶⁷.

5.2.3.1.1 Case Law Overview

When faced with the interpretation of a DTC, in the “*Denmark case*” court decision, the Federal Supreme Court held that: “*Somit haben die Vertragsstaaten eine zwischenstaatliche Übereinkunft nach Treu und Glauben in Übereinstimmung mit der gewöhnlichen, seinen Bestimmungen in ihrem Zusammenhang zukommenden Bedeutung und im Lichte seines Zieles und Zweckes auszulegen. Die vorbereitenden Arbeiten und die Umstände des Vertragsabschlusses sind ergänzende Auslegungsmittel. Gemäss Art. 31 Abs. 3 VRK sind aus dem Zusammenhang in gleicher Weise zu berücksichtigen jede spätere Übereinkunft zwischen den Vertragsparteien über die Auslegung des Vertrags oder die Anwendung seiner Bestimmungen, jede spätere Übung bei*

sunt servanda); in Art. 31 VCLT (General rule of interpretation); in Art. 46 para. 2 VCLT (Invalidation of consent to be bound) and in Art. 69 para. 2 (b) VCLT (Consequences of invalidity of treaty/Acts performed before invalidation).

¹⁰⁶² Art. 26 in conjunction with 31 VCLT.

¹⁰⁶³ In the Preamble, in Art. 26, in Art. 31 para. 1, in Art. 46 para. 2 and in Art. 69 para. 2 (b) VCLT.

¹⁰⁶⁴ SINCLAIR, The Vienna Convention, p. 120.

¹⁰⁶⁵ AUST, p. 187.

¹⁰⁶⁶ SHELTON, Interpretation, p. 167.

¹⁰⁶⁷ See Chapter 5.2.3.5.

der Anwendung des Bertrags, aus der die Übereinstimmung der Vertragsparteien über seine Auslegung hervorgeht, sowie jeder in den Beziehungen zwischen den Vertragsparteien anwendbare einschlägige Völkerrechtssatz"¹⁰⁶⁸.

Contrary to its past decisions¹⁰⁶⁹, the interpretation in this judgment is to a large extent in accordance with the rules of the VCLT¹⁰⁷⁰. It is desirable that this interpretative method continues to be applied by the Federal Tribunal in its future decisions¹⁰⁷¹. In previous decisions, too much importance was given to the intention of the parties and historical elements¹⁰⁷², instead of

¹⁰⁶⁸ Swiss Federal Supreme Court Judgment of 28 November 2005, cons. 3.4.1

(*"Dänemark-Entscheid"*, 2A.239/2005) = StR 2006, p. 217 = RDAF 2006 II, p. 239.

Since the *"Dänemark"* decision, the interpretation rules of the VCLT have been followed. However, the Swiss Federal Supreme Court has falsely been taking into account the historical background of the VCLT.

¹⁰⁶⁹ Before *"Dänemark-Entscheid"*, there was no uniformity among the methods of interpretation. In this vein for the case law of the Federal Supreme Court: Swiss Federal Supreme Court Judgment of 23 December 1970, cons. 6b (BGE 96 I 737); Swiss Federal Supreme Court Judgment of 17 February 1971, cons. 3 (BGE 97 I 359); Swiss Federal Supreme Court Judgment of 22 June 1990, cons. 3a (BGE 116 Ib 217). Federal Commission of Appeals in Tax Matters of 22 February 2000, cons. 5 (SRK 1998-131) = VPB 64.79; Federal Commission of Appeals in Tax Matters of 28 February 2001, cons. 7b/ee (SRK 2000-055) = StR 57, 30 = VPB 65.86 (*"Luxemburg-Entscheid"*); Federal Commission of Appeals in Tax Matters of 7 June 2004, cons. 4b (SRK 2002-032) = VPB 68.162; Federal Administrative Court of 30 October 2008, cons. 8.1, (*"Deutschland-Entscheid"*, A-2163/2007).

¹⁰⁷⁰ Art. 31 para. 1 VCLT represents the first sentence of the print-out: Denmark court decision: *"Somit haben die Vertragsstaaten eine zwischenstaatliche Übereinkunft nach Treu und Glauben in Übereinstimmung mit der gewöhnlichen, seinen Bestimmungen in ihrem Zusammenhang zukommenden Bedeutung und im Lichte seines Zieles und Zweckes auszulegen"*. The following sentence represents Art. 32 VCLT: *"Die vorbereitenden Arbeiten und die Umstände des Vertragsabschlusses sind ergänzende Auslegungsmittel"*. The third sentence represents Art. 31 para. 1 with its lit. a., b. and c and Art. 31 para. 2 VCLT: *"Gemäss Art. 31 Abs. 3 VRK sind aus dem Zusammenhang in gleicher Weise zu berücksichtigen jede spätere Übereinkunft zwischen den Vertragsparteien über die Auslegung des Vertrags oder die Anwendung seiner Bestimmungen [= 31 para. 1 lit. a, comment by the author], jede spätere Übung bei der Anwendung des Bertrags, aus der die Übereinstimmung der Vertragsparteien über seine Auslegung hervorgeht [= 31 para. 1 lit. b], sowie jeder in den Beziehungen zwischen den Vertragsparteien anwendbare einschlägige Völkerrechtssatz [= 31 para. 1 lit. c]"*.

¹⁰⁷¹ In this vein also: BAUMGARTNER, thesis, p. 16.

¹⁰⁷² As may generally be observed from the interpretation of domestic law.

taking into account the objectives of the DTC. In such situations where there was a conflict between the ordinary meaning of the convention and the meaning following the will of the parties, the latter habitually prevailed¹⁰⁷³. Consequently, the interpretation was too strongly influenced by the internal law of one of the contracting states¹⁰⁷⁴ instead of being interpreted according to the rules of the VCLT. This has been criticized by leading scholars¹⁰⁷⁵.

5.2.3.2 *The Relevance of the OECD Model and the OECD Commentary*

5.2.3.2.1 General Remark

The OECD Model and its Commentaries, drafted by the OECD Fiscal Committee are, *de facto*, of great importance and constitute a major source¹⁰⁷⁶ in the interpretation of DTCs. This has been confirmed by the doctrine¹⁰⁷⁷ and in the case law of the Federal Supreme Court and the Federal Administrative Court¹⁰⁷⁸. Recently, there has been a tendency by the OECD not to make material changes in the OECD Model, but to make them instead in the OECD

¹⁰⁷³ WALDBURGER, Die Auslegung von Doppelbesteuerungsabkommen, p. 57.

¹⁰⁷⁴ WALDBURGER, Die Auslegung von Doppelbesteuerungsabkommen, p. 66 et seq.

¹⁰⁷⁵ LOCHER, Einführung internationales Steuerrecht Schweiz, p. 112 et seq.

¹⁰⁷⁶ This can be observed by their frequent reservations about specific explanations in the OECD Commentaries or their consent but with reservations. In this vein also: MATTEOTTI, Interpretation of Tax Treaties and Domestic General Anti-Avoidance Rules, p. 339.

¹⁰⁷⁷ OESTERHELT, Bedeutung des OECD-Kommentars, p. 373 et seq.; OBERSON, droit fiscal international, p. 34; LOCHER, Einführung internationales Steuerrecht Schweiz, p. 130; BLUMENSTEIN/LOCHER, System des Schweizerischen Steuerrechts, p. 38; RIVIER, Interprétation des conventions, p. 101; RYSER, Introduction au droit fiscal international de la Suisse, p. 126; ARNOLD/MCINTYRE, International Tax Primer, p. 113; AULT, The role of the OECD commentaries, p. 144; VOGEL/PROKISCH, General report on the interpretation of double taxation, p. 55-85; VAN RAAD, Interpretation and Application of Tax Treaties by Tax Courts, p. 4; LANG, Later Commentaries of the OECD, p. 7; VOGEL, The Influence of the OECD Commentaries on Treaty Interpretation, p. 614; DANON, thesis, p. 262; OBERSON, bénéficiaire effectif, p. 218.

¹⁰⁷⁸ Among others: Swiss Federal Supreme Court Judgment of 28 November 2005, cons. 3.4.5 (“*Dänemark-Entscheid*”, 2A.239/2005) = StR 2006, 217, 223 = RDAF 2006 II, p. 239; Swiss Federal Supreme Court Judgment of 17 September 1976, cons. 3c (BGE 102

Commentaries. As a result, these Commentaries have become an increasingly important source of international tax law¹⁰⁷⁹. According to Kees Van Raad, the Commentaries serve international uniformity in interpretation and thus, contribute to the avoidance of double taxation¹⁰⁸⁰. The Federal Supreme Court also implicitly gives importance to the OECD Commentaries in order to promote the development of an “*international tax language*”. This may be as well observed, for instance, in a recent federal court decision¹⁰⁸¹. Even though the OECD Model does not have binding effect and is only a basis for the OECD members to use or refer to when concluding DTCs, the OECD Council recommends that its member countries follow the OECD Model¹⁰⁸². In the words of Klaus Vogel and Rainer Prokisch, “*the OECD commentary will be less significant for conventions between an OECD member and a non-member and between two non-members*”¹⁰⁸³.

Ib 264); Swiss Federal Supreme Court Judgment of 10 July 1987, cons. 5b (BGE 113 Ib 195); Swiss Federal Supreme Court Judgment of 27 September 1991, cons. 4b (BGE 117 Ib 248); Federal Commission of Appeals in Tax Matters of 3 March 2005, cons. 3d (SRK 2003-159); Federal Administrative Court of 30 October 2008, cons. 8.1 (“*Deutschland-Entscheid*”, A-2163/2007); Swiss Federal Supreme Court Judgment of 18 January 2011, cons. 3.4.2 (2C.472/2010); Swiss Federal Supreme Court Judgment of 6 May 2008, cons. 5.3 (2C.276/2007); Swiss Federal Supreme Court Judgment of 17 June 2008, cons. 4.2 (2C.537/2007); Swiss Federal Supreme Court Judgment of 6 March 2008, cons. 2.3 (2C.558/2007); Swiss Federal Supreme Court Judgment of 4 April 2006, cons. 3.3 and 4.2 (2A.416/2005); Federal Administrative Court of 7 March 2012 (“*Swap-Entscheid*”, A-6537/2010), consid. 3.2.4.

¹⁰⁷⁹ In this vein among others: OESTERHELT, *Bedeutung des OECD-Kommentars*, p. 375.

¹⁰⁸⁰ VAN RAAD, *Interpretation and Application of Tax Treaties by Tax Courts*, p. 4.

¹⁰⁸¹ Swiss Federal Supreme Court Judgment of 6 May 2008, cons. 5.6 (2C.276/2007):

The Commentary is written and modified by specialists from different countries, who constantly try to adapt it to the new developments occurring in the different contracting states. The OECD Commentary has a great impact on all DTCs that have been based on the OECD Model, their interpretation always following the one put forward in the Commentary.

¹⁰⁸² OECD Commentary 2014, nr. 3 ad. Introduction.

¹⁰⁸³ VOGEL/PROKISCH, *General report on the interpretation of double taxation*, p. 65. In this vein: BAKER, *Double Taxation Conventions*, E-19.

According to Klaus Vogel¹⁰⁸⁴, it must be questioned whether the OECD Commentary may be considered a source for the interpretation of DTCs. The issue arises from the fact that its provisions are constantly being modified and are never officially published¹⁰⁸⁵. In his opinion, a provision from the Commentary can only be taken into account to interpret a DTC concluded prior to its amendment if it has existed for a “*long time*”, meaning a period of 10 years or more. The idea behind this waiting period is to ensure security and certainty for the contracting states as to the content of the DTC and the legal framework in which it is negotiated at the time of its conclusion¹⁰⁸⁶.

It is unanimously recognized that following Art. 38 para. 1 of the Statute of the International Court of Justice, the OECD Model and its Commentaries may not be recognized as a source of international public law¹⁰⁸⁷. This uncertainty regarding the legal status of the OECD Commentaries under the provisions of the VCLT¹⁰⁸⁸ can easily be explained from a theoretical perspective. In practice, it is widely accepted that the OECD Commentaries are applied and used in the interpretation of DTCs¹⁰⁸⁹ as an interpretational aid rather than as a binding source¹⁰⁹⁰. This reference to the Commentaries as an interpretative source has arisen without detailed justification as to the legal basis¹⁰⁹¹. The general importance of the OECD Commentary has neither been

¹⁰⁸⁴ VOGEL/LEHNER, Doppelbesteuerungsabkommen 2003, nr. 123-139 ad. Introduction.

¹⁰⁸⁵ In this vein also: DANON, thesis, p. 265.

¹⁰⁸⁶ VOGEL/LEHNER, Doppelbesteuerungsabkommen 2003, nr. 127 et seq. ad. Introduction.

¹⁰⁸⁷ International Court of Justice of 26 June 1945 published in Systematic Collection of Federal Laws: SR 0.193.501.

¹⁰⁸⁸ OBERSON, droit fiscal international, p. 33-34; DANON, thesis, p. 263-264; UCKMAR, Double Taxation Conventions, p. 158; ARNOLD/MCINTYRE, International Tax Primer, p. 113.

¹⁰⁸⁹ ENGELN, thesis, p. 439; GUTMANN, Tax Treaty Interpretation, p. 113.

¹⁰⁹⁰ PIJL, OECD Commentary, p. 217, 222, 224; AVERY JONES et al., The Interpretation of Income Tax Treaties with Particular Reference to the Commentaries on the OECD Model, p. 113.

¹⁰⁹¹ See Chapter 5.2.1.

disputed in literature nor in worldwide case law¹⁰⁹², and it “*has become a widely accepted guide to the interpretation and application of the provisions of these other model conventions and actual treaties in force*”¹⁰⁹³. Despite their widespread use, the Federal Court has not, interestingly, answered the question as to the legal basis upon which the OECD Commentaries may be used to interpret DTCs¹⁰⁹⁴. This has also been observed by Michael Lang and Florian Brugger: “*The OECD Model Convention and the OECD Commentary carry significant weight in the interpretation of double taxation conventions. If a double taxation convention is, in principle, based on the OECD Model and a certain provision follows the wording of the OECD Model, it is then only reasonable to assume that the contracting states intended such a provision to have the meaning it has in the OECD Model, as outlined in the OECD Commentary*”¹⁰⁹⁵. If the OECD Model and its Commentaries were not considered relevant, the member states would never have the need to make reservations to certain provisions. Indeed, the OECD Commentary itself expressly concludes that it can “*(...) be of great assistance in the application and interpretation of the conventions and, in particular, in the settlement of any disputes*”¹⁰⁹⁶.

¹⁰⁹² Among others: HEINRICH/MORITZ, Interpretation of Tax Treaties, p. 148 et seq.; PIJL, Interpretation of Tax Treaties, p. 545 et seq.; AULT, The role of the OECD commentaries, p. 63-68; VAN DER BRUGGEN, Power of Persuasion, p. 269.

¹⁰⁹³ HELMINEN, The Dividend Concept, p. 13.

¹⁰⁹⁴ A clear rationale as to why the OECD Commentary must be taken into account is missing from the following Federal Court decisions: Swiss Federal Supreme Court Judgment of 24 June 2005, cons. 8.1 (2P.306/2004 / 2A.709/2004); Swiss Federal Supreme Court Judgment of 28 November 2005 (“*Dänemark-Entscheid*”, 2A.239/2005) = StR 2006, 217 = RDAF 2006 II, p. 239; Swiss Federal Supreme Court Judgment of 4 April 2006, cons. 3.3 and 4.2 (ATF 2A.416/2005); Swiss Federal Supreme Court Judgment of 6 May 2008, cons. 5.3 (2C.276/2007); Swiss Federal Supreme Court Judgment of 6 March 2008, cons. 2.3 (2C.558/2007). The court decisions issued by the Federal Commission of Appeals in Tax Matters are not considered here. For a detailed analysis in this connection: OESTERHELT, Bedeutung des OECD-Kommentars, p. 385-386.

¹⁰⁹⁵ LANG/BRUGGER, The role of the OECD Commentary in Tax Treaty Interpretation, p. 107.

¹⁰⁹⁶ OECD Commentary 2014, nr. 29 ad. Introduction.

The controversy lies mainly as to which legal basis permits recourse to the Commentary¹⁰⁹⁷. Courts have increasingly referred to the OECD Model and its Commentary when reaching their decisions¹⁰⁹⁸, especially when the wording of the DTC at issue follows the OECD Model. In the Australian case of *“Thiel”*¹⁰⁹⁹ and the Canadian case of *“Crown Forest”*¹¹⁰⁰, for instance, express reference to the OECD Commentary was permitted for DTC interpretation purposes. In Switzerland, the Federal Supreme Court has not resolved this issue, although it pays much importance to the Commentary and frequently refers to it when interpreting DTCs¹¹⁰¹ where the wording is substantially similar to the corresponding provisions of the OECD Model¹¹⁰². The OECD Commentary itself expressly concludes that it can *“(...) be of great assistance in the application and interpretation of the conventions and, in particular, in the settlement of any disputes”*¹¹⁰³. Various court decisions have referred, from time to time, to the importance of the Commentary in the

¹⁰⁹⁷ Among others: GUTMANN, Tax Treaty Interpretation in France, p. 114. The only country is Mexico which enforced an administrative ruling to adopt the OECD Commentaries as binding sources. In paragraph 2.1.1 the ruling states: *“In order to construe the provisions of any treaties concluded by Mexico in order to avoid double taxation assessments, the commentaries on the model convention shall be applicable so as to avoid double taxation and prevent tax fraud, as referred to in the recommendation adopted by the Council of the Organization for Economic Cooperation and Development adopted on September 21st, 1995 or in any other that would substitute same, to the extent that such commentaries be consistent with the provisions of the treaties concluded by Mexico.”*

¹⁰⁹⁸ OECD Commentary 2014, nr. 29.3 ad. Introduction.

¹⁰⁹⁹ Thiel v FCT (1990) 21 STR 531 (537) (Australia).

¹¹⁰⁰ Crown Forest Industries Limited v The Queen (1995) 95 DTC 5389 at 5396 (Canada).

¹¹⁰¹ Swiss Federal Supreme Court Judgment of 4 April 2006, cons. 3.4.5 (ATF 2A.416/2005); Swiss Federal Supreme Court Judgment of 17 September 1976, p. 269 (ATF 102 Ib 264) = ASA 45, p. 602 et seq. Further, see also other decisions from lower jurisdictions: Federal Administrative Court Judgment of 7 September 2011 (A-813/2010); Administrative Court Fribourg Judgment of 18 June 1999 = StE 2000 A 31.2. nr. 4; Administrative Court Zurich Judgment of 3 February 1994 = StE 1995 A 21.12 nr. 10; Zurich Commission of Appeals in Tax Matters Decision of 21 December 1988 = StE 1989 B 81.4 Nr. 1; Administrative Court Geneva Judgment of 18 May 1988 = StE 1988 A 31.2 Nr. 1.

¹¹⁰² From a UK perspective: SCHWARZ, Tax Treaties, p. 73.

¹¹⁰³ OECD Commentary 2014, nr. 29 ad. Introduction.

interpretation of DTCs¹¹⁰⁴. In a judgment of 4 April 2006 pertaining to the Switzerland - Denmark DTC¹¹⁰⁵, the Federal Supreme Court expressly stated that the DTC *had* to be interpreted in the light of the OECD Model and its Commentary¹¹⁰⁶.

Leading scholars disagree as to whether the use of the OECD Commentary as an interpretative aid is in accordance with the general rules of interpretation under the VCLT¹¹⁰⁷. René Matteotti argues that the OECD Commentary “*does not establish international law*”¹¹⁰⁸. However, in recent literature, the interpretation of DTCs in light of the OECD Model and its Commentary is frequently referred to. Depending on the relevant jurisdiction, it is regarded either as a “*supplementary means of interpretation*” in the sense of Art. 32 VCLT¹¹⁰⁹ (the material of the OECD is only taken into account under certain circumstances), as the “*special meaning*” in the sense of Art. 31 para. 4 VCLT¹¹¹⁰, as the “*ordinary meaning*” in the sense of Art. 31 para. 1 VCLT or as constituting “*their context*” in the sense of Art. 31 para. 2 and 3

¹¹⁰⁴ Swiss Federal Supreme Court Judgment of 17 September 1976, p. 269 (BGE 102 Ib 264) = ASA 45, p. 602 et seq.; Administrative Court Geneva of 18 May 1988 = StE 1988 A 31.2 Nr. 1; Zurich Commission of Appeals in Tax Matters of 21 December 1988 = StE 1989 B 81.4 Nr. 1; Swiss Federal Supreme Court Judgment of 4 April 2006, cons. 3.4.5 (ATF 2A.416/2005); Swiss Federal Supreme Court Judgment of 17 September 1976, p. 269 (ATF 102 Ib 264); Administrative Court Fribourg of 18 June 1999 = StE 2000 A 31.2. nr. 4; Administrative Court Zurich of 3 February 1994 = StE 1995 A 21.12 nr. 10.

¹¹⁰⁵ DTC between Switzerland and Denmark of 23 November 1973, published in the Systematic Collection of Federal Laws: SR 0.672.931.41.

¹¹⁰⁶ Swiss Federal Supreme Court Judgment of 4 April 2006, cons. 3.4.5 (ATF 2A.416/2005).

¹¹⁰⁷ Among others: UCKMAR, Double Taxation Conventions, p. 158.

¹¹⁰⁸ MATTEOTTI, Interpretation of Tax Treaties and Domestic General Anti-Avoidance Rules, p. 339.

¹¹⁰⁹ ARNOLD/MCINTYRE, International Tax Primer, p. 113. MÖSSNER, Zur Auslegung von Doppelbesteuerungsabkommen, p. 403. For a systematic analysis: BAUMGARTNER, thesis, p. 23-24.

¹¹¹⁰ AULT, The role of the OECD commentaries, p. 61; AVERY JONES, Tax Treaty Interpretation in the United Kingdom, p. 364.

VCLT¹¹¹¹ (the material of the OECD is taken into account)¹¹¹². The position of “*special meaning*” in the sense of Art. 31 para. 4 VCLT has been criticized by a group of specialists from various countries under the representation of John Avery Jones: “*What has sometimes been called ‘an international tax language’ could hardly, in many cases, be said to be the natural and ordinary meaning of the relevant words. Where, as is frequently the case, the commentaries enlarge upon, add to and expand their terms of the Model, they can hardly be said to provide the ‘ordinary meaning’ of treaty terms. It may be, therefore, more accurate to consider, if there is sufficient proof that treaty negotiators intended to adopt the meaning of terms set out in the OECD commentaries, that they, or at least some part of them, may provide a ‘special meaning’ for treaty terms. If so, those parts of the commentaries could be covered by paragraph 4 of Article 31, as originally suggested by Ault*”¹¹¹³.

The need for clarity as to the legal basis upon which the OECD Commentaries are taken into account for the interpretation of DTCs is not purely academic as observed by Stefan Oesterhelt¹¹¹⁴. Whether the legal basis is founded under Art. 31 VCLT or under Art. 32 VCLT has practical consequences. In the case of Art. 32, the Commentaries are only used as a supplemental interpretative aid (“*moyen d'interprétation complémentaire*”; “*ergänzende Auslegungsmittel*”), in certain circumstances in which the ordinary language is ambiguous. The Commentaries may only be used to assist the interpretation of the DTC if its meaning cannot be derived from the language and presentation of the words therein. This has recently been confirmed, in September 2011, by the Federal Administrative Court in its “*Ma-*

¹¹¹¹ PROKISCH, Auslegung von Doppelbesteuerungsabkommen, p. 52; OBERSON, Précis de droit fiscal international, p. 34; RIVIER, Interprétation des conventions, p. 129; RYSER, Introduction au droit fiscal international de la Suisse, p. 126; HÖHN, Internationales Steuerrechts, p. 76; DANON, thesis, p. 264-265; RIBES, Courts and Tax Treaty Law, p. 343; VOGEL, The Influence of the OECD Commentaries on Treaty Interpretation, p. 612-616.

¹¹¹² For a systematic analysis: BAUMGARTNER, thesis, p. 19 et seq.

¹¹¹³ AVERY JONES et al., The Interpretation of Income Tax Treaties with Particular Reference to the Commentaries on the OECD Model, p. 19.

¹¹¹⁴ OESTERHELT, Bedeutung des OECD-Kommentars, p. 391 et seq.

deira” case, in which the Court stated that the legal basis on which the Commentaries may be used lies in Art. 32 VCLT¹¹¹⁵. On the other hand, in the case that the legal basis is founded under Art. 31 VCLT, the Commentaries will be applied routinely as part of the ordinary interpretation (“*interprétation selon le sens ordinaire*”; “*gewöhnlichen Bedeutung*”) of DTCs and their language.

It must be assumed in good faith that member states, whose DTC provisions follow the OECD Model, have the intention to give these provisions the meaning intended by the OECD Model and its Commentaries¹¹¹⁶. This view is in line with the opinion of Peter J. Wattel and Otto Marres who consider the Commentaries to be applicable as part of the DTCs “*context*”¹¹¹⁷. American courts and the Internal Revenue Service follow this view¹¹¹⁸.

5.2.3.2.2 Effect of amendments to the OECD Model and its Commentaries in Time

Despite the uncertainty concerning its legal status and its relationship with domestic law under the provisions of the VCLT¹¹¹⁹, Swiss Courts have increasingly referred to the OECD Commentary to assist them in the interpretation of DTCs¹¹²⁰. However, another issue arises regarding the amendments

¹¹¹⁵ Federal Administrative Court Decision of 7 September 2011, cons. 6 and 7 (A-813/2010). This court decision states: “*Ergänzende Auslegungsmittel sind die Vertragsmaterialien und die Umstände des Vertragsabschlusses, welche – nur, aber immerhin – zur Bestätigung oder bei einem unklaren oder widersprüchlichen Auslegungsergebnis heranzuziehen sind*”.

¹¹¹⁶ In this vein: Swiss Federal Supreme Court Judgment of 4 April 2006, cons. 3.4.5 (ATF 2A.416/2005); AVERY JONES, *Tax Treaty Interpretation in the United Kingdom*, p. 18.

¹¹¹⁷ WATTEL/MARRES, *Legal Status of the OECD Commentary*, p. 234.

¹¹¹⁸ *United States v A. L. Burbank & Co.*, 525 F2d9, 15-16 (1975); *Rev Rul.* p. 86- 145; *Taisiei Fire & Marine Ins. Co. v. Commissioner*, 104 TC 535, 548 (1995).

¹¹¹⁹ OBERSON, *Précis de droit fiscal international*, p. 33-34; Danon, *thesis*, p. 263-264; UCKMAR, *Double Taxation Conventions*, p. 158; ARNOLD/MCINTYRE, *International Tax Primer*, p. 113..

¹¹²⁰ OECD Commentary 2014, nr. 29 ad. Introduction. This has been confirmed by various court decisions in Switzerland among others: Swiss Federal Supreme Court Judgment of 4 April 2006 (ATF 2A.416/2005); Swiss Federal Supreme Court Judgment of 17

to the OECD Commentary; “*in concreta*”, whether the most recent Commentary should be applied (dynamic approach) or the Commentary in force at the time of the conclusion of the DTC (static approach). This question is highly relevant since the OECD Model and its Commentaries are subject to various and frequent amendments¹¹²¹, changes¹¹²² and, at times, complete revisions.

According to Michael Edwardes-Ker, the extent of the changes is pertinent – the less substantial the changes, the greater the weight of the subsequent Commentary. He does not explain, however, what a substantial Commentary is. In Swiss doctrine, this question is controversial¹¹²³. During the preparation phase of the Partnership Report, Switzerland made a reservation to Paragraph 32 commenting on Article 23. According to this article, the state of residence becomes dependent on the interpretation of the DTC provisions made by the source state. Switzerland’s reservation expresses that a static approach should be followed in order to avoid the scenario where the source state enlarges its taxing right at a later stage and the residence State is obliged to accept this. In a recent decision of 2014, the Federal Supreme Court went even further by confirming that the judge may, according to the specific circumstances of the case, refer to the OECD Commentary, including a version of the latter which is more recent than the applicable treaty¹¹²⁴. On the other hand, Michael Lang and Florian Brugger share a different view: “*Later Commentary amendments cannot serve to establish the parties’ intentions upon conclusion of a double taxation convention*”¹¹²⁵. Using a version of the OECD Commentary subsequent to the conclusion of a DTC raises fundamental concerns in relation to legal certainty between the contracting parties, as the effect of the terms agreed upon at the conclusion of the DTC may differ if their interpretation subsequently changes thanks to an amended Commentary. Therefore, in the author’s view subsequent Commentaries

September 1976 (ATF 102 Ib 264) = ASA 45, p. 602; Administrative Court Fribourg of 18 June 1999 = StE 2000 A 31.2. nr. 4; Administrative Court Zurich of 3 February 1994 = StE 1995 A 21.12 nr. 10.

¹¹²¹ OECD Commentary 2014, nr. 9 ad. Introduction.

¹¹²² OECD Commentary 2014, nr. 35 ad. Introduction.

¹¹²³ Amongst others: SALOM, thesis, p. 171 et seq.; BAUMGARTNER, thesis, p. 19 et seq.; OBERSON, Précis de droit fiscal international, chiffre 97 et seq.

¹¹²⁴ Swiss Federal Supreme Court Judgment of 25 June 2014, cons. 4.2 (A-4693/2013).

¹¹²⁵ LANG/BRUGGER, The role of the OECD Commentary in Tax Treaty Interpretation, p. 107.

should not be strictly binding, and they should not affect the interpretation of tax treaties concluded prior to their enactment since they do not qualify for consideration under either Art. 31 or Art. 32 of the VCLT.

The OECD Commentary, however, addresses this issue squarely, stating that: *“Amendments to the Articles of the Model Convention and changes to the Commentaries that are a direct result of these amendments are not relevant to the interpretation or application of previously concluded conventions where the provisions of those conventions are different **in substance** (emphasis added by the author) from the amended Articles. However, other changes or additions to the Commentaries are normally applicable to the interpretation and application of conventions concluded before their adoption, because they reflect the consensus of the OECD Member countries as to the proper interpretation of existing provisions and their application to specific situations”*¹¹²⁶. The second sentence of this extract suggests the possibility that without a valid ground in international law the existing interpretation of the text of a DTC could be supplanted by changes in the Commentary¹¹²⁷.

Clearly, this statement goes too far and, therefore, that it should be rejected. Leading Swiss¹¹²⁸ and foreign¹¹²⁹ scholars consider that changes to the Commentaries occurring after the conclusion of a tax treaty can neither amend the DTC, nor retroactively determine its interpretation. This has also been confirmed by the Canadian Supreme Court in the *“Crown Forest”* case, which stated that only a static interpretation based on the 1977 OECD Model and its Commentaries was applicable in order to interpret the DTC

¹¹²⁶ OECD Commentary 2014, nr. 35 ad. Introduction.

¹¹²⁷ OESTERHELT, Bedeutung des OECD-Kommentars, p. 380.

¹¹²⁸ OBERSON, Précis de droit fiscal international, p. 34; WALDBURGER, Die Auslegung von Doppelbesteuerungsabkommen, p. 61; RIVIER, Droit Fiscal International, p. 101; OESTERHELT, Bedeutung des OECD-Kommentars, p. 380.

¹¹²⁹ LANG, Die Bedeutung des Musterabkommens und des Kommentars der OECD, p. 24 seq.; VOGEL, The Influence of the OECD Commentaries on Treaty Interpretation, p. 612, 615; ELLIS, The Influence of the OECD Commentaries on Treaty Interpretation, p. 618; VAN RAAD, Interpretation and Application of Tax Treaties by Tax Courts, p. 4; AVERY JONES, The effect of changes in the OECD Commentary, p. 102; LANG, Amendments of the OECD Commentary, p. 6; WATTEL/MARRES, Legal Status of the OECD Commentary, p. 225 et seq.

concluded in 1980 between the United States and Canada¹¹³⁰. One may wonder why the Federal Supreme Court has instead followed the view that the most recent OECD Commentaries should be applied (dynamic approach)¹¹³¹. It should be noted, however, that in most of its decisions no particular reference is made to the issue¹¹³² and there is no clear legal basis for this approach¹¹³³. In a decision of April 2006, the Court interpreted a DTC in light of the OECD Commentaries despite the fact that the latter did not even exist when the agreement was concluded. This creates a lack of legal certainty between the parties to DTCs because the interpretation of the terms agreed upon may differ later if a subsequent update to the OECD Commentaries affects their interpretation¹¹³⁴. A May 2008 decision¹¹³⁵ illustrates that the extent of such changes may be significant. This decision

¹¹³⁰ See Footnote 1100. The static approach is clearly followed by the Austrian Supreme Administrative Court since its case of 31 July 1996 (Nr. 92/13/0172).

¹¹³¹ See the analysis from Stefan Oesterheld in OESTERHELT, *Bedeutung des OECD-Kommentars*, p. 386 et seq; Swiss Federal Supreme Court Judgment of 24 June 2005 (2P.306/2004 / 2A.709/2004) with regard to Art. 17 OECD Model; Swiss Federal Supreme Court Judgment of 28 November 2005 ("*Dänemark-Entscheid*", 2A.239/2005) with regard to Art. 1 OECD Model; Swiss Federal Supreme Court Judgment of 28 November 2005 (2P.140/2005) with regard to Art. 24 para. 3 OECD Model; Swiss Federal Supreme Court Judgment of 17 March 2006, cons. 3.2 (2A.643/2005) with regard to Art. 16 OECD Model; Swiss Federal Supreme Court Judgment of 4 April 2006, cons. 3.1 (ATF 2A.416/2005); Swiss Federal Supreme Court Judgment of 6 March 2008, cons. 2.3 (2C.558/2007) with regard to Art. 23 OECD Model; Swiss Federal Supreme Court Judgment of 6 May 2008, cons. 5.3 (2C.276/2007) with regard to Art. 17 OECD Model; Swiss Federal Supreme Court Judgment of 17 June 2008, cons. 4.2 (2C.537/2007) with regard to Art. 5 OECD Model; Swiss Federal Supreme Court Judgment of 14 October 2010, cons. 2.3 (2C.236/2010) with regard to Art. 15 OECD Model; Swiss Federal Supreme Court Judgment of 18 January 2011, cons. 4 (2C.472/2010) with regard to Art. 4 OECD Model; Swiss Federal Supreme Court Judgment of 25 June 2014, cons. 4.2 (A-4693/2013) with regard to Art. 10 DTC between Switzerland and Luxembourg.

¹¹³² Among others: Swiss Federal Supreme Court Judgment of 24 June 2005, cons. 8.1 (2P.306/2004 / 2A.709/2004). In this vein see the detailed analysis in: OESTERHELT, *Bedeutung des OECD-Kommentars*, Footnote 84.

¹¹³³ OESTERHELT, *Bedeutung des OECD-Kommentars*, p. 392-394.

¹¹³⁴ Swiss Federal Supreme Court Judgment of 4 April 2006 (ATF 2A.239/2005). Against: OBERSON, *Précis de droit fiscal international*, p. 35; GANI, *Note de critique de l'arrêt du Tribunal fédéral*, p. 254 et seq.

¹¹³⁵ Swiss Federal Supreme Court Judgment of 6 May 2008 (2C.276/2007).

does not state, however, whether subsequent Commentaries are relevant or irrelevant. It may certainly be said that the less substantial the changes are, the greater the weight the later Commentaries should have. This is to respect the principle of legal certainty under which security and stability as to the content of the DTC at the time of its conclusion should be safeguarded. This approach was not followed in the decision from the Federal Tribunal mentioned above¹¹³⁶, concluding that the judge may refer to the OECD Commentary, including a version that was issued after the treaty that is under review. The court, however, explicitly limited this to a close interpretation safeguarding its original intention: “(...) à tout le moins cela vaut-il lorsqu’une modification du Commentaire ne change pas la réglementation antérieure, mais la précise ou l’explique”¹¹³⁷. In the author’s view, this combination of two methods, which may be called “static-dynamic method”, aims at preserving the initial purpose of an agreement and does therefore not raise fundamental concerns in relation to legal certainty between the contracting parties. Indeed, the effect of the terms agreed upon at the conclusion of a DTC may differ if their interpretation subsequently changes due to an amended Commentary.

5.2.3.3 *The Relevance of the OECD Reports*

The OECD Reports express opinions on current, controversial and insufficiently discussed DTC issues and are occasionally released by Working Parties of the Fiscal Committee of the OECD. These reports are usually published after approval by the CFA, and often have a direct influence on modifications of the OECD Model and Commentary. In the case of such modifications, these Reports represent a valuable reference as to the reasons behind them. Since the Reports are drawn up by representatives of the OECD member states, they also provide valuable guidance for taxpayers as to how a DTC will be interpreted by the tax administration of a given state. An illustrative example is the Partnership Report which primarily serves as an aid to DTC interpretation.

¹¹³⁶ Swiss Federal Supreme Court Judgment of 25 June 2014, cons. 4.2 (A-4693/2013).

¹¹³⁷ Swiss Federal Supreme Court Judgment of 25 June 2014, cons. 4.2 (A-4693/2013).

As mentioned earlier, the 2009 CIV Report will be of particular importance for the present analysis and certain of its aspects will be extensively discussed herein. For the sake of completeness, the author will first briefly clarify the legal relevancy of these documents. The CIV Report has been issued by an informal Consultative Group on the Taxation of Collective Investment Vehicles and Procedures for Tax Relief for Cross-Border Investors (hereafter: ICG), which was established by the CFA. The Report includes a comprehensive set of non-binding recommendations¹¹³⁸ regarding policy and legal issues specifically in relation to CISs. However, the amendments which were ultimately included in the 2010 and 2014 version of the OECD Commentary are deemed incorporated into them and should thus be governed by the principles mentioned above. To the contrary, proposals which do not lead to changes to the OECD Commentary should not be given more legal weight than ordinary scholarly writing¹¹³⁹. These recommendations, however, constitute a source of non-binding guidance that may have “*moral force*”, even if they are not legally binding upon the member countries¹¹⁴⁰.

5.2.3.4 *The Relevance of Other Countries’ Court Decisions*

Foreign court decisions can give useful guidance with regard to the interpretation of DTCs. However, according to the principle of sovereignty of each state, they do not have formal binding effect on other domestic courts. The weight accorded to foreign court decisions depends on various factors. First of all, foreign court decisions should not be given more importance than ordinary scholarly writing. But, however, and even if they are not legally binding upon the courts of other member countries, they have a “*moral force*” - always depending on how convincing their reasoning is and whether the foreign court has in fact interpreted the matter correctly¹¹⁴¹.

¹¹³⁸ This is also supported by case-law as demonstrated by David Ward. See: WARD, *The Role of the Commentaries*, p. 100.

¹¹³⁹ In this vein: DANON, thesis, p. 266.

¹¹⁴⁰ AVERY JONES et al., *The Interpretation of Income Tax Treaties with Particular Reference to the Commentaries on the OECD Model*, p. 8.

¹¹⁴¹ WARD, *Courts and Tax Treaty Law*, p. 161.

The Federal Administrative Court has also looked into foreign court decisions, especially in its more recent judgments, in order to attempt to ensure a coherent interpretation, avoiding potential conflicts¹¹⁴².

5.2.3.5 *The Relevance of Domestic Tax Legislation*

In practice, “*renvoi*” to internal law are important and may facilitate the resolution of controversial issues relating to interpretation when there is no express definition of a term in a DTC or the relevant DTC definition is unclear. In this regard, the most important general rules of interpretation are set forth in Art. 3 para. 2 OECD Model and have been included in all current Swiss DTCs¹¹⁴³. The relevance of domestic tax legislation derives directly from this Article, as well as indirectly from Arts. 31 and 32 VCLT, according to which Art. 3 para. 2 OECD Model is considered as a “*lex specialis*”¹¹⁴⁴. The connection should not be characterized as a true “*lex specialis*” versus “*lex generalis*” relationship since the interpretation rules of Arts. 31 and 32 VCLT are always applicable *alongside* Art. 3 para. 2 OECD Model¹¹⁴⁵. This Article indicates that undefined terms in DTCs should preferentially be given a meaning in accordance with domestic law, “*unless the context*” of the country applying the DTC “*otherwise requires*”¹¹⁴⁶.

This raises the question of how the “*context otherwise requires*” should be understood and, in particular, what the appropriate steps to follow are before interpreting ambiguous and undefined terms under domestic law¹¹⁴⁷. First, the legal definitions in Art. 3 para. 1 should certainly be considered. They include: “*person, company, enterprise, enterprise of a Contracting State, international traffic, competent authority, national [and] business*”. Second,

¹¹⁴² Federal Administrative Court of 21 January 2010, cons. 3.7.11. (A-7789/2009).

¹¹⁴³ HONGLER, *Hybride Finanzierungsinstrumente*, p. 205.

¹¹⁴⁴ DANON, *thesis*, p. 315

¹¹⁴⁵ VAN DER BRUGGEN, *Vienna Convention*, p. 153.

¹¹⁴⁶ Art. 3 para. 2 OECD Model. The origin of the concepts and expressions derives from the UK legislation of 1860, the Canadian legislation of 1886 and the Australian legislation of 1852. Interestingly, this concept has not been used in the US. See in detail the analysis of AVERY JONES et al., *The Origin of Concepts and Expressions Used in the OECD Model and their Adoption by States*, p. 221.

¹¹⁴⁷ AVERY JONES, *Interpretation of Tax Treaties*, Part II, p. 90 et seq.

besides these general definitions, additional Articles referring to specific terms, for example “*resident*”¹¹⁴⁸, “*permanent establishment*”¹¹⁴⁹, “*dividends*”¹¹⁵⁰, “*interest*”¹¹⁵¹ and “*royalties*”¹¹⁵² should also be taken into account. In order to interpret terms which are used in DTCs but are not defined therein, the OECD Model, in its Art. 3 para. 2, refers to domestic law. Nevertheless, the option to refer to domestic law is open only if the DTC does not expressly contain a legal definition of the term, and as long as the context does not require otherwise.

Victor Uckmar specifies that, with regard to the reference to internal law, “*the meaning under tax law shall prevail*”¹¹⁵³ if the two differ. Interestingly, in the French version of the OECD Model, domestic law should not only give its meaning to single terms, but in a wider sense to “*terme ou expression*”. This is in line with the definition given by the Oxford Dictionary as the word “*term*” also has a wider sense, referring to “*any word, group of words expressing a notion or conception or denoting an object or thought*”¹¹⁵⁴. Therefore, whole phrases or parts of phrases may be interpreted under domestic tax law.

The two principal theories regarding the interpretation of Art. 3 para. 2 OECD Model are discussed below: the Domestic Law Theory¹¹⁵⁵ and the International Law Theory¹¹⁵⁶.

5.2.3.5.1 Representatives of the Domestic Law Theory

Representatives of the “*Domestic Law Theory*” defend the priority of domestic law interpretations by relying on the second half of the sentence of Art. 3 para. 2 OECD Model, and in particular on the expression “*unless the*

¹¹⁴⁸ Art. 4 OECD Model.

¹¹⁴⁹ Art. 5 OECD Model.

¹¹⁵⁰ Art. 10 OECD Model.

¹¹⁵¹ Art. 11 OECD Model.

¹¹⁵² Art. 12 OECD Model.

¹¹⁵³ UCKMAR, Double Taxation Conventions, p. 160.

¹¹⁵⁴ ENGELEN, thesis, p. 265.

¹¹⁵⁵ See Chapter 5.2.3.5.1.

¹¹⁵⁶ See Chapter 5.2.3.5.2.

context otherwise requires” (“*wenn der Zusammenhang nichts anderes erfordert*”; “*sauf si le context exige une interprétation différente*”)¹¹⁵⁷. Therefore, if there is no definition of a term in the DTC itself, it will be interpreted according to domestic law. Under this theory, the sovereignty of each state and its legal security are protected as only domestic laws may find application¹¹⁵⁸. Despite these advantages, most Swiss commentators do not follow this theory¹¹⁵⁹ due to problems its application may cause, especially the possibility of diverging interpretations causing definition, attribution and qualification conflicts, which in turn could result in international double taxation¹¹⁶⁰.

5.2.3.5.2 Representatives of the International Law Theory

The majority of the Swiss doctrine follows the “*International Law Theory*” which considers recourse to domestic law interpretation to be an “*ultima ratio*”, and is therefore restrictively applied¹¹⁶¹ in a subsidiary way. The interpretation of terms in international law has priority over domestic law interpretations. First, it should be established whether the DTC itself provides a definition of the term. If a definition is not ascertainable from the DTC, the meaning of the term in domestic law should be used only as an “*ultima ratio*”, so long as a definitive and clear meaning of the term cannot be deduced from the general principles of interpretation laid down in Arts. 31 to 33 of the VCLT¹¹⁶². This interpretation relies on the second half of the sentence of Art. 3 para. 2 OECD Model, and in particular on the expression “*unless the context otherwise requires*”. Based on the meaning of the words (grammatical arguments) as well as based on the object and purpose of avoiding double taxation (teleological arguments) the word “*requires*” means that the threshold to give preference to an autonomous and uniform interpretation is high.

¹¹⁵⁷ VOGEL/PROKISCH, General report on the interpretation of double taxation, p. 49.

¹¹⁵⁸ HONGLER, Hybride Finanzierungsinstrumente, p. 206.

¹¹⁵⁹ Among others: MÄUSLI, thesis, p. 156 et seq.

¹¹⁶⁰ See Chapter 4.1.3.

¹¹⁶¹ LOCHER, Einführung internationales Steuerrecht Schweiz, p. 123; OBERSON, Précis de droit fiscal international, p. 36; LANG, Die Bedeutung des Musterabkommens und des Kommentars der OECD, p. 34 et seq.; RIVIER, Interprétation des conventions, p. 3.

¹¹⁶² HONGLER, Hybride Finanzierungsinstrumente, p. 210.

The International Law Theory clearly reduces the possibilities for interpretative divergence between the residence and source states and therefore assists in reducing the risk of international double taxation.

5.2.3.5.3 Selected Swiss Court Decisions in a Nutshell

In a 1984 Federal Court decision the Swiss Federal Supreme Court was confronted with the definition of the term “*dividend*” in a DTC. Its decision clearly follows the “*Domestic Law Theory*”. In particular, it states with regard to the source state (“*lex fori*”): “*Si la Convention ne définit pas elle-même la notion de dividende, il est admis en doctrine qu'en vertu de l'art. II al. 2, il faut donner à toute expression non autrement définie le sens que lui attribue la législation fiscale de l'Etat où la prestation imposable trouve sa source (...)*”¹¹⁶³. In 1990, the Swiss Federal Supreme Court stated with regard to the source state view (“*lex fori*”): “*Das [the international method of interpretation applied by the Swiss Federal Court, comment by the author] gilt auch für die Auslegung von Doppelbesteuerungsabkommen, wenn diese nicht selber besondere Auslegungsregeln (Definitionen) enthalten oder subsidiär auf die Bedeutung der verwendeten Begriffe in der 'lex fori' verweisen*”¹¹⁶⁴. It is difficult to conclude from this statement whether the Swiss Federal Supreme Court follows the “*International Law Theory*” or the “*Domestic Law Theory*”. In a court decision of 1998, the Swiss Federal Supreme Court indicated more clearly that it follows the “*International Law Theory*”: “*Nur wenn ein Abkommen – im Lichte dieser Regeln [Art. 31 – 33 VCLT, comment by the author] ordnungsgemäss ausgelegt – eine bestimmte Frage weder ausdrücklich noch stillschweigend regelt, ist es angängig, subsidiär die Begriffe und Konzeptionen des anwendbaren Landesrechts zur Auslegung beizuziehen*”¹¹⁶⁵.

The Swiss Federal Administrative Tribunal in 2010 also referred to the identical doctrine of the Swiss Federal Supreme Court and held that recourse to domestic law is only admissible if an agreement expressly refers to it or as a

¹¹⁶³ Swiss Federal Supreme Court Judgment of 5 April 1984, cons. 4c (ATF 110 Ib 127).

¹¹⁶⁴ Swiss Federal Supreme Court Judgment of 22 June 1990, cons. 3a, p. 221 (BGE 116 Ib 217).

¹¹⁶⁵ Swiss Federal Supreme Court Judgment of 17 March 1998, cons. E. 3a (BGE 124 V 225).

last resort¹¹⁶⁶. A more recent court decision of the Swiss Federal Administrative Tribunal of the same year is even more precise and result-oriented, indicating that recourse to domestic law is only admissible “*wenn die allgemeinen Auslegungsregeln kein genügend klares Resultat zu liefern vermögen*”¹¹⁶⁷.

The confusion in case law reveals the general lack of principles and ambiguity to understand Art. 3 para. 2 OECD Model. More recent case law, however, increasingly follows the “*International Law Theory*”, concluding that domestic law should *generally* not be referred to when interpreting DTCs, its application being subsidiary to general methods of interpretation. Therefore, domestic law may only be taken into account as a last resort and when interpretation is not possible by other means. The author hopes that the Federal Supreme and Administrative Court will, in the future, maintain this more straight-forward method of interpretation and abandon the “*methodless*” and “*unclear*” practice previously followed in relation to Art. 3 para. 2 OECD Model¹¹⁶⁸.

5.2.3.5.4 Intermediate Conclusion

Methodologically, Art. 3 para. 2 OECD Model constitutes an international treaty clause and should, thus, be subject to the methods of interpretation in Arts. 31 to 33 VCLT. According to the rules on interpretation in the VCLT, Art. 3 para. 2 OECD Model states that, if a definition is not provided for in the agreement, to understand the “*ratio legis*” of the norm, the interpretation must be conducted according to its context and taking into account the objective and purpose of the DTC. In this sense, the core objectives of DTCs are the avoidance of double taxation and the prevention of fiscal evasion. In this regard, an interpretation following the domestic law of one of the contracting states is likely to be in contradiction with the agreement and compromises its purpose. By having recourse to domestic law, there is a risk that qualification conflicts will arise, potentially triggering double taxation or double non-taxation. Double taxation must be avoided through a consistent agreement.

¹¹⁶⁶ Federal Administrative Court 21 January 2010, cons. 3.6.1. (A-7789/2009).

¹¹⁶⁷ Federal Administrative Court 30 November 2010, cons. 4.3. (A-4911/2010).

¹¹⁶⁸ See WALDBURGER, Die Auslegung von Doppelbesteuerungsabkommen, p. 66.

This thesis submits and concludes that preference should be given to the “*International Law Theory*” in order to ensure the most autonomous and uniform interpretation of DTCs possible¹¹⁶⁹. Consequently, interpretation should not follow the domestic rules applicable to ordinary domestic statutes. Recourse to domestic law is only admissible if an agreement expressly refers to it. Otherwise, such recourse should be a last resort, only turned to if the general principles of interpretation laid down in Arts. 31 to 33 of the VCLT do not provide a definitive and clear meaning of the relevant term or phrase¹¹⁷⁰.

This does not signify that domestic law is of no relevance for the contracting states when interpreting international agreements. In fact, when an autonomous interpretation is reached, a higher significance may be given to internal law. There is often a connection between DTC provisions and domestic law provisions, and therefore an interpretation according to internal law may occasionally be justified. Generally though, an interpretation deriving from internal law would not necessarily have to be taken into account in the interpretation of DTCs.

The alternative view would result in differences in interpretation, which inevitably lead to international double taxation or international double non-taxation¹¹⁷¹. For these reasons, Art. 3 para. 2 OECD Model must be applied restrictively and should follow the objective and purpose of the general international principles of interpretation deriving from Art. 31 et seq. VCLT¹¹⁷². On this basis, Art. 3 para. 2 OECD Model would appear to be redundant. As a result, some leading scholars went a step further and suggested to eliminate this provision¹¹⁷³.

5.2.3.5.5 Timing Issues Related to Changes of the “Lex Fori”

In the event that there is an effective “*renvoi*” to domestic law, the question arises as to which internal law must be referred to - the law at the moment

¹¹⁶⁹ See Chapter 5.2.3.5.2.

¹¹⁷⁰ HONGLER, *Hybride Finanzierungsinstrumente*, p. 210.

¹¹⁷¹ See Chapter 5.2.3.5.1.

¹¹⁷² LOCHER, *Einführung internationales Steuerrecht Schweiz*, p. 129.

¹¹⁷³ VOGEL/PROKISCH, *General report on the interpretation of double taxation*, p. 53.

the DTC was signed or the law at the time of interpretation?¹¹⁷⁴ This discussion distinguishes static “*renvoi*” from so-called ambulatory or dynamic “*renvoi*”¹¹⁷⁵. According to a literal interpretation of Art. 31 para. 1 VCLT, static “*renvoi*” must apply. Ian Sinclair, however, analyzed ICJ court decisions and demonstrated that the ambulatory or dynamic “*renvoi*” prevails. He concludes that such a method is appropriate¹¹⁷⁶ as it takes the latest developments into account. It should be noted that this interpretative method may violate the “*pacta sunt servanda*” principle and, thus, impact upon the legal certainty of the agreement¹¹⁷⁷, whose original intention may not be fulfilled. Despite the noted issues, this interpretative method is also preferred by the OECD¹¹⁷⁸. In particular, Art. 3 para. 2 OECD Model, in connection with Art. 2 para. 4 OECD Model, leads to the application of dynamic “*renvoi*”. According to these articles, taxes arising after the ratification of the DTC will nevertheless be subject to it. Therefore, the OECD Model does not refer to the applicable law at the time of ratification but rather to the actual law including its latest developments. It may be argued that the objective of the legislator was that the “*renvoi*” to the “*lex fori*” included in Art. 3 para. 2 OECD Model always referred to current internal law.

The possibility to interpret an undefined term according to domestic law presents the risk that a state could override a DTC by amending its domestic provisions. The application of dynamic “*renvoi*” is therefore limited in the case of substantial changes occurring in internal tax law which would be contrary to the content and purpose of the DTC between the two contracting states.

¹¹⁷⁴ For the avoidance of doubt, references to an internal law in this context are generally taken to exclude references to that legal system’s conflict of law rules. On the topic of *renvoi* in general see: SHARPE, The Multiple Uses of Renvoi in Rule and Interest Analysis-Based Choice-Of-Law Regimes.

¹¹⁷⁵ FITZMAURICE, International Court of Justice, p. 359 et seq.

¹¹⁷⁶ SINCLAIR, Interpretation, p. 83 et seq.; WATTEL/MARRES, Characterization of Fictitious Income, p. 71 as well as WATTEL/MARRES, Legal Status of the OECD Commentary, p. 223.

¹¹⁷⁷ E contrario: WATTEL/MARRES, Legal Status of the OECD Commentary, p. 222.

¹¹⁷⁸ OECD Commentary 2014, nr. 13 ad. Art. 3.

5.2.3.6 *The Relevance of Parallel Treaties*

Another controversial issue is whether other DTCs concluded by Switzerland may be considered a “*source of interpretation*”¹¹⁷⁹. More concretely, Sergio André Rocha questions “*whether other DTCs entered into by the contracting states can be considered internal law for the purpose of the renvoi referred to in paragraph 2 of Article 3 of the conventions*”¹¹⁸⁰. Although one must not disregard the interpretative value that parallel treaties may offer, they should not be considered internal legislation for the purpose of the “*renvoi*” in Art. 2 para. 3 OECD Model. The specific purpose of this provision is to seek definitions from domestic law. However, no DTC provision reflects the domestic definition or interpretation of a particular term. Consequently, parallel treaties should not be considered to constitute internal law. However, this does not mean that parallel DTCs may not be a source of inspiration and aid throughout the interpretation process¹¹⁸¹.

5.2.3.7 *The Relevance of Foreign Legislation*

In order for authorities and courts to effectively avoid double taxation in both contracting states, a common interpretation - one which is most likely to be accepted in both contracting states - should be sought¹¹⁸². This was observed by Kees Van Raad in 1996: “*Knowledge of the reasoning of foreign colleagues should, in particular, prove useful on questions involving the more complex treaty provisions*”¹¹⁸³. The German Supreme Court¹¹⁸⁴, for instance, follows the “*principle of uniform interpretation*” (“*Gebot der Entscheidungsharmonie*”; “*principe de l’interprétation concordante*”), according to which the tax authority should take foreign legislation into account when interpreting DTCs. However, they should not refer to foreign practices without a clear and precise understanding of their meaning and significance. According to Peter Locher, this method is not officially recognized

¹¹⁷⁹ SANDLER, Tax Treaties and Controlled Foreign Company Legislation, p. 83.

¹¹⁸⁰ ROCHA, Interpretation Double Taxation Conventions, p. 127.

¹¹⁸¹ AVERY JONES, National report on the interpretation of double taxation conventions, p. 611; ROHATGI, Basic International Taxation, p. 47.

¹¹⁸² OBERSON, Précis de droit fiscal international, p. 38.

¹¹⁸³ VAN RAAD, Interpretation and Application of Tax Treaties by Tax Courts, p. 5.

¹¹⁸⁴ Among others: German Supreme Court of 24 February 2000, 399 (BStBl. II 2000).

in Switzerland, even though several court decisions have implicitly applied the concept in seeking harmonized interpretations¹¹⁸⁵.

To the contrary, according to Robert Waldburger¹¹⁸⁶, the principle of uniform interpretation is doubtlessly referred to in academic literature¹¹⁸⁷. However, there has been no implicit or explicit mention of this method with regards to the interpretation of DTCs¹¹⁸⁸ from a Swiss perspective. Furthermore, based on two court decisions¹¹⁸⁹, the author demonstrates that DTCs should only be interpreted from a Swiss point of view, without taking foreign concepts into consideration¹¹⁹⁰. If foreign concepts and practices were to be taken into account, this would require an explicit legal provision¹¹⁹¹. Today, in principle, Swiss authorities and courts do not take foreign legislation and foreign court decisions into consideration when interpreting DTC terms. Rather, they follow an interpretation according to Swiss domestic law¹¹⁹².

5.3 Final Considerations on the Interpretation of Double Tax Conventions to Collective Investment

¹¹⁸⁵ LOCHER, Einführung internationales Steuerrecht Schweiz, p. 129.

¹¹⁸⁶ WALDBURGER, Die Auslegung von Doppelbesteuerungsabkommen, p. 58. In this vein also HONGLER, Hybride Finanzierungsinstrumente, p. 202.

¹¹⁸⁷ RIVIER, Interprétation des conventions, p. 125 et seq.; LOCHER, Einführung internationales Steuerrecht Schweiz, p. 129 et seq. and BÉBIE, thesis, p. 41.

¹¹⁸⁸ WALDBURGER, Die Auslegung von Doppelbesteuerungsabkommen, p. 59. In this vein also: BAUMGARTNER, thesis, p. 17.

¹¹⁸⁹ Swiss Federal Supreme Court Judgment of 18 December 1940 (BGE 66 I 265) and Swiss Federal Supreme Court Judgment of 17 March 1967 (BGE 93 I 189).

¹¹⁹⁰ According to a Swiss Federal Supreme Court Judgment of 18 December 1940, cons. 1 (BGE 66 I 265): “*Es ist nicht darauf Rücksicht zu nehmen, ob die deutsche Praxis sich auf einen anderen Boden stellt.*”

¹¹⁹¹ Swiss Federal Supreme Court Judgment of 26 May 1967 (BGE 93 I 194).

¹¹⁹² BERNEHARDT/BEYERLIN, Recht zwischen Umbruch und Bewahrung, p. 1554.

Schemes and Trusts – Methodological and Systematic Interpretation

The interpretation of DTCs, and the legal sources of those DTCs such as the VCLT¹¹⁹³, the OECD Model, its Commentaries¹¹⁹⁴ and Reports¹¹⁹⁵, domestic tax legislation¹¹⁹⁶, parallel treaties¹¹⁹⁷ and foreign legislation¹¹⁹⁸ are of considerable importance to the avoidance of double taxation. The methods of such interpretation are also paramount in the avoidance of double taxation. In this sense, since DTCs are “*worded in a rather abstract and general way, setting out basic principles rather than detailed rules*”¹¹⁹⁹ interpretation and methods of interpretation are key aspects to avoid double taxation. The aim of this section is to summarize and propose a basis for a methodological and systematical method of interpretation in light of Swiss DTCs, and the current OECD Model and its Commentaries. The OECD Model and its Commentaries will be of particular relevance when the author performs the analysis in connection with hybrid entities such as CISs and trusts¹²⁰⁰.

The issue of interpretation is far from being unanimously resolved. In this sense, it is fair to say that it is accepted and recognized that DTC interpretation should be done in light of the VCLT, and the different OECD materials; however, there is no uniform and recognized approach for the selection (“*Reihenfolge*”; “*séquence*”) of the interpretation rules included in Arts. 31-

¹¹⁹³ See Chapter 5.2.3.1.

¹¹⁹⁴ See Chapter 5.2.3.2.

¹¹⁹⁵ See Chapter 5.2.3.3.

¹¹⁹⁶ See Chapter 5.2.3.5.

¹¹⁹⁷ See Chapter 5.2.3.6.

¹¹⁹⁸ See Chapter 5.2.3.6.

¹¹⁹⁹ WHEELER, Persons qualifying for treaty benefits, p. 52.

¹²⁰⁰ See Chapter 6.

33 of the VCLT¹²⁰¹. As will be demonstrated, this selection can impact the application of the OECD materials and the final interpretation of a DTC¹²⁰².

Generally, if the term under analysis is defined in the DTC, it should be interpreted by reference to the relevant DTC and, if that DTC follows the OECD Model and the relevant country is an OECD member state (such as Switzerland)¹²⁰³, the interpretation should also be undertaken in light of the relevant OECD materials (including the OECD Model and its Commentaries). As a rule, one should refer to the Commentary in force at the time of the conclusion of the DTC (static approach), or as long as the treaty's original intention is safeguarded, to a version of the Commentary that is more recent than the applicable treaty¹²⁰⁴. While OECD Reports¹²⁰⁵, other countries' court decisions¹²⁰⁶, parallel treaties¹²⁰⁷ and foreign legislation¹²⁰⁸ may be a source of inspiration and aid throughout the interpretative process, these should not necessarily be given more legal weight than ordinary scholarly writing¹²⁰⁹. It should be noted, however, that the OECD Reports simply constitute a source of non-binding legal guidance, which may only have "*moral force*"¹²¹⁰.

¹²⁰¹ Most authors generally only state that the legal status of the OECD Commentary remains unclear without referring to the issue of selections. Among others: RIVIER, *Interprétation des conventions*, p. 113; RYSER, *Introduction au droit fiscal international de la Suisse*, p. 126; OBERSON, *Précis de droit fiscal international*, p. 29; DANON, thesis, p. 262; SCHWARZ, *Tax treaties*, p. 42; AVERY JONES, *Interpretation of Tax Treaties*, Part I, p. 14, 90; PROKISCH, *Auslegung von Doppelbesteuerungsabkommen*, p. 52; VIITALA, thesis, p. 73.

¹²⁰² See Chapter 5.2.3.2.

¹²⁰³ See Chapter 5.2.3.2.

¹²⁰⁴ See Chapter 5.2.3.2.2.

¹²⁰⁵ See Chapter 5.2.3.3.

¹²⁰⁶ See Chapter 5.2.3.4.

¹²⁰⁷ See Chapter 5.2.3.6.

¹²⁰⁸ See Chapter 5.2.3.7.

¹²⁰⁹ In this vein: DANON, thesis, p. 266.

¹²¹⁰ AVERY JONES et al., *The Interpretation of Income Tax Treaties with Particular Reference to the Commentaries on the OECD Model*, p. 8.

On the other hand, if the term is not defined in the DTC, Art. 3 para. 2 OECD Model does not automatically follow the domestic rules applied to ordinary domestic statutes. Recourse to domestic law, with preference given to its domestic tax law (“*lex fori*” interpretation)¹²¹¹ is only admissible if an agreement expressly refers to it. This recourse is generally of last resort, and only if application of the general principles of interpretation of Arts. 31 to 33 of the VCLT do not result in a definitive and clear meaning of the relevant term or phrase. As a rule, “*static renvoi*” is applied, meaning that the internal law at the moment when the DTC was signed is applicable¹²¹². Where there is such a reference to domestic law, certain issues arise regarding the interpretation of DTC terms by different contracting states who apply the general “*renvoi*” provision of Art. 3 para. 2 OECD Model¹²¹³.

Several scholars suggested that the interpretation of the undefined treaty term should be tested by giving it an autonomous interpretation under the VCLT in order to ensure that the result is an acceptable meaning of the term within the limits of Arts. 31 to 33 VCLT¹²¹⁴. In particular, these limits provide for literal and grammatical arguments (based on the meaning of the words), systematic arguments (based on the contract as a whole), teleological arguments (based on the object and purpose of avoiding double taxation) and, as a subsidiary principle, historical arguments (based on materials from negotiations). Approaching interpretation by reference to an autonomous interpretation should ensure that the common intention of the parties is respected and an acceptable meaning of the term in question is applied¹²¹⁵.

As per the approach followed in Switzerland, even though it is accepted and recognized that DTC interpretation should be done in light of the VCLT, and the different OECD materials., there is no uniform and recognized approach for the selection (“*Reihenfolge*”; “*séquence*”) of the interpretation rules included in Arts. 31-33 of the VCLT. It is uncertain, in this sense, which of those articles should be given priority when interpreting a DTC. This, in turn, influences on how much weigh the OECD materials have in the final interpretation, and whether they should be considered as “*supplementary*”

¹²¹¹ See Chapter 5.2.3.5.

¹²¹² See Chapter 5.2.3.5.5

¹²¹³ See Chapter 5.2.3.

¹²¹⁴ Amongst others: BAUMGARTNER, thesis, p. 36.

¹²¹⁵ See Chapter 5.2.3.1.

means of interpretation"; as the "*special meaning*"; as the "*ordinary meaning*"; or as constituting "*their context*"¹²¹⁶.

The Federal Tribunal and the Federal Administrative Tribunal, for instance, regularly refer to the OECD Commentary as an interpretative aid in their recent case law. It is unclear, however, whether the legal basis for such reference is founded on Art. 32 VCLT or on Art. 31 VCLT as well.

The manner of choosing interpretative aids without a definitive guidance and the lack of uniformity in this context may be observed in the case of Art. 3 para. 2 OECD Model, dealing with the application of domestic law. Interpretative terms from domestic law should only be used as an "*ultima ratio*", and as long as a definitive and clear meaning of the treaty term cannot be deduced. This approach, however, is not unanimously followed, and case law has been ambiguous when interpreting Art. 3 para. 2 OED Model. Recent case law, though, has increasingly followed the "*International Law Theory*", concluding that domestic law should *generally* not be referred to when interpreting DTCs, and its application should be subsidiary to the general methods of interpretation.

¹²¹⁶ See Chapter 5.2.2.

Part 3
Application of Double Tax Con-
ventions to Collective Investment
Schemes and Trusts

Part 3 - Application of DTCs to CISs and Trusts

6 Conditions for the Application of Double Tax Conventions

Doubt is not an agreeable condition, but certainty is an absurd one
(François-Marie Arouet (Voltaire), 1694-1778)

6.1 General Introduction

In this chapter, the author will try to determine whether DTCs can be applied to CISs and Trusts. In order to answer this question, the author will first outline the work of the OECD in the field of hybrid entities, such as CISs, Trusts and Partnerships, providing a systematic overview and explaining the content and aim of these OECD Reports¹²¹⁷. In a second step, the OECD Reports will systematically be outlined and compared to each other with regard to the definition of the terms (i) “*person*”, (ii) “*resident*”, (iii) “*beneficial owner*” and (iv) “*attribution of income*”¹²¹⁸. In particular, the requirements of person¹²¹⁹, residency¹²²⁰, beneficial ownership¹²²¹ and attribution of income¹²²² will be analyzed as pertains to the applicability of DTCs to CISs, Trusts and Partnerships in light of the OECD Reports. This section will analyze in detail how each requirement has been interpreted and applied in case law and by scholars. Furthermore, in this chapter the author will provide an overview of how the relief methods of Arts. 23A and 23B of the OECD

¹²¹⁷ See Chapter 6.1.1.

¹²¹⁸ See Chapter 6.1.2.

¹²¹⁹ See Chapter 6.1.2.3.2.

¹²²⁰ See Chapter 6.1.2.3.3.

¹²²¹ See Chapter 6.1.2.3.4.

¹²²² See Chapter 6.1.2.3.5.

Model Tax Convention apply to these hybrid entities¹²²³. Thereafter, the author will analyze the scope and delimitation of each Report in order to understand their respective application to hybrid entities such as partnerships, CISs and trusts¹²²⁴. Additionally, the author will overview practical cases to solve situations of conflict of qualifications¹²²⁵. Finally, the requirements for DTC access are analyzed individually in greater detail, taking into consideration relevant court decisions as well as literature¹²²⁶. Due to the systematic approach of the analysis, where the requirements for DTC access are considered from multiple perspectives, certain repetitions are intended for the purpose of clarity and in order to ensure a comprehensive overview.

The application of DTCs to hybrid entities such as CISs and trusts is a controversial and debated issue in international tax law. Even today, there is a lack of clear methodology establishing a uniform framework for the application of DTCs to CISs and trusts. This is particularly significant given the rapid globalization that has taken place in recent years, and the corresponding increasing importance of CISs and trusts.

By way of analogy to Voltaire, “*certainty*” cannot be achieved in respect of the application of DTCs to hybrid entities such as CISs and trusts. Despite the existence of such uncertainties in international tax law, CISs and trusts have gained real economic significance and have become increasingly relevant within Switzerland’s financial center, due to their various advantages for wealth owners¹²²⁷.

In today’s tax-transparent and increasingly globalized world, securing DTC access for CISs and trusts has become a key aspect for investors and beneficiaries. For lawyers, tax advisers, relationship managers, parties involved in trust relationships (including beneficiaries, trustees, settlors and protectors) and parties involved in CIS relationships (such as investors and fund managers), it is paramount that these issues are resolved in order to avoid conflicts between multiple tax jurisdictions that could result in double taxation and deter investors from using these types of structures. From a purely economic

¹²²³ See Chapter 6.1.2.3.6.

¹²²⁴ See Chapter 6.1.3.

¹²²⁵ See Chapter 6.6.

¹²²⁶ See Chapters 6.2; 6.3; 6.4 and 6.5.

¹²²⁷ See Chapter 1.

perspective, this question is directly linked with the performance of investments made through CISs and trusts. For lawyers, investors and other stakeholders, the prospect of uncertainty in this area of law may be troublesome¹²²⁸. Most financial centers, such as Switzerland, have not yet realized that providing for a clear framework to apply DTCs to CISs and trusts could be a source of relevant competitive advantage in today's transparent world, and would likely attract new investments as the after-tax return becomes increasingly important.

As mentioned, there are legal uncertainties regarding the interpretation of the various tax criteria applied across different tax jurisdictions, and the question of whether CISs and trusts can gain access to DTCs. For example, it is not clear whether CISs and trusts are considered "*liable to tax*" and therefore "*resident*" for Swiss DTC purposes, within the meaning of Art. 4 para. 1 OECD Model. In this sense, three main taxation models for CISs and trusts may be defined: (i) in some jurisdictions, CISs (and by analogy, to trusts) are treated as fiscally-transparent entities ("*flow-through*")¹²²⁹; (ii) in others, they are tax-exempt entities ("*tax-exempt*")¹²³⁰; and (iii) in some, they are considered to present the essential characteristics of a tax-subject ("*fiscally-opaque*")¹²³¹. The question of whether a CIS or trust itself may benefit from a DTC depends, amongst other conditions, on each jurisdiction's tax treatment and which tax classification is applied in a cross-border scenario by the residence and source state.

¹²²⁸ For trusts see in this vein: RYSER, double taxation treaties, p. 310.

¹²²⁹ See generic model (a) in: BONGAARTS/ED, General report on the taxation of investment funds, p. 38.

¹²³⁰ See generic models (b), (c) and (d) in: BONGAARTS/ED, General report on the taxation of investment funds, p. 38.

¹²³¹ See generic models (e) in: BONGAARTS/ED, General report on the taxation of investment funds, p. 38.

6.1.1 Systematic Overview of the Work of the OECD in the field of Hybrid Entities

6.1.1.1 General Remark

This chapter provides an analysis as well as a systematic overview of the recent OECD work in the field of hybrid entities (Partnerships, Collective Investment Schemes and Trusts). Within this scope, the crucial question arises as to whether and under what conditions the (i) Partnership Report (inserted into the 2000 version of the OECD Commentary), (ii) Collective Investment Vehicle Report (inserted into the 2010 version of the OECD Commentary) and (iii) Discussion Draft on BEPS Action 2 Draft (Treaty Issues) may be applicable.

Recently, the OECD has paid particular attention to trusts in the context of the “*beneficial ownership*” requirement by the OECD Discussion Draft on Clarification of the Meaning of “*Beneficial Owner*” in the OECD Model Tax Convention of 29 April 2011 (hereafter: the “*Discussion Draft on Beneficial Owner*”)¹²³², and the Revised Discussion Draft on Clarification of the Meaning of “*Beneficial Owner*” of 19 October 2012 (hereafter: the “*Revised Discussion Draft on Beneficial Owner*”)¹²³³, both of which aim at providing some clarity to such complex arrangements. In these Discussion Drafts, the OECD attempted for the first time to address some of the more controversial questions relating to the “*beneficial ownership*” requirement for trusts. Finally, the changes of the Revised Discussion Draft were included in the OECD’s latest Commentary, published on 15 July 2014.

¹²³² See the Report of the OECD’s Committee on Fiscal Affairs (“*CFA*”), Clarification of the Meaning of “Beneficial Owner” in the OECD Model Tax Convention, in: Public Discussion Draft, 29 April 2011.

¹²³³ See the Report of the OECD’s Committee on Fiscal Affairs (“*CFA*”), Clarification of the Meaning of “Beneficial Owner” in the OECD Model Tax Convention, in: Public Revised Discussion Draft, 19 October 2012.

6.1.1.2 *Partnership Report*

On August 16, 1999, the OECD Committee on Fiscal Affairs (CFA) released a report titled “*Application of the OECD Model Tax Convention to Partnerships*” (hereafter: the “*Partnership Report*”). The primary issue discussed in the Partnership Report, as reflected by the title of the Report, was the application of the OECD Model Convention to partnerships. These recommendations are, in fact, amendments to the OECD Commentary within the framework of its 2000 update.

The report addresses the application of the OECD Model to partnerships,¹²³⁴ illustrated by examples of cases in which the OECD identified issues regarding the entitlement of partnerships to access DTCs. It focuses on asymmetrical situations in which one jurisdiction allocates income to a partnership, whereas another jurisdiction does not consider partnerships to be taxable entities, resulting in the income being allocated to the partners. The main difficulty arose from the varying degrees of tax transparency in different jurisdictions, ranging from fully-transparent to fiscally-opaque. This conflict has been the cause of much debate among scholars.

The main conclusions of the Partnership Report are the following: (i) partnerships are considered persons within the definition of Article 3 because they either fall under the definition of a company or they form a body of persons, respectively; (ii) if a partnership is fiscally-transparent, it cannot be considered a resident of a state; (iii) the test as to whether a partnership is fiscally-transparent includes analyzing the amount of tax paid by the partnership that is related to the personal characteristics of the partners; (iv) if the partnership is not entitled to DTC benefits, the partners are entitled to access to the treaty that their state of residency has entered into, but only to the extent of the respective income allocated to each partner by the partnership; (v) the state of source is bound by the qualification of the state of residence of the partnership.

¹²³⁴ Jacques Sasseville has observed that the principles and solutions discussed in the Partnership Report are similar to the solution adopted by the 1996 US Model and the final regulations to IRC 894 (c), which also applies to trusts and other similar hybrid entities. See: SASSEVILLE, Partnership Report, p. 623 et seq.

6.1.1.3 *Collective Investment Vehicle Report*

Seven years after the Partnership Report's publication, in February of 2006, the Committee on Fiscal Affairs (CFA) established the OECD's Informal Consultative Group (ICG) which published the "*Report on the Taxation of Collective Investment Vehicles and Procedures for Tax Relief for Cross-Border Investors*" of 12 January 2009 (hereafter: the "*ICG Report*")¹²³⁵. Two modified reports followed and were published on 9 December 2009, and 12 January 2010, on "*The Granting of Treaty Benefits with respect to the Income of Collective Investment Vehicles*" (hereafter: the "*Discussion Draft on CFA Report*")¹²³⁶. Both of them deal with these controversial questions as well. On 31 May 2010, the CFA adopted the Discussion Draft in its final version (hereafter: the "*CFA Report*")¹²³⁷. The CFA Report's conclusions and recommendations mainly follow those of the ICG Report and the Discussion Draft on the CFA Report. These recommendations are, in fact, amendments to the OECD Commentary. On 22 July 2010, they were approved and included in the OECD Commentary within the framework of its 2010 update¹²³⁸. These conclusions remain in the latest 2014 version of the OECD Commentary.

The CFA Report is divided into two parts. In its first part, the OECD Committee addresses the treaty entitlement of CISs according to the provisions of the OECD Model, and discusses the question of whether a CIS may be considered a resident person as well as the beneficial owner of income. In the second part, the OECD Committee proposes model provisions for member states to use as a basis when drafting DTCs. The main conclusions of the Collective Investment Vehicle Report are: (i) application of the term CIS is limited to funds that are widely held in a diversified portfolio of securities

¹²³⁵ See the Report of the OECD's Informal Consultative Group ("*ICG*"), *The Taxation of Collective Investment Vehicles and Procedures for Tax Relief for Cross-Border Investors, on the Granting of Treaty Benefits with respect to the Income of Collective Investment Vehicles*, in: OECD Report, 12 January 2009.

¹²³⁶ See the Report of the OECD's Committee on Fiscal affairs ("*CFA*"), *The Granting of Treaty Benefits with respect to the Income of Collective Investment Vehicles*, in: Public Discussion Draft, 9 December 2009 and 12 January 2010.

¹²³⁷ See the Report of the OECD's Committee on Fiscal affairs ("*CFA*"), *The Granting of Treaty Benefits with respect to the Income of Collective Investment Vehicles*, in: OECD Report, 31 May 2010.

¹²³⁸ OECD Commentary 2014, nr. 6.8 et seq. Art. 1.

whilst being subject to investor protection regulation in the country in which they are established; (ii) a CIS structured as a company is a person as defined by Article 3 of the OECD Model Convention, but is not a person if it is treated as a form of joint ownership; (iii) when the CIS is structured as a trust, the issue becomes less clear, and whether the CIS can be considered a person as defined by Article 3 of the OECD Model Convention will depend either on whether both contracting countries recognize the trust as a taxpayer, or whether they have negotiated the inclusion of trusts in the treaty; (iv) as for the residency test, legal form and the tax treatment of the CIS varies from country to country. Therefore, the issue should be addressed through bilateral negotiations; (v) a widely-held CIS should be treated as the beneficial owner of the income it receives, so long as the managers of the CIS have discretionary powers to manage the assets on behalf of the CIS's interest holders, and the CIS meets the requirements of being a person and a resident; (vi) if the CIS is not able to claim tax treaty benefits, a system allowing the CIS to make claims with respect to investors would be in the best interests of business and governments, avoiding administrative difficulties that would arise from each individual investor having to submit a claim.

6.1.1.4 OECD Discussion Draft and Final Report on BEPS Action Nr. 2 (Treaty Issues)

On March 19, 2014, the OECD released two Public Discussion Drafts as part of its Base Erosion and Profit Shifting (hereafter: “*BEPS*”) Action Plan, relating to Action 2, Hybrid Mismatch Arrangements. The BEPS Action Plan, adopted by the OECD in July of 2013, is aimed at ensuring that hybrid instruments and entities are not used to unduly obtain benefits of treaties, for example, by using schemes that result in double non-taxation. On October 5, 2015, the OECD released its Final Report on BEPS Action Nr. 2.

The first document (BEPS Action Nr. 2: Neutralise the Effects of Hybrid Mismatch Arrangements, Recommendations for Domestic Laws) provides recommendations for domestic rules to be adopted by countries in order to neutralize the differences in the taxation treatment of hybrid mismatch arrangements (hybrid entities and hybrid instruments). The second document (BEPS Action Nr. 2: Neutralise the Effects of Hybrid Mismatch Arrangements, Treaty Issues) discusses the effect of those rules on the OECD Model Tax Convention and proposes changes to the Convention as pertains to the treatment of hybrid entities. Of particular interest to this study is the second topic of this document, focused on “*ensuring that transparent entities are*

not used to obtain the benefits of treaties unduly". This second document complements the first one, and suggests changes such as an express provision in the OECD Model Tax Convention, which would ensure that hybrid entities which are wholly or partly fiscally-transparent ("*flow-through*") are not unduly used to obtain treaty benefits. This provision aims to guarantee that the attribution of income rule derived from the Partnership Report applies also to wholly or partly fiscally-transparent entities or arrangements "*that were not directly covered by the Report*"¹²³⁹. The provision, therefore, clearly does not apply to tax-exempt entities ("*tax-exempt*") and tax-subject entities ("*fiscally-opaque*"). The suggested provision reads as follows¹²⁴⁰:

"For the purposes of this Convention, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State shall be considered to be income of a resident of a Contracting State but only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State."

The main conclusions and recommendations of BEPS Action Nr. 2 (Treaty issues) are threefold. Firstly, the report deals with dual resident entities, concluding that: (i) the proposed revised version of Article 4(3) of the Discussion Draft of Action nr. 6 (Preventing Treaty Abuse) does not address all of the BEPS' concerns regarding dual-resident entities, (ii) countries should include provisions in their domestic laws to deem an entity that is not a resident of a particular country under a tax treaty to not be considered a resident under domestic law, and (iii) comments should be made to the continuing discussion of the draft on Action Nr. 6.

Secondly, and of particular interest to this study, the Final Report proposes a modification to Article 1 of the Convention explicitly inserting an "*attribution rule*" concerning hybrid entities¹²⁴¹. This rule would apply only to wholly or partly fiscally-transparent ("*flow-through*") entities or arrangements, and determines that the income derived by these entities will only be

¹²³⁹ OECD, Final Report on BEPS Action Nr. 2, ad Art. 1 para. 26.5 (Treaty Issues).

¹²⁴⁰ OECD, Final Report on BEPS Action Nr. 2, ad Art. 1 para. 2 (Treaty Issues).

¹²⁴¹ See provision as outlined above.

considered income of the resident provided that the income is treated, for purposes of taxation by that state, as income of a resident of that state.

Finally, the Final Report points out the need of coordinating changes in domestic law and how this may affect articles of the Convention, specifically with regards to (i) denial of deductions, (ii) elimination of double-taxation, (iii) potential application of anti-discrimination provisions in the Convention.

6.1.2 Comparison of the Partnership Report, Collective Investment Vehicles Report and the OECD Final Report on BEPS Action Nr. 2

6.1.2.1 General Remark

In this Chapter, the findings of the Partnership Report, the Collective Investment Vehicles Report, and the recent OECD Final Report on BEPS Action Nr. 2 (Treaty Issues) will be systematically outlined and compared amongst each other with regard to the definition of the terms (i) “*person*”, (ii) “*resident*”, (iii) “*beneficial owner*” and (iv) “*attribution of income*”. The aim is to outline and clarify the main findings of these OECD materials in a comparative view whilst addressing any divergences from the findings. The delimitation of the Partnership Report as well as the Final Report on BEPS Action Nr. will be discussed in the following Chapters¹²⁴². This Chapter deals exclusively with the Reports themselves and the OECD Commentaries in which the suggestions from the Reports have ultimately been included¹²⁴³.

¹²⁴² See Chapter 6.1.3.

¹²⁴³ The Partnership Report was included in the 2000 update of the OECD Commentary whereas the CIVs Report was ultimately included in the 2010 revision of the OECD Commentary.

6.1.2.2 *Definitions of Hybrid Entities*

6.1.2.2.1 Introduction

This Chapter will assess the definitions of hybrid entities¹²⁴⁴ by analysing the Partnership Report, the Collective Investment Vehicles Report, and the OECD Final Report on BEPS Action Nr. 2 (Treaty Issues). Moreover, it will describe their scope and situations to which each of these Reports apply. Finally, it will shift to an overall conclusion by comparing all three Reports.

6.1.2.2.2 The Partnership Report

The Partnership Report defines partnerships as “*entities that qualify as such under civil or commercial laws*” of each contracting country¹²⁴⁵. The Partnership Report refers to the domestic laws (in particular civil and commercial laws) of each contracting state and therefore creates no separate definition of the term “*partnership*” within the Partnership Report.

6.1.2.2.3 The Collective Investment Vehicles Report

The Collective Investment Vehicles Report, as opposed to the Partnership Report, contains a proper definition of CISs which does not distinguish between the various legal forms Collective Investment Schemes may adopt in practice. The CIVs Report limits the scope of the report to CISs defined as funds that are (i) widely held, (ii) hold a diversified portfolio of securities, and (iii) are subject to investor-protection regulation in the country in which they are established¹²⁴⁶. The CIVs Report acknowledges that CISs can take various legal forms depending on the country in which they are established,

¹²⁴⁴ This is an undefined term in tax law which generally refers to persons other than individuals and companies such as partnerships, non-corporate CISs (following the definition in the OECD Commentary) and trusts (following the definition in the Hague Convention), which are either (i) fiscally-transparent entities (“*flow-through*”), or (ii) partially or completely tax-exempt entities (“*tax-exempt*”). These entities bear the risk of mismatches due to differences which could arise under the domestic tax laws of the residence and source states such as qualification conflicts, which may then lead to different treatment under, and differential application of, DTCs.

¹²⁴⁵ OECD, Partnership Report, para. 2 and OECD Commentary 2014, nr. 2 ad. Art. 1.

¹²⁴⁶ CFA Report, para. 1 and OECD Commentary 2014, nr. 6.8 ad. Art. 1.

such as contracts, trusts, and contractual arrangements¹²⁴⁷. Interestingly, the CIVs Report does not refer to the partnership form as a CIS¹²⁴⁸, as opposed to e.g. the Swiss Federal Act on Collective Investment Schemes of 23 June 2006 (CISA), where the partnership form is seen as a CIS for Switzerland.

6.1.2.2.4 The OECD Final Report on BEPS Action Nr. 2 (Treaty Issues)

Lastly, the OECD Final Report on BEPS Action Nr. 2 broadly refers to hybrid mismatch “*entities or arrangements*”¹²⁴⁹ that are unduly used to obtain treaty benefits. The Final Report contains a wide definition of entities and mismatch arrangements, namely “*(...) entities or arrangements that one or both contracting states treat as wholly or partly fiscally transparent for tax purposes*”¹²⁵⁰, resulting in a lower aggregate tax burden for the parties to the arrangement. The OECD Final Report on BEPS Action Nr. 2 encompasses hybrid entities that are treated differently under the laws of two or more jurisdictions, and hybrid instruments (including hybrid financial instruments and transfers, hybrid entity payments, and reverse and imported mismatches) that are treated differently under the laws of two or more jurisdictions¹²⁵¹. This usually involves the conflict of fiscally-transparent and fiscally-opaque entities. It is important to point out that the OECD Final Report on BEPS Action Nr. 2 only targets entities or arrangements that result in an erosion of the tax base in one or more jurisdictions where the arrangement is structured¹²⁵².

The OECD Final Report on BEPS Action Nr. 2 expands the definition provided by the Partnership Report. Its scope includes the income of “*wholly or partly fiscally transparent entities or arrangements*” that were not directly addressed by the Partnership Report such as trusts¹²⁵³. Paragraph 37 of the

¹²⁴⁷ CFA Report, para. 1 and OECD Commentary 2014, nr. 6.8 ad. Art. 1.

¹²⁴⁸ In this vein also: STEVENS, Comparison between Partnership and Collective Investment Schemes Report, p. 104.

¹²⁴⁹ OECD, Final Report on BEPS Action Nr. 2, Art. 1 (Treaty Issues).

¹²⁵⁰ OECD, Final Report on BEPS Action Nr. 2, ad Art. 1 para 26.3 (Treaty Issues).

¹²⁵¹ OECD Final Report on BEPS Action Nr. 2, para. 1 and 3 (Treaty Issues); OECD Final Report on BEPS Action Nr. 2, para. 23 (Recommendations for Domestic Laws).

¹²⁵² OECD, Final Report on BEPS Action Nr. 2, para. 26 (Recommendations for Domestic Laws).

¹²⁵³ OECD, Final Report on BEPS Action Nr. 2, ad Art. 1 para 26.3 (Treaty Issues).

Partnership Report, indeed, raised the issue of certain difficulties that may arise in its application to entities such as trusts, but deferred the analysis of these entities to a future revised version of the report which has yet to be completed¹²⁵⁴. The BEPS Report addresses the concerns raised in paragraph 37 of the Partnership Report¹²⁵⁵ and provides answers to the issues of entities and arrangements that are considered partly or wholly fiscally-transparent. As a result, it seems that the OECD Final Report on BEPS Action Nr. 2's scope is broader than that of the Partnership or CIVs Report because it refers to "*wholly or partly fiscally transparent*" entities or arrangements for tax purposes¹²⁵⁶.

6.1.2.2.5 Conclusions

It can be concluded and it is fair to say that these reports were drafted to deal with very different problems. Therefore, the result of the above is that the scope of each of the Reports and the definitions contained therein differ, but may sometimes overlap. Nevertheless, the result is that comparing the three documents, it can be noticed that the Partnership Report is the report providing the narrowest scope as it limits its application to hybrid entities structured as partnerships, as defined by the domestic laws of each contracting state¹²⁵⁷. The CIVs Report and the Final Report on BEPS Action Nr. 2, conversely, have a wider scope of application as they apply regardless of the legal form used by the hybrid entity. The CIVs Report and the Final Report on BEPS Action Nr. 2, however, are not identical. The CIVs Report's scope is limited to the named structure in the title, that is, "*Collective Investment Schemes*" ("*kollektive Kapitalanlagen*"; *placements collectifs de capitaux*"), which encompasses all of the various possible legal forms that are

¹²⁵⁴ OECD, Partnership Report, para. 37. This has been confirmed by Patricia Brown who was a member of the working group at the time. See BROWN, Tax Treatment of Collective Investment Vehicles, p. 33.

¹²⁵⁵ OECD Final Report on BEPS Action Nr. 2, ad Art. 1 paras. 26.3 and 26.4 (Treaty Issues).

¹²⁵⁶ OECD Final Report on BEPS Action Nr. 2, para. 26.5 (Treaty Issues).

¹²⁵⁷ See Chapter 6.1.3.2.

widely held, hold a diversified portfolio of securities, and are subject to investor-protection regulation¹²⁵⁸. Conversely, the Final Report on BEPS Action Nr. 2 encompasses entities or arrangements that result in an erosion of the tax base in one or more jurisdictions where the arrangement is structured, irrespective of the individual legal form¹²⁵⁹.

The various definitions provided by the Reports show the diverse nature and characteristics of the entities and arrangements regulated by each Report. They also show the difficulties that may arise when trying to apply the conclusions of one Report to hybrid entities that do not have the same characteristics as the entities and arrangements specifically regulated by that Report. Nevertheless, it is conceivable that both the OECD Final Report on BEPS Action Nr. 2 and the Collective Investment Vehicle Report may be applicable¹²⁶⁰ with regard to CISs in the form of a partnership. Interestingly, the Collective Investment Vehicle Report does not expressly make reference to partnerships constituting in the form of a CIS. All these points show a lack of systematic consideration by the OECD of how hybrid entities may be able to access DTC benefits in general. The crucial questions of which Report should be applied in such circumstances remains unclear and unanswered¹²⁶¹.

6.1.2.3 *The Application of Double Tax Conventions*

6.1.2.3.1 Introduction

In order to be able to access a Double Tax Convention under the OECD Model Tax Convention, the entity claiming such benefits shall (i) be qualified as a “*person*” covered by the Convention; (ii) be a “*resident*” for tax purposes; (iii) be the “*beneficial owner*” of the income received; and (iv) the

¹²⁵⁸ CFA Report, para. 1 and OECD Commentary 2014, nr. 6.8 ad. Art. 1.

¹²⁵⁹ The delimitation of the the Partnership Report, the Collective Investment Vehicles Report, and the recent OECD Final Report on BEPS Action Nr. 2 (Treaty Issues) is discussed in Chapter 6.1.3.

¹²⁶⁰ See Chapter 6.1.3.

¹²⁶¹ See Chapter 6.1.3. STEVENS, Comparison between Partnership and Collective Investment Schemes Report, p. 102.

income must “*be attributed to*” the relevant person, not only temporarily received or simply passed through them. The next paragraphs will explore how each of these requirements is treated under the Partnership Report, the CIVs Report, and the Final Report on BEPS Action Nr. 2.

6.1.2.3.2 Person

6.1.2.3.2.1 Introduction

The OECD Model defines persons as “*an individual, a company, and any other body of persons*”¹²⁶². Clarifying this definition is necessary, as a hybrid entity will only be allowed to have access to a DTC if it may be considered as a “*person*” under Art. 3 OECD Model. This Chapter concludes with a brief overview on how the term “*person*” is defined under the above-mentioned Reports and whether the latter introduce any changes to the OECD Model¹²⁶³.

6.1.2.3.2.2 The Partnership Report

Although the Partnership Report acknowledges that the characterization of partnerships as “*persons*” is not uniform amongst the different countries in which partnerships may be established, the Report determines that “*partnerships*” shall be considered as “*persons*”, either because they fall within the definition of “*company*” or because they constitute “*other bodies of persons*”¹²⁶⁴. A further explanation hereof can be found in the OECD Commentary¹²⁶⁵.

6.1.2.3.2.3 The Collective Investment Vehicles Report

Under the CIV Report, the determination of whether a CIS is a “*person*” depends on its legal structure¹²⁶⁶. CISs may adopt different types of legal structures as explored in Chapter 2.1.5. Thus, their characterization as a “*person*”

¹²⁶² Article 3 para. 1 lit (a) of the OECD Model.

¹²⁶³ For further analysis see Chapter 6.2.

¹²⁶⁴ OECD, Partnership Report, para. 30 and OECD Commentary 2014, nr. 2 ad. Art. 3.

¹²⁶⁵ OECD Commentary 2014, nr. 2 ad. Art. 3.

¹²⁶⁶ CFA Report, para. 23 and OECD Commentary 2014, nr. 6.10 ad. Art. 1.

for DTC purposes will depend on the structure adopted by the CIS¹²⁶⁷, and on whether the country in which the CIS is established treats that structure as a “*person*” for purposes of tax treaties¹²⁶⁸. In this sense, generally, a CIS structured as a company will clearly constitute a “*person*” under Art. 3 OECD Model, whereas a CIS in the form of a joint ownership vehicle or contractual arrangement will not fall within the definition of “*person*”¹²⁶⁹. As for trusts, the CIVs Report points out the difficulties in analysing trusts generally due to the different tax treatment afforded to this legal structures by common law countries (where usually the trust constitutes a tax payer), and civil law countries (where the trust is, in principle, not a tax payer)¹²⁷⁰.

6.1.2.3.2.4 Conclusion

By modifying the Commentary to Art. 3 of the OECD Model, it has been shown that partnerships are “*persons*” and may claim tax benefits under the OECD Model. However, this is not so clear in the case of a CIS since the question of whether it can benefit from a DTC depends on the legal structure it has adopted and how the country of establishment treats that legal structure for purposes of tax treaty benefits.

As far as the solution adopted by the Partnership Report for CISs is concerned, it has been argued that the definition of “*person*” contained in the Partnership Report cannot directly be applied to CIS, such as trusts, because trusts can adopt the form of companies or bodies of persons, but also structures that combine other types of entities and do not mirror the partnerships’ organization¹²⁷¹.

¹²⁶⁷ CFA Report, para. 23 and OECD Commentary 2014, nr. 6.10 ad. Art. 1.

¹²⁶⁸ CFA Report, para. 25 and 26 and OECD Commentary 2014, nr. 6.10 ad. Art. 1. In this vein amongst others: STEVENS, Comparison between Partnership and Collective Investment Schemes Report, p. 106; BROWN, Tax Treatment of Collective Investment Vehicles, p. 28-29.

¹²⁶⁹ CFA Report, para. 25 and OECD Commentary 2014, nr. 6.10 ad. Art. 1.

¹²⁷⁰ CFA Report, para. 26 and OECD Commentary 2014, nr. 6.10 ad. Art. 1.

¹²⁷¹ STEVENS, Comparison between Partnership and Collective Investment Schemes Report, p. 104-105.

6.1.2.3.3 Resident

6.1.2.3.3.1 Introduction

The Convention defines “*resident*” as any person who, under the laws of a contracting states “*is liable to tax*”, “*by reason of his domicile, residence, place of management, or any other similar criteria*”¹²⁷². This definition is relevant in order to determine the personal scope of the Convention.¹²⁷³ The following paragraphs will deal with the approach taken by the Partnership Report, the CIVs Report, and the Discussion Draft on BEPS Action Nr. 2 regarding the term of “*resident*”¹²⁷⁴.

6.1.2.3.3.2 The Partnership Report

In order to determine whether a partnership is a “*resident*” within the terms of the OECD Model Convention, the central question is whether a contracting state treats the income derived from the partnership as the income of one of its residents.

The Partnership Report adopts, in the words of Ton Stevens, a “*digital approach*”¹²⁷⁵ by differentiating between two situations. Firstly, the Partnership Report states that when the partnership is treated as a company or taxed in the same way, the partnership is a “*resident*” in terms of the OECD Model Convention, and is therefore a resident in the sense of Art. 4 OECD Model¹²⁷⁶. Secondly, the Partnership Report deals with partnerships that are treated as fiscally-transparent in the state of organization. These partnerships are not “*liable to tax*” within the meaning of Art. 4 OECD Model, and thus cannot be a “*resident*”¹²⁷⁷. The tax benefits of the DTC, therefore, would not apply. In such cases, the partners (as natural or legal persons) remain entitled to the DTC benefits with respect to their liability to tax for the share of income from the partnership, and under the terms of the treaty entered into by

¹²⁷² Article 4 of the OECD Model Tax Convention.

¹²⁷³ OECD Commentary 2014, nr. 1 ad. Art. 4.

¹²⁷⁴ For further analysis see Chapter 6.3.

¹²⁷⁵ STEVENS, Comparison between Partnership and Collective Investment Schemes Report, p. 106-107.

¹²⁷⁶ OECD, Partnership Report, para. 33 and OECD Commentary 2014, nr. 5 ad. Art. 1.

¹²⁷⁷ OECD, Partnership Report, para. 34 and OECD Commentary 2014, nr. 5 ad. Art. 1.

the country of which the partners are residents¹²⁷⁸. Thus, whether the partnership is liable to tax depends on whether the amount of tax payable on the partnership is determined in relation to the personal characteristics of the partners¹²⁷⁹.

6.1.2.3.3.3 The Collective Investment Vehicles Report

The determination of whether a CIS is a “*resident*” of a contracting state depends on the tax treatment of the CIS in the state of establishment, which may vary considerably from one country to another¹²⁸⁰. The CIVs Report distinguishes between fiscally-transparent and fiscally-opaque entities. Amongst fiscally-opaque entities, the CIVs Report differentiates four types of tax treatments: (i) CISs that are tax-exempt under the condition that they fulfil certain criteria; (ii) CISs that are subject to tax but whose base is reduced in proportion to distributions paid to investors; (iii) CISs subject to a low or zero tax rate; and (iv) CISs that are fully taxed but use mechanisms to grant credit for the investor payment to avoid double taxation¹²⁸¹.

The CIVs Report only excludes from the definition of “*resident*” those CISs that are fiscally-transparent and totally and unconditionally exempt¹²⁸². A CIS will be considered a “*resident*” if the contracting state treats the CIS as fiscally-opaque, even when that state does not in fact impose any tax on the CIS¹²⁸³. Thus, the residence test used by the CIVs Report is consistent with the definition of “*liable to tax*” contained in Paragraph 8.5 of the Commentary on Art. 4 of the OECD Model Convention. The CIVs Report, however, recognizes that not all countries agree with the principles of Paragraph 8.5. Therefore, the CIVs Report suggests that the issue of residency should be negotiated between contracting countries¹²⁸⁴.

¹²⁷⁸ OECD, Partnership Report, para. 35, 42 and 46 and OECD Commentary 2014, nr. 8.8 ad. Art. 4.

¹²⁷⁹ OECD, Partnership Report, para. 40 and OECD Commentary 2014, nr. 8.8 ad. Art. 4.

¹²⁸⁰ CFA Report, para. 27 and OECD Commentary 2014, nr. 6.11 ad. Art. 1.

¹²⁸¹ CFA Report, para. 28 and OECD Commentary 2014, nr. 6.12 ad. Art. 1.

¹²⁸² CFA Report, para. 29 and OECD Commentary 2014, nr. 6.11 ad. Art. 1.

¹²⁸³ CFA Report, para. 29 and OECD Commentary 2014, nr. 6.12 ad. Art. 1.

¹²⁸⁴ Paragraph 8.6 of the Commentary on Article 4 to the OECD Model Convention, Paragraph 30 of the CIVs Report.

6.1.2.3.3.4 The OECD Final Report on BEPS Action Nr. 2 (Treaty Issues)

The purpose of the BEPS Report is to suggest changes to the OECD Model Tax Convention in order to ensure that hybrid instruments and entities are not used to unduly obtain benefits from DTCs. The Report deals with treaty issues related to dual-resident entities and fiscally-transparent entities.

For the case of dual treaty residency, the Report proposes to change Art. 4 para. 3 of the OECD Model in the sense that the aforementioned cases shall be solved on a case-by-case basis, rather than on the basis of the current rule of effective place of management¹²⁸⁵. The Report also suggests incorporating changes to domestic laws to prevent such dual-resident entities from claiming residency of one state under the domestic law of that state, and to be resident of another state under a tax treaty¹²⁸⁶.

As for fiscally-transparent entities, the Report follows the approach taken by the Partnership Report and extends this approach to other entities that were not covered by the Partnership Report, such as trusts¹²⁸⁷. The Report suggests that income derived from or through an entity or arrangement, which is treated as wholly or partly fiscally-transparent under the tax law of either Contracting State, shall be considered income of a “*resident*” of a Contracting State only to the extent that the income is treated, for purposes of taxation by that State, as income of a “*resident*” of that State¹²⁸⁸.

6.1.2.3.3.5 Conclusions

In light of the above, it can be concluded that the Partnership Report correctly outlines the path to be followed under the two situations that may arise when determining whether a partnership shall be considered a “*resident*” for purposes of the OECD Model.

¹²⁸⁵ OECD Final Report on BEPS Action nr. 2, para. 7 (Treaty Issues)

¹²⁸⁶ OECD Final Report on BEPS Action nr. 2, para. 8 (Treaty Issues)

¹²⁸⁷ OECD Final Report on BEPS Action nr. 2, ad Art. 1 para. 26.4, 26.5, 26.8 (Treaty Issues)

¹²⁸⁸ OECD Final Report on BEPS Action nr. 2, ad Art. 1 para. 26.3 (Treaty Issues)

Some authors, however, have voiced criticism when the same approach is followed in the case of CISs. These authors state that the approach taken by the Partnership Report regarding transparent entities does not take into account the complexities of CISs, and therefore cannot strictly be applied to these entities¹²⁸⁹. In this sense, if the reasoning of the Partnership Report is followed and the treaty benefits also apply to fiscally-transparent CISs, it would be fair for the investors to be able to claim the benefits¹²⁹⁰. But this would be hard or even impossible in the context of CISs, which are usually comprised of numerous investors changing periodically, thus making it almost impossible to track and allocate income to an individual investor¹²⁹¹. For this reason, the CIVs Report suggests that these issues shall be dealt through special treaty provisions negotiated individually between the contracting states¹²⁹².

As far as the CIVs Report is concerned, it correctly excludes from the definition of “*resident*” those CISs that are fiscally-transparent (“*flow-through*”). This approach seems adequate since CISs can receive income and derive capital gains from different sources or even property situated in different states, trustees and beneficiaries can be individuals or corporations as well as “*residents*” of different and numerous states, and shares might be issued or redeemed on a daily basis. Thus, allocating income to the underlying entity might be more complex than in the case of partnerships¹²⁹³. From a practical perspective, if the approach of the Partnership Report were applied to CISs and income attributed to the underlying entity, the number of investors and changes in ownership would make it administratively complex for individual investors to obtain refunds, exemptions, etc. for smaller claims¹²⁹⁴.

¹²⁸⁹ VANN, Beneficial Ownership: Recent Trends, p. 303

¹²⁹⁰ BROWN, Tax Treatment of Collective Investment Vehicles, p. 33.

¹²⁹¹ BROWN, Tax Treatment of Collective Investment Vehicles, p. 34.

¹²⁹² CFA Report, para. 30 and OECD Commentary 2014, nr. 6.13 ad. Art. 1; VANN, Beneficial Ownership: Recent Trends, p. 303; STEVENS, Comparison between Partnership and Collective Investment Schemes Report, p. 106.

¹²⁹³ BROWN, Tax Treatment of Collective Investment Vehicles, p. 36.

¹²⁹⁴ STEVENS, Comparison between Partnership and Collective Investment Schemes Report, p. 109.

The Final Report on BEPS Action Nr. 2 adopts the same solution as the Partnership Report for partly or wholly fiscally-transparent entities, but specifically includes entities that are not included in the Partnership Report, such as trusts¹²⁹⁵. The Report aims to prevent entities from claiming treaty benefits when none of the states treat the entity's income as the income of one of its residents.

6.1.2.3.4 Beneficial Ownership

6.1.2.3.4.1 Introduction

The concept of “*beneficial ownership*” (“*Nutzungsberechtigung*”; “*bénéficiaire effectif*”) is crucial for determining the personal scope of application of a DTC¹²⁹⁶. This concept was introduced by Articles 10, 11 and 12 of the OECD Model¹²⁹⁷, and is the most widely known mechanism for eliminating access to DTCs for artificial structures designed to benefit individuals and corporations, in order to prevent their misuse (anti-treaty-shopping mechanism)¹²⁹⁸.

On 29 April 2011, the OECD released a Public Discussion Draft in order to clarify the definition of “*beneficial owner*”¹²⁹⁹. This first Discussion Draft concludes that the recipient of the income is the “*beneficial owner*” of that income if he has the “*full right to use and enjoy*” the income he receives,

¹²⁹⁵ OECD Final Report on BEPS Action nr. 2, ad Art. 1 para. 26.4, 26.5, 26.8 (Treaty Issues).

¹²⁹⁶ Beneficial ownership is to be distinguished from being the beneficiary of a trust under Swiss domestic law, as held by the Swiss Federal Administrative Court in its decision dated 18 March 2011 (A-7013/2010). For further analysis, see BERSHEDA, Recent decisions of the Swiss Federal Administrative Court.

¹²⁹⁷ See Chapter 6.5.

¹²⁹⁸ See Footnote 1821.

¹²⁹⁹ OECD, Clarification of the meaning of “Beneficial Owner” in the OECD Model Tax Convention Discussion Draft, 2011.

unconstrained by a contractual or legal obligation to pass on the payment received to another person¹³⁰⁰. Accordingly, agents, nominees, conduit companies acting as a fiduciary or administrator are thus excluded from the definition of “*beneficial owner*”¹³⁰¹.

This definition raised issues, for example, in regards to distribution obligations of CISs, which are typically considered to be entitled to tax treaty benefits¹³⁰². The problem is that the recipient of the payments (i.e. the CIS/trust) does not usually have the “*full right to use and enjoy*” this income because there is a legal or contractual obligation to re-distribute the income to the investors¹³⁰³.

To provide further clarification on this point, on 19 October, 2012 the OECD Released a Revised Discussion Draft on the meaning of “*beneficial owner*”¹³⁰⁴. The Revised Discussion Draft addressed this concern and concluded that if there is an obligation to pass on the payment but this obligation is “*unrelated*” to the payment received, the recipient shall still be considered the “*beneficial owner*” of the income¹³⁰⁵. In which circumstances a payment is “*related*” or “*unrelated*” has not been clarified by the Discussion Drafts. However, the Revised Draft specifically states that distribution obligations of CIVs constitute “*unrelated*” obligations for the purpose of the “*beneficial owner*” test¹³⁰⁶. The changes of the Revised Discussion Draft were included in the OECD’s latest Commentary, published on 15 July 2014

¹³⁰⁰ OECD, Clarification of the meaning of “Beneficial Owner” in the OECD Model Tax Convention Discussion Draft, 2011, para. 12.4.

¹³⁰¹ OECD, Clarification of the meaning of “Beneficial Owner” in the OECD Model Tax Convention Discussion Draft, 2011, Para. 12.4.

¹³⁰² OECD, Clarification of the meaning of “Beneficial Owner” in the OECD Model Tax Convention Revised Discussion Draft, 2012, para. 13.

¹³⁰³ OECD, Clarification of the meaning of “Beneficial Owner” in the OECD Model Tax Convention Revised Discussion Draft, 2012, para. 12.

¹³⁰⁴ OECD, Clarification of the meaning of “Beneficial Owner” in the OECD Model Tax Convention Revised Discussion Draft, 2012.

¹³⁰⁵ OECD, Clarification of the meaning of “Beneficial Owner” in the OECD Model Tax Convention Revised Discussion Draft, 2012, para. 12.4.

¹³⁰⁶ OECD, Clarification of the meaning of “Beneficial Owner” in the OECD Model Tax Convention Revised Discussion Draft, 2012, para. 12.4.

The following paragraphs provide an explanation as to how the different Reports approach the issue of “*beneficial ownership*” of income.

6.1.2.3.4.2 The Partnership Report

Interestingly, the Partnership Report does not focus on the requirement of having a “*beneficial owner*”. The Report rather deals with conflicts of attribution¹³⁰⁷ and links the concept of beneficial ownership to the resident person¹³⁰⁸, which goes against the original purpose of the beneficial ownership concept¹³⁰⁹. The Partnership Report solves the problem of determining “*beneficial ownership*” by applying the respective term on “*attribution of income*”. Therefore, according to the Report, if the partnership is treated as fiscally-opaque (intransparent), the partnership is deemed to be the “*beneficial owner*” of the income it receives. However, if the partnership is fiscally-transparent, the partners would be considered to be the “*beneficial owners*” (depending on their respective state of residence for treaty purposes)¹³¹⁰.

¹³⁰⁷ OECD, Partnership Report, para. 54: “*Another approach would involve consideration of the terms of the distributive rules in the relevant Articles of the Convention. Under that analysis, in the case of dividends, interest and royalties, the inquiry would be whether or not the recipient of the item of income was the beneficial owner of the income under the laws of the State of residence of the taxpayer claiming treaty benefits and thus the taxpayer in relation to the income. In the case of a partnership treated as transparent under the laws of the source State but as a taxable entity under the laws of the residence State, the entity itself and not the partners would be treated as the beneficial owner (emphasis added by the author). Because of the treatment of the income in the State of residence, the partners would not be the beneficial owners of the income for purposes of the treaty. Thus the partners would not be entitled to treaty benefits in those circumstances and whether the entity was so entitled would depend on whether it independently qualified as a resident*”.

¹³⁰⁸ In this vein also: LANG, General report on double non-taxation, p. 44.

¹³⁰⁹ VANN, Beneficial Ownership: Recent Trends, p. 301.

¹³¹⁰ OECD, Partnership Report, para. 54 and OECD Commentary 2014, nr. 8.8 ad. Art. 4.

Interestingly, some countries such as Austria solve the problem of beneficial ownership by applying the term on “*attribution of income*”. Katharina Kubik demonstrates with Austrian case law how a trust in Austria is always the beneficial owner of income that Austria attributes to the trust, pursuant to its term on “*attribution of income*”. See KUBIK, thesis, p. 157.

6.1.2.3.4.3 The Collective Investment Vehicles Report

The “*beneficial owner*” concept is controversial and difficult to apply in the context of CISs, in particular because the term is not defined in the OECD Model. Due to this lack of definition, the CIVs Report determines that the term would ordinarily be given the meaning under the law of the country applying the Convention¹³¹¹. As a result, some countries have even taken the extreme position that CISs may never be the “*beneficial owners*” of the income they receive¹³¹².

This is mainly due to the fact that for CISs, one can easily argue that they are seen as conduit companies and, therefore, cannot be the “*beneficial owners*” of the income they receive. Some authors argue that a CIS cannot be considered the beneficial owner of income, as CISs are fiscally-transparent. Due to this transparency, they conclude that the investors, and not the CIS, should be considered the “*beneficial owners*” of the underlying assets held by CISs¹³¹³. This position erroneously equates interest in the CIS to ownership in the underlying assets. The CIV Report correctly points out that the investor has no right to the underlying assets, but rather a right to receive an amount equal to the value of his allocable share of the assets¹³¹⁴. The CIV Report also acknowledges some other difficulties in treating investors as the “*beneficial owners*”, as investors usually do not have discretionary powers to manage the assets. Also, investors who may be residents of different states receive different tax treatment as pertains to the income they receive from the CIS in their country of residence. As income of a particular asset cannot be attributed to a particular investor, this prevents a clear determination as to who is the “*beneficial owner*” of that income.

The tax policy idea intends to give source states treaty benefits at the level of the interposed CIS. The CIVs Report clearly follows this idea. Thus, a vehicle that meets the definition of a CIS as explained in paragraph 4 of the Report is to be considered the “*beneficial owner*” of the income it receives, as

¹³¹¹ CFA Report, para. 31 and OECD Commentary 2014, nr. 6.14 ad. Art. 1.

¹³¹² CFA Report, para. 31. In this view also: BROWN, Tax Treatment of Collective Investment Vehicles, p. 29.

¹³¹³ BROWN, Tax Treatment of Collective Investment Vehicles, p. 35.

¹³¹⁴ CFA Report, para. 32 and OECD Commentary 2014, nr. 6.14 ad. Art. 1.

long as the managers of the CIS have discretionary powers to manage the assets on behalf of the investors, and the CIS meets the requirements to be considered a “*person*” and a “*resident*” of the state in which the CIS is established¹³¹⁵.

Considering the above, it appears that the CIVs Report, unlike the Partnership Report, does not consider as “*beneficial owners*” whoever income is attributed to according to the domestic law of the residence state. The CIVs Report is silent on the term of “*attribution of income*”¹³¹⁶ and, for the avoidance of additional complexity, the definition of a CIS as explained in paragraph 4 of the CIV Report is to be applied when determining the “*beneficial owner*” of income.

6.1.2.3.4.4 The OECD Final Report on BEPS Action Nr. 2 (Treaty Issues)

The BEPS Report does not define the term “*beneficial owner*”. It only distinguishes the issue of income attribution from the “*beneficial ownership*” requirement¹³¹⁷. The BEPS Report clearly demonstrates with an example that the “*attribution of income*” requirement must be differentiated from the “*beneficial ownership*” requirement¹³¹⁸. Considering that the term “*attribution of income*” is defined by domestic law whereas the concept of “*beneficial owner*” has an international fiscal meaning, there may be situations where income can be attributed to an entity under domestic laws, but said entity might not be the “*beneficial owner*” as required by the OECD Model.

Also, the BEPS Report interestingly states that the attribution of income requirement has “*a broad meaning and covers any income that is earned by or through an entity or arrangement, regardless of the view taken by each Contracting State as to who derives that income for domestic tax purposes and regardless of whether or not that entity or arrangement has legal personality or constitutes a person as defined in Art. 3 para. 1 (a) OECD Model*”¹³¹⁹.

¹³¹⁵ CFA Report, para. 33 and OECD Commentary 2014, nr. 6.14 ad. Art. 1.

¹³¹⁶ See Chapter 6.1.2.3.5.

¹³¹⁷ OECD, Discussion Draft on BEPS Action Nr. 2, para. 26.14 (Treaty Issues).

¹³¹⁸ OECD, Discussion Draft on BEPS Action Nr. 2, para. 26.14 (Treaty Issues).

¹³¹⁹ OECD, Discussion Draft on BEPS Action Nr. 2, para. 26.8 (Treaty Issues).

Therefore, according to the BEPS Draft, it seems that the term “*attribution of income*” must also be given an autonomous (international fiscal) meaning comparable to that of “*beneficial ownership*”, and not rely purely on the civil law characterization of the state of which a person is a resident¹³²⁰. It is the author’s view that the confusion not only imposes limits on the hierarchy between the “*beneficial ownership*” and “*attribution of income*” terms,¹³²¹ but also stretches further as it is not even clear whether the “*attribution of income*” term has to be given an autonomous (international fiscal) meaning or a pure civil law characterization according to domestic laws¹³²².

6.1.2.3.4.5 Conclusion

The three documents take different approaches to the requirement of “*beneficial ownership*”. While the Partnership Report links the test used to determine whether an entity is a resident of a contracting state, the CIVs Report adopts a straightforward solution according to which the CIS is always the “*beneficial owner*” of the income it receives (provided it is a “*person*” and a “*resident*”).

The OECD tried to shed light on the definition of “*beneficial owner*” by releasing a first Discussion Draft. However, this document only contained general remarks and did not treat the particular case of CISs. This omission may lead to the conclusion that the OECD does not intend the concept of “*beneficial ownership*” to be applicable in the context of CISs, comparable to the situation prevailing for partnerships.

From a policy perspective, CISs have different goals in terms of tax incentives than partnerships or other fiscally-transparent entities.¹³²³ CISs are ruled by the neutrality principle according to which direct investment and investment through a CIS are treated the same for tax purposes. It seems that the view that more appropriately reflects the goals of these entities is the one

¹³²⁰ See for further information Chapter 6.5.2.2.

¹³²¹ See Chapter 6.5.2.

¹³²² See Chapter 6.4.

¹³²³ STEVENS, Comparison between Partnership and Collective Investment Schemes Report, p. 106.

that treats CISs as the “*beneficial owners*” of income, as opposed to a flow-through approach¹³²⁴.

In an attempt to achieve neutrality, this approach may however raise concerns regarding treaty shopping. By establishing that the CIS is always the beneficial owner of the income it receives, investors from non-treaty countries might be able to enjoy tax treaty benefits when investing through a CIS established in a country that is a treaty party and thus grants treaty benefits to CISs¹³²⁵.

The CIVs Report states that the approach adopted in the Report does not mean that a CIS is in a different or better position than other investors with respect to aspects of the “*beneficial ownership*” requirement that are unrelated to the CIS’s status as such¹³²⁶. As an example, the Report explains that a CIS receiving an item of income could not be deemed to be the “*beneficial owner*” of that income if an individual receiving an item of income under the same circumstances would not be considered the “*beneficial owner*” of that income¹³²⁷.

Finally, the BEPS Draft does not give a separate definition of the term “*beneficial owner*”, but rather clarifies that the terms “*beneficial owner*” and “*attribution of income*” are conceptually different and independently defined by domestic and international law.

6.1.2.3.5 Attribution of Income

6.1.2.3.5.1 Introduction

The objective of the “*attribution of income*” (“*Einkünftezurechnung*”; “*attribution du revenu*”) requirement is to attribute, as a matter of domestic law, a tax object (any income such as dividends or interest payments) to a tax subject (e.g. a hybrid entity, an individual or company) in a contracting

¹³²⁴ BROWN, Tax Treatment of Collective Investment Vehicles, p. 19-24.

¹³²⁵ BROWN, Tax Treatment of Collective Investment Vehicles, p. 28.

¹³²⁶ CFA Report, para. 35 and OECD Commentary 2014, nr. 6.34 ad. Art. 1.

¹³²⁷ CFA Report, para. 35 and OECD Commentary 2014, nr. 6.34 ad. Art. 1.

state¹³²⁸. The OECD Model defined this requirement explicitly for the first time with regard to wholly or partly fiscally-transparent entities (“*flow-through*”) but has not done the same for tax-exempt entities (“*tax-exempt*”) and tax-subject entities (“*fiscally-opaque*”).

6.1.2.3.5.2 The Partnership Report

The Partnership Report gives several examples to determine when a partnership or the partners themselves are entitled to claim treaty benefits, and in which situations the income should be attributed to them¹³²⁹. The Report states the principle that an item of income is considered “*paid to*” a resident of a contracting state provided that the latter exercises its taxing power over the income¹³³⁰. In order to avoid an attribution conflict, the Partnership Report determines that the source state is obliged to follow the attribution of income made by the residence state¹³³¹. Example 4 of the Partnership Report for bilateral situations and Example 7 of the Partnership Report for triangular situations follow this approach. According to the OECD, the source state has to grant treaty benefits to persons to whom the income at issue is being attributed in the other contracting state¹³³².

6.1.2.3.5.3 The Collective Investment Vehicles Report

In the case of CISs, the CIVs Report is silent regarding the interpretation of the term “*paid to*”. Therefore, some authors consider that one appropriate meaning could be the one developed in the Partnership Report, stating that

¹³²⁸ Article 10 para. 1 OECD Model uses the expression “*dividends paid by a company*”; Article 11 para. 1 OECD Model mentions “*interest arising in a Contracting State and paid to a resident*”; and Article 12 para. 2 OECD Model states that “*the term royalties as used in this Article means payments of any kind received as consideration for*”.

¹³²⁹ OECD, Partnership Report, para. 47-92 and OECD Commentary 2014, nr. 6.4 ad.

Art. 1.

¹³³⁰ OECD, Partnership Report, para. 48, 56 and OECD Commentary 2014, nr. 6.4 ad.

Art. 1.

¹³³¹ OECD, Partnership Report, para. 47 and OECD Commentary 2014, nr. 6.4 ad. Art. 1.

¹³³² OECD Commentary 2014, nr. 5 and 6.2 ad. Art. 1; OECD Commentary 2014, nr. 8.8 ad. Art. 4. Amongst others: DANON, thesis, p. 317.

an item of income is considered “*paid to*” a resident of a contracting state if the latter exercises its taxing power over the income¹³³³.

However, it should be mentioned that this approach has been criticized as the different characteristics and dynamics of CISs might prevent the direct application of the principles outlined in the Partnership Report¹³³⁴. As mentioned previously, true tax neutrality could be difficult to achieve for CISs with a large number of changing investors. Also, there might be a significant deferral of income, resulting in difficulties in determining when a transfer of income has occurred and thus, when income should be attributed to someone.

6.1.2.3.5.4 The OECD Final Report on BEPS Action Nr. 2 (Treaty Issues)

The BEPS Draft suggests the inclusion of an express provision into the OECD Model based on the 2006 US Model Tax Convention, ensuring that an item of income is allocated to the taxpayer benefiting from a DTC. This “*attribution rule*” applicable to hybrid mismatch “*entities or arrangements*” should be clearly interpreted and seen in the context of the Partnership Report and the distributive rules of the OECD Model¹³³⁵. The OECD’s aim is to ensure that each single item of income is attributed to a resident for the purpose of benefitting from DTC access.

6.1.2.3.5.5 Conclusion

The Partnership Report sheds light on the definition of the term “*paid to*”, which was not previously defined in the OECD Model. The Partnership Report, however, does not apply to other types of hybrid entities, such as CISs and trusts¹³³⁶. The CIVs Report is silent in this respect, and some authors suggested applying the principles of the Partnership Report to CISs and trust

¹³³³ FREITAS DE MORAES E CASTRO, Treatment of Hybrid Entities, p. 280 et seq.

¹³³⁴ BROWN, Tax Treatment of Collective Investment Vehicles, p. 33-34.

¹³³⁵ OECD, Discussion Draft on BEPS Action Nr. 2, para. 26.13 (Treaty Issues).

¹³³⁶ See Chapter 6.1.3.2.

structures¹³³⁷. This can be problematic in the case of CISs structured as entities that do not mirror partnerships, such as CISs with numerous investors, each of them subject to different tax treatment. Lastly, the BEPS Report does not provide a definition of the term “*paid to*”, but rather encourages the incorporation of rules to allocate income to the resident to whom tax benefits should be granted.

Robert Danon has challenged the approach taken by the Discussion Draft with a systematic approach¹³³⁸. In particular, Robert Danon suggests that the Discussion Draft should refer to the distributive rules and define terms such as “*paid to*” or “*derived by*”, since the OECD Model requires a connection between the income and the taxpayer¹³³⁹. In the author’s view, defining the term “*attribution of income*” is a matter of domestic law, yet the text of the draft suggests that the term “*paid to*” has a broad meaning and covers any income that is earned by or through an entity or arrangement, regardless of the view taken by each contracting state¹³⁴⁰. As a result, the term “*paid to*” seems to have an autonomous fiscal meaning in the draft. The author also suggests that, in the cases where a state of residence fictitiously attributes an item of income to a person that is not the “*beneficial owner*” of that income (such as a settlor in a trust), and that person is effectively taxed, the contracting states should consider this person as the “*beneficial owner*” even if this person does not enjoy ownership over the income received¹³⁴¹. Therefore, this person should be able to have access to treaty benefits.

6.1.2.3.6 Relief under Art. 23 A and Art. 23 B OECD Model for Income Derived from Partnerships, Collective Investment

¹³³⁷ The delimitation of the the Partnership Report, the Collective Investment Vehicles Report, and the recent OECD Final Report on BEPS Action Nr. 2 (Treaty Issues) is discussed in Chapter 6.1.3.

¹³³⁸ Comments by Robert Danon on the OECD Discussion Draft on BEPS Action Nr. 2 (Treaty Issues), p. 151-158.

¹³³⁹ Comments by Robert Danon on the OECD Discussion Draft on BEPS Action Nr. 2 (Treaty Issues), p. 151.

¹³⁴⁰ OECD, Discussion Draft on BEPS Action Nr. 2, para. 26.8 (Treaty Issues).

¹³⁴¹ Comments by Robert Danon on the OECD Discussion Draft on BEPS Action Nr. 2 (Treaty Issues), p. 155.

Schemes and Trusts

6.1.2.3.6.1 Introduction

Arts. 23 A and 23 B OECD Model deal with the issue of juridical double taxation, namely where the same income or capital is taxed in the hands of the same person by more than one state¹³⁴². The OECD does not intend to solve situations of economic double taxation, i.e., where two different persons are taxed on the same income¹³⁴³. Arts. 23 A and 23 B OECD Model provide for two mechanisms in order to eliminate juridical double taxation: the principle of exemption (Art. 23 A OECD Model), and the principle of credit (Art. 23 B OECD Model)¹³⁴⁴. Generally, partnerships', CISs' and Trusts' income consist of movable capital property, such as dividends and interests. These structures usually hold an investment portfolio and do not perform any business activity. As a result, such income will easily be subject to withholding taxes in the country of source where the investment is located, leading to double taxation¹³⁴⁵.

The introduction to the OECD Commentary defines juridical double taxation as the imposition of comparable taxes in two or more states on the same taxpayer, in respect to the same subject matter, and for the same taxation period¹³⁴⁶. Thus, the OECD Model only focuses on juridical and not on economic double taxation. The distinction between juridical and economic double taxation might be problematic when trying to apply the above-mentioned relief methods of the OECD Model to hybrid entities such as partnerships, CISs and trusts.

Following the graphic below, for example, problems may occur when the country of source (Country A) withholds taxes on dividends or interest payments and, at the same time, the country of residence of the respective part-

¹³⁴² See Chapter 4.1.2.1. In this vein also: Further information you will find in OECD Commentary 2014, nr. 1 ad. Arts. 23 A and 23 B.

¹³⁴³ See Chapter 4.1.2.2. In this vein also: OECD Commentary 2014, nr. 2 ad. Arts. 23 A and 23 B.

¹³⁴⁴ OECD Commentary 2014, nr. 13-17 ad. Arts. 23 A and 23 B.

¹³⁴⁵ For further details, see Chapter 4.1.2.

¹³⁴⁶ OECD Commentary 2014, nr. 1.

ners, investors or beneficiaries (Country C) levies taxes on that same income (see graphic below). If the country of residence (Country C) considers hybrid entities such as partnerships, CISs or trusts as tax-subject entities (*“fiscally-opaque”*), the dividend withholding tax in the country of source (Country A) and the income tax in the residence country (Country C) cannot be considered international juridical double taxation as defined by the OECD Commentary for the following reasons.

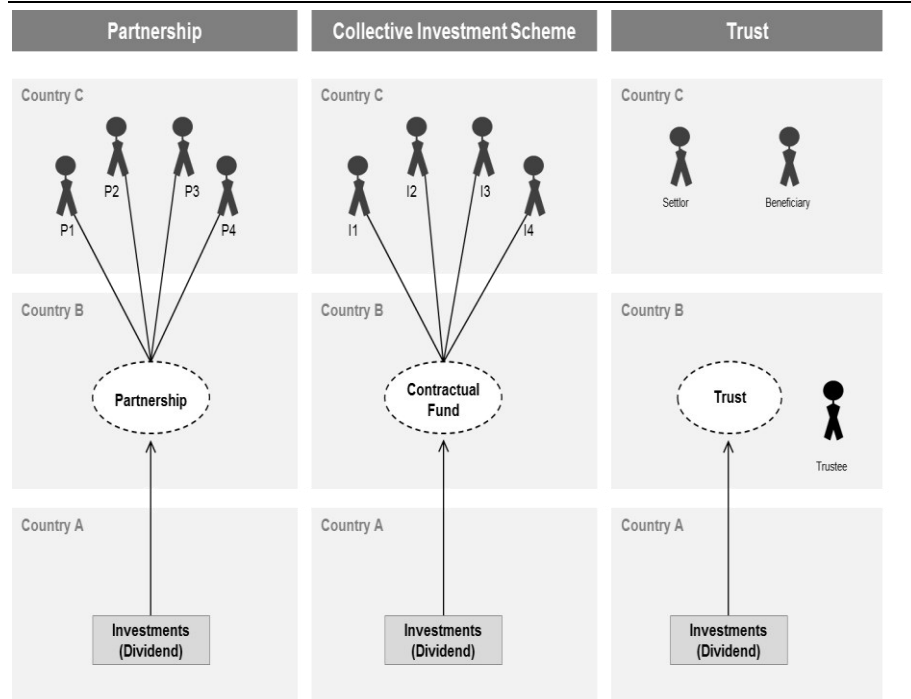
Firstly, it can be argued that the dividend withholding tax levied by the country of source (Country A) on distributed dividend and interest payments is not imposed on the same item of income as the income tax levied by the country of residence (Country C) since the latter concerns the subsequent repatriation of profits. Secondly, the dividend withholding tax in the country of source (Country A) is paid by the entity located in Country B, while the income tax in the country of residence (Country C) is not necessarily paid by the same taxpayer. Lastly, these taxes are not always due for the same taxation period¹³⁴⁷. In the particular case of CISs, granting tax relief to investors might raise concerns when the income derived by the investors is reinvested. If the income is reinvested before the proceeds are distributed, it could be difficult to determine which income should be taxable. In any event, it remains unclear whether the relief should be granted at the time when the income is being paid or withheld, or when the income is being repatriated, possibly years later¹³⁴⁸.

The following paragraphs will analyse the application of the relief provided for by Art. 23 A and Art. 23 B OECD Model in the light of the Partnership Report, the Collective Investment Vehicles Report and the recent OECD Final Report on BEPS Action Nr. 2 (Treaty Issues).

¹³⁴⁷ BROWN, Tax Treatment of Collective Investment Vehicles, p. 70.

¹³⁴⁸ BROWN, Tax Treatment of Collective Investment Vehicles, p. 69.

Figure 6.1: Relief under Art. 23 A and Art. 23 B OECD Model for income derived from Partnerships, Collective Investment Schemes and Trusts



Source: Own figure

6.1.2.3.6.2 The Partnership Report

In order to analyze the application of the double taxation relief provided for by Art. 23 A and 23 B OECD Model to partnerships, it is necessary to distinguish three types of situations.

The first situation concerns the case where a partnership is treated as a resident. For that case, the Partnership Report provides that the partnership can claim tax relief through either the credit or the exemption method¹³⁴⁹. If the

¹³⁴⁹ OECD, Partnership Report, para. 104-106 and OECD Commentary 2014, nr. 6.7 ad. Art. 1.

partnership's income purely consists of dividends and interests, double taxation relief is given through the credit method¹³⁵⁰.

The second situation involves a partnership that is treated as fiscally-transparent ("*flow-through*") by both the residence country of the partners (Country C) and the residence country of the partnership (Country B). In this situation, the "*flow-through*" approach of the Partnership Report obliges Country C to give relief on the level of the partners who are residents of Country C for taxes withheld by the source country (Country A)¹³⁵¹.

The third situation considered by the Partnership Report is the more complex case of hybrid situations as outlined below¹³⁵². The Report focuses on two major issues: (i) problems of conflicts of qualification, and (ii) conflicts of income allocation for the state of residence¹³⁵³. The Partnership Report acknowledges that the application of the relief methods of Art. 23 OECD Model to these situations may raise some difficulties¹³⁵⁴.

Conflicts of qualification arise when, due to differences in their domestic laws, the source state and the residence state apply different provisions of the convention in order to qualify a certain income¹³⁵⁵. Thus, there is no disagreement on whether the Convention as such should be applicable. However, under their domestic laws, both states give a different treatment to a certain income, which leads to the application of different treaty provisions when qualifying the income at issue¹³⁵⁶.

¹³⁵⁰ In this vein: STEVENS, Comparison between Partnership and Collective Investment Schemes Report, p. 110.

¹³⁵¹ OECD, Partnership Report, para. 56. Further: STEVENS, Comparison between Partnership and Collective Investment Schemes Report, p. 109.

¹³⁵² OECD, Partnership Report, para. 93 and OECD Commentary 2014, nr. 6.7 ad. Art. 1 and 32.1 et seq. ad. Art. 23.

¹³⁵³ OECD, Partnership Report, para. 93 and OECD Commentary 2014, nr. 6.7 ad. Art. 1 and 32.1 et seq. ad. Art. 23.

¹³⁵⁴ OECD, Partnership Report, para. 93 and OECD Commentary 2014, nr. 6.7 ad. Art. 1 and 32.1 et seq. ad. Art. 23.

¹³⁵⁵ OECD, Partnership Report, para. 94 and OECD Commentary 2014, nr. 6.4 ad. Art. 1 and 32.1 et seq. ad. Art. 23.

¹³⁵⁶ See Chapter 4.1.3.2.1.

The Partnership Report illustrates in its Example 13¹³⁵⁷ the conflict with a loan between a partnership resident of Country B and a partner resident of Country C. Both treat the loan differently under their domestic laws¹³⁵⁸. Country B recognizes the loan and allows a deduction for the interest paid to the partner under Art. 11. On the other hand, Country C considers this to be the distribution of the partner's shares in the partnership, taxable under Art. 7. The tax consequences for the partner depend on whether Country B uses the exemption (resulting in partial non-taxation) or the credit method (total avoidance of non-taxation).

In providing solutions to these conflicts, the Partnership Report recognizes that, subject to the provisions and limitations of its tax conventions, it is for the source state (Country A) to determine under its domestic laws how taxation takes place and who is subject to taxes¹³⁵⁹. The method applied by the state of residence (Country C) in order to qualify an item of income under the convention has no impact on how that item is being taxed by the source state and who has to pay taxes on it. The way the residence state (Country C) eliminates double taxation, however, depends on how the source state applies the convention¹³⁶⁰.

Regarding the application of the relief methods, the Partnership Report clarifies in its Example 14¹³⁶¹ that the residence state (Country C) is required to

¹³⁵⁷ Partnership Report, Example 13: "Partner A makes a loan to partnership P, which has been established in State P where it carries on a business through a permanent establishment. P pays interest to A. State P recognizes loans between partners and partnerships; under its domestic legislation State P allows P a tax deduction for the interest. State R does not recognize loans between partners and partnerships under its domestic law. Both States treat partnerships as transparent entities and apply Article 7 to the income of P, but State P applies Article 11 to the interest payment and State R does not."

¹³⁵⁸ OECD, Partnership Report, para. 95.

¹³⁵⁹ OECD Partnership Report, para. 103 and OECD Commentary 2014, nr. 32.3 ad. Arts. 23 A and 23 B.

¹³⁶⁰ OECD Partnership Report, para. 103 and OECD Commentary 2014, n5. 32.3 ad. Arts. 23 A and 23 B; STEVENS, Comparison between Partnership and Collective Investment Schemes Report, p. 111.

¹³⁶¹ Partnership Report, Example 14: "Partner A, a resident of State R, sells his interest in P to D, a resident of State R, for an amount that exceeds A's adjusted basis in the interest. Under State R's domestic law, State R treats P as a company and would regard the

grant the relief of Art. 23 OECD Model, despite the conflicts of qualification resulting from the differences between domestic laws¹³⁶². The residence state, however, is not obliged to grant tax relief when the qualification conflict does not arise from different provisions of the applicable domestic laws, but from different interpretations of facts or provisions of the DTCs¹³⁶³. In the latter case, the residence state may argue that the source state has not imposed taxes in accordance with the provisions of the Convention and refuse to provide tax relief¹³⁶⁴.

The Partnership Report also outlines that conflicts of qualification might result in double non-taxation¹³⁶⁵. This would be the case where the residence state (Country C) considers that the source state is not precluded from taxing a certain income, and it therefore grants an exemption. The source state, conversely, considers that it is not entitled to tax the item under the Convention. To solve this situation, the Partnership Report introduces paragraph 4 to Art. 23 A of the OECD Model. According to this paragraph, paragraph 1 of Art. 23 A OECD Model does not apply when the source state has applied the Convention to exempt the income or applied paragraph 2 of Art. 10 or 11 of the OECD Model¹³⁶⁶.

The Partnership Report also addresses conflicts of income allocation arising from the fact that two contracting states classify differently the same entity so that one state treats a partnership as a tax-subject entity (“*fiscally-opaque*”) whereas the other state treats the same partnership as fiscally-

gain as a capital gain of a resident of State R. Under State P's domestic law, State P treats P as fiscally transparent and would regard the gain as attributable to a State P permanent establishment.”

¹³⁶² OECD Partnership Report, para. 105 and OECD Commentary 2014, nr. 32.1 et seq. ad. Arts. 23 A and 23 B.

¹³⁶³ OECD Partnership Report, para. 108 and OECD Commentary 2014, nr. 32.1 et seq. ad. Arts. 23 A and 23 B.

¹³⁶⁴ OECD Partnership Report, para. 108 and OECD Commentary 2014, nr. 32.1 et seq. ad. Arts. 23 A and 23 B.

¹³⁶⁵ See Chapter 4.1.4.

¹³⁶⁶ OECD Partnership Report, para. 113, 114 and OECD Commentary 2014, nr. 32.6 ad. Arts. 23 A and 23 B.

transparent entity (“*flow-through*”)¹³⁶⁷. In example 16¹³⁶⁸, the Partnership Report clarifies how Art. 12 OECD Model is to be applied in cases where a partner is a resident of a country (Country C) that treats the partnership as a fiscally-transparent entity and where the partnership is a resident of another country (Country B) treating the partnership as a tax-subject entity. It is assumed that the partnership derives royalty income from the source country (Country A)¹³⁶⁹. The Report concludes that, when a partnership is a resident of the residence country (Country B), the provisions of the Convention that restrict source country’s (Country A) power to tax the partnership on its income do not restrict the source country’s (Country A) power to tax the partners who are its own residents on their share of income from the partnership¹³⁷⁰. In any event, the partner’s residence country (Country C) still has to grant the benefits of Art. 23 OECD Model to the partners¹³⁷¹.

The Partnership Report also illustrates another problem that may arise in cases of income allocation conflicts with regard to the application of Art. 23 OECD Model. Example 17¹³⁷² describes the following facts: A partnership resident of Country B generates a certain income in year 1 and distributes this income to partner P1, resident of Country C in year 2. Country B treats the partnership as a company and taxes the income generated in year 1, and

¹³⁶⁷ OECD Partnership Report, para. 124 and OECD Commentary 2014, nr. 32.7 ad. Arts. 23 A and 23 B.

¹³⁶⁸ Partnership Report, Example 16: “*P is a partnership established in State P. Partner B is a resident of State R while Partner A is a resident of State P. State P treats the partnership as a taxable entity while State R treats it as a transparent entity. P derives royalty income from State R that is not attributable to a permanent establishment in State R. P has an office in State P and may therefore be considered to have a permanent establishment in State P.*”

¹³⁶⁹ OECD Partnership Report, para. 124 and OECD Commentary 2014, nr. 32.7 ad. Arts. 23 A and 23 B.

¹³⁷⁰ OECD Partnership Report, para. 128 and OECD Commentary 2014, nr. 32.7 ad. Arts. 23 A and 23 B.

¹³⁷¹ OECD Partnership Report, para. 129 and OECD Commentary 2014, nr. 32.7 ad. Arts. 23 A and 23 B.

¹³⁷² Partnership Report, Example 17: “*P is a partnership established in State P. A and B are P’s partners who reside in State R. State P treats P as a taxable entity while State R treats it as a transparent entity. P derives royalty income from State P that is not attributable to a permanent establishment in that State.*”

the distribution of that income as dividends in year 2. Country C treats the partnership as fiscally-transparent and taxes the partner (following the Partnership Report named as P1) in year 1 on the income generated by the partnership. The distribution of that income in year 2 has no tax effect in the residence country of the partner (Country C)¹³⁷³.

The solution to this situation provided by the Partnership Report is as follows: if Country C is an exemption state (i.e. a country applying the exemption method), it has to exempt from tax the generation of profits in year 1 and Art. 10 OECD Model would allow that state to tax the income once it is distributed. If Country C is a credit state (i.e. a country applying the credit method), it should not be expected to credit the tax levied by Country B upon distribution against its own tax levied upon generation¹³⁷⁴. Example 18 of the Partnership Report clarifies this with an example¹³⁷⁵.

If Country B taxes the partnership at the time when the income is generated and Country C taxes the partners for the same income (i.e., tax is imposed on the same income, but the taxpayers are different), Country C has to give credit for the source tax levied on the partnership in Country B¹³⁷⁶.

¹³⁷³ OECD Partnership Report, para. 133 and OECD Commentary 2014, nr. 32.8 ad. Arts. 23 A and 23 B.

¹³⁷⁴ OECD Partnership Report, para. 137 and OECD Commentary 2014, nr. 69.2 and 69.3 ad. Arts. 23 A and 23 B.

¹³⁷⁵ Partnership Report, Example 17: *“In year 1, P, which is established and has a permanent establishment in State P, earns profits of 1 million. In year 2, P distributes to A, a resident of State R, his share in the profits earned in Year 1 (300,000). Under State P’s domestic law, P is a company and the profits would be taxed in year 1 at 40% (400,000). In Year 2, a further withholding tax (30,000) on the distribution to A would be imposed (by treating it as a dividend). Under State R’s domestic law, P is fiscally transparent, and State R would tax A in Year 1 on A’s share in P’s profits (500,000). State R would treat the distribution in Year 2 as having no tax effect.”*

¹³⁷⁶ OECD Partnership Report, para. 139.

6.1.2.3.6.3 The Collective Investment Vehicles Report

The CIV Report addresses the application of the tax relief methods provided for by Art. 23A and 23 B OECD Model¹³⁷⁷. Moreover, it discusses the question of whether the CIS or its investors would be entitled to claim tax relief. The CIV Report outlines three situations.

Firstly, the CIV Report points out that a CIS that is treated as a resident according to Art. 4 OECD Model can claim foreign tax credit. This credit, however, will likely go unused because CISs usually do not fulfil the requirement of residency¹³⁷⁸.

Secondly, if the CIS is treated as fiscally-transparent (*“flow-through”*) in the contracting state where it is established (Country B) and the investors are also residents of that same contracting state (contrary to the figure above), then each investor should be entitled to claim foreign tax credit with respect to its proportionate share of the foreign withholding taxes paid on the income of the CIS from Country A¹³⁷⁹. Conversely, if the investor is a tax-resident of a country other than the CIS’ residence country (Country C), the question of whether the investor may claim foreign tax credit depends on how Country C qualifies the CIS established in the state of establishment (Country B)¹³⁸⁰.

This third situation might involve an investor resident of a third State (Country C) which also considers the CIS as fiscally-transparent (*“flow-through”*). The CIV Report acknowledges that this situation might require specific legislation. The CIV Report, however, suggests that relief from the double taxation arising if the CIS’ residence country (country B) levied a withholding tax on earnings distributed to the investors in Country C could be achieved

¹³⁷⁷ In the case of movable capital property such as dividends and interests, such relief is provided only by the credit method.

¹³⁷⁸ CFA Report, para. 42.

¹³⁷⁹ CFA Report, para. 43. In this vein: BROWN, *Tax Treatment of Collective Investment Vehicles*, p. 67.

¹³⁸⁰ BROWN, *Tax Treatment of Collective Investment Vehicles*, p. 67.

by exempting income, providing a deduction for dividends, or refunding the foreign withholding tax to the CIS¹³⁸¹.

Moreover, the situation may occur that an investor is located in a third country (Country C) which considers the CIS to be a tax-subject entity (“*fiscally-opaque*”). In that scenario, the third state (Country C) might not provide foreign tax credit for the withholding taxes levied on income generated in Country A, but received by the CIS established in Country B. The reason for this is that the third country (Country C) would consider the CIS in its state of residence (Country B) as the beneficial owner of the income¹³⁸². The CIV Report suggests to solve this problem by including a provision in the OECD Commentary that allows the investor resident of the third country (Country C) who owns an interest in a CIS established in another country (Country B) but is subject to tax in Country C, to get a deduction from the income tax in its residence country of an amount equal to the tax paid in the third country¹³⁸³.

This solution has been subject to criticism because some countries may be reluctant to include such provision in a bilateral treaty. In fact, the fear is that this might constitute a two-party solution to a multilateral problem¹³⁸⁴. Moreover, there might be a neutrality problem because this solution requires the contracting state in which the investor is a resident to grant a greater foreign tax credit than it would have been granted if the investor had invested directly¹³⁸⁵. Another problem is that such provision might require a contracting state to provide tax relief for taxes paid to a third country, without the certainty that this country would provide reciprocal benefits. Finally, the provision raises questions as to whether this constitutes a case of economic (not within the scope of Art. 23 OECD Model) and not juridical double taxation (covered by Art. 23 OECD Model).

¹³⁸¹ CFA Report, para. 43.

¹³⁸² CFA Report, para. 44; BROWN, Tax Treatment of Collective Investment Vehicles, p. 67.

¹³⁸³ CFA Report, para. 45.

¹³⁸⁴ CFA Report, para. 46; BROWN, Tax Treatment of Collective Investment Vehicles, p. 69.

¹³⁸⁵ CFA Report, para. 46.

6.1.2.3.6.4 The OECD Final Report on BEPS Action Nr. 2 (Treaty Issues)

The BEPS Report suggests a modification to paragraph 2 of Art. 1 OECD Model. It reaffirms the conclusions found for partnerships and the state's right to tax its own residents¹³⁸⁶. This fact, however, does not restrict the obligation of the contracting state to provide relief for double taxation under Art. 23 A and 23 B OECD Model if income of a resident of that State is taxed by another state in accordance with the Convention¹³⁸⁷. The BEPS Report also clarifies that the recommendations of the Working Party Nr. 11 Discussion Draft concerning the elimination of double taxation do not raise issues with respect to the application of Art. 23 A and B OECD Model¹³⁸⁸.

6.1.2.3.6.5 Conclusion

The application of the relief methods provided for by Art. 23 A and 23 B OECD Model raises questions when tax relief is claimed by partnerships, CISs and trusts, in particular in hybrid situations.

When the partnerships or CISs are treated as fiscally-transparent entities (*"flow-through"*), both the Partnership Report and the CIV Report grant tax relief either to the partners or the investors¹³⁸⁹. On the other hand, when CISs are treated as a tax-subject entities (*"fiscally-opaque"*), the CIV Report suggests to include a provision that would allow the investor considered *"liable to tax"* of a third country (Country C), and a treaty resident of that same country to get a deduction from the income tax levied by the third country of an amount equal to the tax paid in that third country¹³⁹⁰. The idea behind this is to achieve tax neutrality between direct investments and investments through CISs.

¹³⁸⁶ OECD, Final Report on BEPS Action Nr. 2 (Treaty Issues), ad Art. 1 para. 26.16.

¹³⁸⁷ OECD, Final Report on BEPS Action Nr. 2 (Treaty Issues), ad Art. 1 para. 26.16.

¹³⁸⁸ OECD, Final Report on BEPS Action Nr. 2 (Treaty Issues), ad Art. 1 para. 26.16.

¹³⁸⁹ OECD Partnership Report, para. 56; CFA Report, para. 43 and OECD Commentary 2014, nr. 32.7 ad. Arts. 23 A and 23 B.

¹³⁹⁰ CFA Report, para. 45; STEVENS, Comparison between Partnership and Collective Investment Schemes Report, p. 112.

Finally, the BEPS Report reaffirms the principle that the resident state's right to tax its own residents does not prevent it from providing relief under Arts. 23 A and 23 B OECD Model in cases when one of its residents would also be subject to tax in the source state¹³⁹¹.

6.1.3 Delimitation of the Work of the OECD in the field of Hybrid Entities

6.1.3.1 General Remark

This chapter will analyze the scope of both the Partnership Report¹³⁹² and the Final Report on BEPS Action Nr. 2¹³⁹³ (hereafter: the BEPS Report) and whether CISs, trusts and partnerships differ in such a way that these Reports cannot be applied interchangeably. The chapter will specifically focus on how the work of the OECD in the field of hybrid entities, such as the (i) Partnership Report and the (ii) Final Report on BEPS Action Nr. 2 find systematic interpretation. This first paragraph attempts to answer the question of whether the findings of the Partnership Report can be applied to hybrid entities such as CISs and trusts simultaneously with the CIV Report, and how to delimit the scope of application for the Final Report on BEPS Action Nr. 2 with regard to CISs. Later, this chapter will outline what the leading scholars' approach to this issue is. Finally, this chapter provides a short conclusion and a proposed solution.

6.1.3.2 Does the Partnership Report limit its scope to Partnerships?

The question of whether the Partnership Report applies to other non-corporate entities such as CISs and trusts for the application of DTCs is unclear and will be explored in this subchapter¹³⁹⁴.

¹³⁹¹ OECD, Final Report on BEPS Action Nr. 2 (Treaty Issues), para. 26.16.

¹³⁹² See Chapter 6.1.3.2.

¹³⁹³ See Chapter 6.1.3.3.

¹³⁹⁴ Amongst others: BAKER, The Application of the Convention to Partnerships, Trusts and Other Non-Corporate Entities, p. 1; FREITAS DE MORAES E CASTRO, Treatment of Hybrid Entities, p. 280.

The introduction of the Partnership Report states that the Report applies to “*partnerships, trusts and other non-corporate entities*”¹³⁹⁵. The 1999 Partnership Report, however, explicitly refers to partnerships only as “*entities that qualify as such under civil or commercial laws*” of each contracting country¹³⁹⁶. Thus, by its own terms, the Partnership Report refers only to “*partnerships*”¹³⁹⁷. Although CISs and trusts may occasionally face problems similar to those affecting partnerships, more often than not CISs are confronted with increasingly complex problems.

6.1.3.2.1 Differences in Structure between CISs, Trusts and Partnerships

The first difficulty that one encounters when extending the solutions of the Partnership Report to CISs and trusts is that, as seen, the structure of CISs and trusts can clearly not be assimilated to the partnerships’ structure. Indeed, the Partnership Report itself acknowledges the difficulties that may arise when trying to apply the Report to partnerships with a large number of partners, who are residents of different states, a typical scenario in CIV cases¹³⁹⁸. Most partnerships are usually comprised of a small number of partners. Normally, a partner leaving the partnership or the entry of a new partner results in termination of the partnership. In that scenario, it seems easy, and even desirable as a tax policy, for a state to allocate the partnership’s income to a specific partner. On the other hand, the situation for CISs and trusts is quite different and not necessarily comparable. CISs usually have hundreds or thousands of investors. Likewise, trusts have, depending on the trust relationship at issue, beneficiaries with a mere expectation, as opposed to a fixed entitlement to receive certain distributions. This makes it very difficult (or even impossible) to allocate income to each unit holder of a CIS or beneficiary in a trust relationship¹³⁹⁹ based on the findings of the Partnership Report.

¹³⁹⁵ OECD, Partnership Report, para. 1 and OECD Commentary 2014, nr. 2 ad. Art.1.

¹³⁹⁶ OECD, Partnership Report, para. 2 and OECD Commentary 2014, nr. 2 ad. Art. 1. In detail: BROWN, Tax Treatment of Collective Investment Vehicles, p. 33; KUBIK, thesis, p. 162.

¹³⁹⁷ OECD, Partnership Report, para. 37.

¹³⁹⁸ OECD, Partnership Report, para. 75.

¹³⁹⁹ With regard to CIS, see: BROWN, Tax Treatment of Collective Investment Vehicles, p. 33

6.1.3.2.2 Limitations Drawn from CIV Report Findings

Another argument against the application of the Partnership Report to CISs and trusts relies on the publication of a report that deals exclusively with CISs. On 31 May 2010, the OECD Committee published a report entitled “*The Granting of Treaty Benefits with respect to Income of Collective Investment Vehicles*” (hereafter: the CIV Report). The CIV Report specifically deals with the interpretation of the general provisions regarding the personal scope of application and the treaty entitlement of CISs. This might lead to the conclusion that the application of the Partnership Report, which directly only addresses partnerships, is not appropriate for other types of business schemes. The fact that this Report was released after the Partnership Report of 1999 further weighs in favor of a non-application of the principles outlined in the Partnership Report to CISs.

Some authors have compared both the Partnership Report and the CIVs Report, concluding that, even though the CIVs Report refers on many occasions to the solutions provided by the Partnership Report, there are situations where the particularities of CISs may prevent a direct application of the solutions of the Partnership Report to CISs. This author concludes that a different approach that adapts to the specific structure of CISs may be required¹⁴⁰⁰.

Along the same lines, the author outlines that the scope and definitions adopted by the Partnership Report do not always encompass all of the CIVs’ situations. As mentioned above, the Partnership Report defines partnerships “*as entities that qualify as such under the civil or commercial law of each treaty partner*”¹⁴⁰¹. Thus, there is no separate definition of a partnership. The CIV Report, on the other hand, contains an autonomous definition of CIVs, namely funds that are widely held, hold a diversified portfolio of securities, and are subject to investor protection regulation in the country where they are established¹⁴⁰². The two distinct definitions provided reveal the different nature and characteristics inherent to both types of entities.

¹⁴⁰⁰ See Chapter 6.1.3.2.1; STEVENS, Comparison between Partnership and Collective Investment Schemes Report, p. 102.

¹⁴⁰¹ OECD, Partnership Report, para. 2 and OECD Commentary 2014, nr. 2 ad. Art. 1. See detailed analysis in Chapter 6.1.2.2.2.

¹⁴⁰² As examples, the CISs can adopt various legal forms such as indicated in paragraph 1: “*trusts, companies, and contractual arrangements*”. However, the legal form of a partnership is clearly not mentioned.

6.1.3.2.3 Look-Through Approach of Partnership Report not always practical for CISs

Another reason that seems to prevent the direct application of the Partnership Report to CISs relies on the fact that the look-through approach adopted by the Partnership Report is not always a practical solution for CISs. Under the Partnership Report, partners are entitled to claim treaty benefits when the partnership is treated as fiscally-transparent (“*flow-through*”). This solution might be difficult to apply to CISs because a large number of investors and changes in ownership will administratively prevent individual claims by investors from obtaining refunds, exemptions, etc. Also, in most jurisdictions income or gains are not attributed to the investors when the CIS itself receives them. Instead, they are attributed to the investors only once the fund decides to distribute said income. Therefore, true transparency is hard to achieve in the case of CISs because the investors have no right to receive the income until the fund decides to make a distribution¹⁴⁰³.

6.1.3.2.4 Opinions of Leading Scholars

In spite of the limitations outlined above, leading scholars nevertheless support the applicability of the Partnership Report findings to any circumstances regarding conflicts of attribution for other non-corporate entities¹⁴⁰⁴.

Jessica Salom and Hugues Salomé went a step even further in their IFA Branch Report for the 2014 IFA Congress in India. They concluded that the Partnership Report should apply not only to other non-corporate entities but even to corporate entities other than partnerships, without providing further explanations for their reasoning¹⁴⁰⁵.

In a recent doctoral thesis, Lars Gläser demonstrates, whilst considering the lack of grounds for application of the OECD Model, that the state of source

¹⁴⁰³ BROWN, Tax Treatment of Collective Investment Vehicles, p. 34.

¹⁴⁰⁴ LANG, Besteuerung von Einkünften bei unterschiedlichen Personen, p. 527 et seq.; KUBIK, thesis, p. 162; DANON, thesis, p. 323; DANON, Conflicts of Attribution, p. 210. Against: BROWN, Tax Treatment of Collective Investment Vehicles, p. 33; GLÄSER, thesis, p. 128.

¹⁴⁰⁵ SALOM/SALOMÉ, Qualification of taxable entities and treaty protection, p. 804.

is not bound by the rules of income attribution of the country of residence¹⁴⁰⁶. Furthermore, even if a contracting state accepts the Partnership Report, this does not necessarily lead to the resolution of all conflicts of attribution to be governed by the Partnership Report. Lars Gläser correctly points out that the application of the Partnership Report to all cases of conflicts of attribution would result in a delegation of legislative authority from the source state to the residence state. This can certainly not be the goal when drafting a DTC¹⁴⁰⁷.

Indeed, when the Partnership Report was drafted, by its terms it applied only to partnerships, and not to other hybrid entities such as CISs and trusts. This narrow scope surprised even some of those who had participated in the project. This was the position of, for example, Patricia Brown, a former U.S. tax treaty negotiator and later the principal drafter of the CIV Report¹⁴⁰⁸. Paragraph 37 of the Partnership Report, indeed, raised the issue of certain difficulties that may arise in its application to entities such as trusts, but deferred the analysis of these entities to a future revised version of the report which has yet to be completed¹⁴⁰⁹. This was, again, the position of the drafters of the Partnership Report, such as Patricia Brown. The recently published OECD Final Report on BEPS Action Nr. 2, a more recent report of the OECD, clearly confirms the assumption that the statements contained in the Partnership Report do not address other types of hybrid entities. Consequently, the OECD Final Report on BEPS Action Nr. 2 suggested certain modifications to ensure that income of transparent entities is treated in accordance with the principles of the Partnership Report¹⁴¹⁰.

Commentators of the BEPS Report have stated that the principles of the Partnership Report should be applied to partnerships and other wholly or partly fiscally-transparent entities¹⁴¹¹. In his comments to the BEPS Report, Robert Danon states that the BEPS Report should be interpreted so as to

¹⁴⁰⁶ GLÄSER, thesis, p. 129 in connection with OECD, Partnership Report, para. 47.

¹⁴⁰⁷ GLÄSER, thesis, p. 129.

¹⁴⁰⁸ BROWN, Tax Treatment of Collective Investment Vehicles, p. 33.

¹⁴⁰⁹ OECD, Partnership Report, para. 37. Further see: BROWN, Tax Treatment of Collective Investment Vehicles, p. 33.

¹⁴¹⁰ OECD, Final Report on BEPS Action Nr. 2, para. 435 (Treaty Issues).

¹⁴¹¹ Comments submitted by the International Alliance for Principled Taxation on Public Discussion Draft on BEPS Action Nr. 2, p. 280-281.

clarify and confirm the principles of the Partnership Report since the Partnership Report recognized that its principles were not only applicable to partnerships, but could also be relevant with respect to other entities such as trusts¹⁴¹².

6.1.3.2.5 Conclusion

A balance of all the factors and arguments outlined in this chapter shows that the OECD did not intend the findings of the Partnership Report to be directly applicable to other hybrid entities such as CISs and trusts. Patricia Brown, a former U.S. tax treaty negotiator and the principal drafter of the CIV Report, clearly stated that there was no consensus to extend the scope of the Partnership Report to CISs and trusts as this Report “[did] not adapt itself well to the significantly more complex practical and conceptual problems” posed by CISs and trusts¹⁴¹³.

6.1.3.3 *Does the Final Report on BEPS Action Nr. 2 Limit its Scope to Trusts and Partnerships without Extending to CISs?*

This subchapter will analyse the scope of the Final Report on BEPS Action Nr. 2. The main aim is to determine which types of entities the BEPS Report applies to, with a particular focus on trusts, partnerships and CISs. In order to be able to answer this question, it is important to determine the objective of the BEPS initiative.

6.1.3.3.1 Objective of the BEPS Initiative

The BEPS Report states that the report calls for the development of instruments, model treaty provisions and recommendations to neutralize the effects (e.g. unintended double non-taxation, double deduction, long-term deferral) of hybrid instruments and entities¹⁴¹⁴. Thus, the BEPS Report

¹⁴¹² OECD, Partnership Report, para. 37.

¹⁴¹³ BROWN, Tax Treatment of Collective Investment Vehicles, p. 33; FREITAS DE MORAES E CASTRO, Treatment of Hybrid Entities, p. 284.

¹⁴¹⁴ OECD, Final Report on BEPS Action Nr. 2, para. 429 (Treaty Issues).

intends, amongst other goals, to prevent transparent entities from being used to unduly obtain tax treaty benefits¹⁴¹⁵.

Commentators of the BEPS Draft have explained that the “*effect*” of the mismatch - and not the instruments or entities (such as CISs) themselves - should be addressed by the BEPS Draft¹⁴¹⁶. These commentators further clarified that “*base erosion*” and “*double non-taxation*” - as opposed to the instruments and entities that may cause hybrid mismatches - are the problems targeted by the BEPS Draft¹⁴¹⁷.

6.1.3.3.2 Investment Industry Concerns

Members of the investment industry commenting on the BEPS Draft have expressed concerns about the lack of uniformity and the uncertainty that would result from the implementation of the BEPS recommendations by different domestic legislations¹⁴¹⁸. CISs with real business purposes investing in different countries and having investors from diverse jurisdictions face the risk of an unreasonable administrative burden when trying to comply with the BEPS recommendations¹⁴¹⁹. Unnecessary administrative burdens might result, for example, from the application of paragraph 26.1 of the proposed commentary on Art. 1. This paragraph states that if a contracting state cannot obtain tax information about a person claiming tax treaty benefits, it should not grant the benefits, but might instead use a refund mechanism. The lack of CISs investors’ information might result in them never being entitled to claim tax treaty benefits, but only being able to claim refunds. Refund mechanisms, however, are administratively burdensome, costly and time consuming for taxpayers and tax administrations¹⁴²⁰.

¹⁴¹⁵ OECD, Discussion Draft on BEPS Action Nr. 2, para. 429 (Treaty Issues).

¹⁴¹⁶ Comments submitted by BusinessEurope Tax Policy Group on Public Discussion Draft on BEPS Action Nr. 2, p. 111.

¹⁴¹⁷ Comments submitted by BusinessEurope Tax Policy Group on Public Discussion Draft on BEPS Action Nr. 2, p. 111.

¹⁴¹⁸ Comments submitted by the Confederation of Netherlands of Industry and Employers on Public Discussion Draft on BEPS Action Nr. 2, p. 141

¹⁴¹⁹ Comments submitted by the European Banking Association on Public Discussion Draft on BEPS Action Nr. 2, p. 188.

¹⁴²⁰ Comments submitted by Deloitte UK on Public Discussion Draft on BEPS Action Nr. 2, p. 170.

Simply eliminating mismatches without considering whether there is actually a tax-avoidance purpose might be an excessive and inappropriate measure to prevent a comparatively scant amount of abusive companies from avoiding tax. A particular concern is that in many countries operating a self-assessment system for corporation tax, the taxpayers will have to ascertain the tax treatment of individual arrangements in other countries by themselves. Such a task may impose enormous administrative burdens and costs on taxpayers¹⁴²¹. Similarly, commentators expressed the concern that if each country decides individually whether or not to incorporate hybrid mismatch rules into domestic law, arrangements may be subjected to multiple tax systems and regulations, leading to the a greater risk of double taxation if there is no intergovernmental cooperation¹⁴²².

6.1.3.3.3 Issues Arising from Varying Regulations across Domestic Jurisdictions

Furthermore, the approaches proposed by the Discussion Draft could create situations in which a legitimate deduction is denied in all jurisdictions involved, under one or more different local tax rules or BEPS Action Plan initiatives, resulting in economic double taxation¹⁴²³. The application of the BEPS Draft to CISs also raises concerns because the BEPS Draft has not considered the recommendations of the CIVs Report, and does not take into account the special characteristics of CISs, such as the wide variety of type, origin and tax status of investors¹⁴²⁴. In the author's view, it is not understandable why the Discussion Draft on BEPS Action Nr. 2 has not examined CISs in light of the current discussion and does not further clarify the treatment of CISs. Indeed, the application of the draft to CISs that enjoy different

¹⁴²¹ Comments submitted by the Japan Foreign Trade Council on Public Discussion Draft on BEPS Action Nr. 2, p. 341.

¹⁴²² Comments submitted by the Japan Foreign Trade Council on Public Discussion Draft on BEPS Action Nr. 2, p. 341.

¹⁴²³ Comments submitted by BASF The Chemical Company on Public Discussion Draft on BEPS Action Nr. 2, p. 61; Comments submitted by the International Alliance for Principled Taxation on Public Discussion Draft on BEPS Action Nr. 2, p. 284.

¹⁴²⁴ Comments submitted by PriceWaterhouseCoopers on Public Discussion Draft on BEPS Action Nr. 2, p. 418-419.

treatment in domestic legal systems will be complex because the recommendations require changes in domestic laws¹⁴²⁵.

In this sense, commentators of the BEPS Draft have rightly expressed their concerns in applying the BEPS Action Nr. 2 recommendations to transactions involving CISs as defined by the CIVs Report¹⁴²⁶. The Draft proposes to include in the OECD Model provisions and commentaries to ensure that income of wholly or partly fiscally-transparent entities is treated, for the purposes of the Convention, in accordance with the principles of the Partnership Report¹⁴²⁷.

The same commentators suggest that the addition to paragraph 26.5 suggested by the BEPS Draft, stating that the Partnership Report conclusions should extend to situations that “*were not directly covered by the Report*”, fails to acknowledge the conclusions reached in the CIVs Report¹⁴²⁸. The CIVs Report, in this sense, has already examined whether the conclusions of the Partnership Report could be extended to CISs, balancing the specific characteristics of CISs. Thus, the BEPS Action Nr. 2 should not extend the conclusions of the Partnership Report to CISs and these entities should not be covered by the scope of the BEPS Draft because they are hardly ever involved in the type of transactions against which BEPS Action Nr. 2 is directed¹⁴²⁹.

6.1.3.3.4 High Administrative Burden Associated with Applying

¹⁴²⁵ Comments submitted by PriceWaterhouseCoopers on Public Discussion Draft on BEPS Action Nr. 2, p. 412.

¹⁴²⁶ Comments submitted by Investment Company Institute (ICI) & ICI Global on Public Discussion Draft on BEPS Action Nr. 2, p. 311-312.

¹⁴²⁷ Comments submitted by Deloitte UK on Public Discussion Draft on BEPS Action Nr. 2, p. 170.

¹⁴²⁸ Comments submitted by Investment Company Institute (ICI) & ICI Global on Public Discussion Draft on BEPS Action Nr. 2, p. 316.

¹⁴²⁹ Comments submitted by Investment Company Institute (ICI) & ICI Global on Public Discussion Draft on BEPS Action Nr. 2, p. 311-312.

BEPS Recommendations to Unrelated-Party Transactions

Additionally, the application of the BEPS recommendations with regard to unrelated-party transactions¹⁴³⁰ in the context of CISs may result in a high administrative compliance burden that does not outweigh the possible risk of “*base erosion*”¹⁴³¹. CISs are usually comprised of complex structures with numerous investors. The taxpayer’s deduction or inclusion is linked to whether that deduction or inclusion is granted or required in another jurisdiction. Such an approach is impossible to apply to entities with numerous members because it would impose a significant compliance burden on taxpayers, particularly if information is to be obtained from non-related entities and/or entities not under state control¹⁴³². Taxpayers would be required to assess not only how a certain arrangement is to be treated in the tax law of their own jurisdiction, but they would also have to understand the tax laws of the jurisdiction of their counterparties (which may in certain cases be several different jurisdictions). The tax treatment in each jurisdiction may be unclear and unpredictable¹⁴³³. Also, there might be substantial difficulties regarding the availability of investors’ information¹⁴³⁴, coupled with confidentiality issues preventing disclosure of the investors’ information¹⁴³⁵.

6.1.3.3.5 Issues Resulting from Timing Differences in Taxation

Moreover, the way CISs are structured can lead to timing differences in taxation as investors may not be taxed until the investment returns are being received. However, this does neither result in base erosion nor in untaxed income¹⁴³⁶. The consultation document appears to confirm that mere timing

¹⁴³⁰ OECD, Discussion Draft on BEPS Action Nr. 2, para. 140 (Recommendations for domestic laws)

¹⁴³¹ Comments submitted by BIAC on Public Discussion Draft on BEPS Action Nr. 2, p. 87-88.

¹⁴³² OECD, Discussion Draft on BEPS Action Nr. 2, para. 26.6 (Treaty Issues)

¹⁴³³ Comments submitted by BusinessEurope and PriceWaterhouseCoopers on Public Discussion Draft on BEPS Action Nr. 2, p. 113, 411 and 417.

¹⁴³⁴ Comments submitted by BVCA on Public Discussion Draft on BEPS Action Nr. 2, p. 98 et seq.

¹⁴³⁵ Comments submitted by BVCA on Public Discussion Draft on BEPS Action Nr. 2, p. 98.

¹⁴³⁶ OECD, Discussion Draft on BEPS Action Nr. 2, para. 26.10, 26.11 (Treaty Issues)

differences are not intended to be caught under the BEPS Draft rules¹⁴³⁷. If the draft rules were applicable to CISs, a relieving mechanism would be necessary when the timing differences are reversed in order to avoid double taxation for investors or penal asymmetry (e.g. tax for investors with no deduction for the payer). But such a mechanism would be hugely complex to establish across a diverse investor base and considering the frequent changes of investors. Also, the fund profit sharing ratios would make administering the arrangements very difficult in practice¹⁴³⁸. Even if investors do not change, taxpayers may face complex tracking challenges if they are forced to demonstrate the timing of a later year detriment in one country in order to claim the original benefit in another country¹⁴³⁹.

6.1.3.3.6 Compatibility issues with BEPS Draft due to Different Purposes of CISs

Considering the above, CISs should not be subject to the BEPS Draft recommendations because their aim is, as a general rule, not to benefit from mismatches resulting in “*double non-taxation*”, but rather the accomplishment of neutrality in investments¹⁴⁴⁰. Indeed, CISs are not normally set-up to benefit from mismatches¹⁴⁴¹, but are hybrid due to the largely diversified basis of investors originating from different jurisdictions and the diversity of jurisdictions these vehicles invest in¹⁴⁴². Such an arrangement is not based on aggressive tax planning, but is merely the result of different legal rules in different jurisdictions, and rarely results in “*double non-taxation*”.

¹⁴³⁷ OECD, Discussion Draft on BEPS Action Nr. 2, para. 26.10, 26.11 (Treaty Issues); Comments submitted by BVCA and PriceWaterhouseCoopers on Public Discussion Draft on BEPS Action Nr. 2, p. 95-96; 415-416.

¹⁴³⁸ Comments submitted by BVCA on Public Discussion Draft on BEPS Action Nr. 2, p. 97.

¹⁴³⁹ Comments submitted by the International Alliance for Principled Taxation on Public Discussion Draft on BEPS Action Nr. 2, p. 290.

¹⁴⁴⁰ Comments submitted by BVCA Taxation Committee on Public Discussion Draft on BEPS Action Nr. 2, p. 99.

¹⁴⁴¹ Comments submitted by the Chartered Institute of Taxation on Public Discussion Draft on BEPS Action Nr. 2, p. 125.

¹⁴⁴² Comments submitted by the International Alliance for Principled Taxation on Public Discussion Draft on BEPS Action Nr. 2, p. 291.

Indeed, some commentators on the draft have acknowledged that it cannot automatically be assumed that a transaction resulting in double exemption (or exemption plus deferral) is necessarily contrary to the intent of the relevant treaty. While the general policy of treaties is to avoid double taxation and not to create opportunities for double exemption, these commentators affirm that *“it is also the case that double exemption (or exemption plus deferral) can legitimately arise in many different circumstances under treaties”*¹⁴⁴³.

In any event, the goal of CISs is to make it possible for different investors to pool their investments without creating an additional layer of tax, or in other words, to benefit from tax neutrality. Directly applying the BEPS rules to CISs without a *“purpose test”*¹⁴⁴⁴ to ascertain the reasons for the mismatch would result in CISs becoming *“innocent victims of anti-treaty shopping rules and anti-hybrid rules”*¹⁴⁴⁵.

6.1.3.3.7 Conclusion

Taking into account their diverse ownership and structure, these pooled investment vehicles may, as a result, become innocent victims of anti-treaty shopping rules and anti-hybrid rules. In order to prevent this from happening, BEPS Action Nr. 2 should not be applied to CISs¹⁴⁴⁶.

6.1.4 Introduction to the Access of DTCs by Collective Investment Schemes and Trusts

Whether a CIS or its investors or by way of analogy a trust and its beneficiaries, settlors or even trustees are entitled to DTC benefits is a delicate question. Answering this question entails taking position on several difficult

¹⁴⁴³ Comments submitted by the International Alliance for Principled Taxation on Public Discussion Draft on BEPS Action Nr. 2, p. 288.

¹⁴⁴⁴ Comments submitted by the Investment Management Association on Public Discussion Draft on BEPS Action Nr. 2, p. 327, and Comments submitted by the European Banking Association on Public Discussion Draft on BEPS Action Nr. 2, p. 189.

¹⁴⁴⁵ Comments submitted by PriceWaterhouseCoopers on Public Discussion Draft on BEPS Action Nr. 2, p. 419.

¹⁴⁴⁶ Comments submitted by BVCA on Public Discussion Draft on BEPS Action Nr. 2, p. 99.

problems and the resolution of uncertainties regarding the interpretation of DTCs by both the residence and source states¹⁴⁴⁷. In particular, difficulties arise when trying to characterize a CIS or trust as a “*person*”¹⁴⁴⁸, “*resident*”¹⁴⁴⁹ and “*beneficial owner*”¹⁴⁵⁰, and, where appropriate, the “*attribution of income*” requirement¹⁴⁵¹. In order to gain access to a DTC, generally both contracting states have to accept that the CIS/trust fulfills each of the above mentioned requirements. Moreover, it is logical that DTC entitlement cannot be concurrently claimed by a CIS and its investors, or by a trust and its beneficiaries or settlor, in respect of the same tax liability¹⁴⁵².

However, the practical importance of securing withholding tax benefits to CISs and trusts cannot be underestimated. Such is demonstrated by the daily calculation of net asset values within CISs, since it is the basis for subscriptions and redemptions, the calculation of which takes into account expected and received amounts provided by DTC entitlements such as withholding tax benefits. Within CISs, any discrepancy between the net asset value and their real value can lead to problems for investors who have purchased, sold or redeemed their interests.

¹⁴⁴⁷ BUZANICH, Hybrid Entities, p. 72 et seq.

¹⁴⁴⁸ See Chapter 6.2.

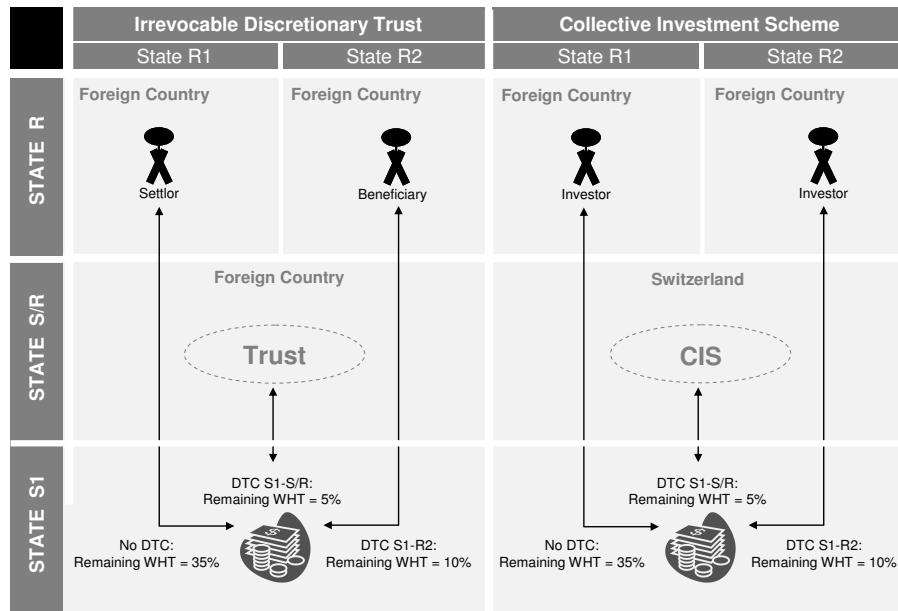
¹⁴⁴⁹ See Chapter 6.3.

¹⁴⁵⁰ See Chapter 6.5.

¹⁴⁵¹ See Chapter 6.4.

¹⁴⁵² In this vein: RYSER, double taxation treaties, p. 317.

Figure 6.2: Introduction to Access to DTCs by CISs and Trusts



Source: Own figure

6.1.5 Temporal Scope of Application

As a general rule, DTCs come into force as soon as ratification instruments are exchanged¹⁴⁵³. DTCs are concluded for an indefinite period of time and may normally be terminated before the end of each civil year providing a six months' notice¹⁴⁵⁴.

¹⁴⁵³ Art. 30 OECD Model.

¹⁴⁵⁴ Art. 31 OECD Model.

6.1.6 Territorial Scope of Application

The territorial scope of application of a DTC comprises the contracting states' aggregated territories. This territorial scope can be modified by including a territory that was originally excluded. This possibility is set forth in Art. 29 OECD Model.

6.1.7 Material Scope of Application

DTCs generally apply to income taxes and income and capital taxes as specified by the DTC¹⁴⁵⁵. However, Art. 2 OECD Model does not give a specific definition of the exact types of taxes to which it might be applicable. Therefore, if no autonomous meaning of DTC terms can be gathered by the application of Arts. 31 to 33 VCLT¹⁴⁵⁶, as a last resort and in order to determine the type of taxes involved, one must refer to each contracting state's domestic tax law. Swiss DTCs generally cover federal, cantonal and communal taxes on income and cantonal and communal taxes on capital. Certain DTCs, mainly those concluded with Anglo-Saxon countries, exclude capital taxes from their scope of application¹⁴⁵⁷. The inconsistency between income and capital taxes amongst different countries does not affect the present study, since this analysis focuses on income taxes.

6.1.8 Personal Scope of Application

The most controversial questions arise from the personal scope of application or "*ratione personae*" of DTCs. According to Art. 1 OECD Model, the Convention is applicable only to "*persons who are residents of one or both contracting states*"¹⁴⁵⁸. This statement contains two conditions – personality and residence - which are necessarily linked with two other requirements which are not expressly stated in this Article: beneficial ownership¹⁴⁵⁹ and

¹⁴⁵⁵ Art. 2 OECD Model.

¹⁴⁵⁶ See Chapter 5.2.3.5.

¹⁴⁵⁷ Among others: Art. 2 para. 2 (a) DTC Switzerland-United States; Art. 2 para. 1 DTC Switzerland-United Kingdom; Art. 2 para. 3 DTC Switzerland-South Africa; Art. 2 para. 3 DTC Switzerland-Mexico.

¹⁴⁵⁸ Art. 1 OECD Model.

¹⁴⁵⁹ See Chapter 6.5.

the attribution of income¹⁴⁶⁰. Interestingly, the OECD Commentary and the CFA Report make no reference to this fourth requirement.

6.2 The Term “Person” under Article 3 OECD Model

6.2.1 General Introduction

The term “*person*” constitutes the starting point when analyzing the application of a DTC. The requirement is set forth in Art. 1 OECD Model that defines which persons may benefit from the DTC. This legal norm is, therefore, the starting key provision in determining whether a DTC finds application or not. Following a literal interpretation, if the requirements deriving from Art. 1 OECD Model are not fulfilled, the DTC should not be applicable. Surprisingly, and even though the term is referred to in numerous provisions in the OECD Model, no definition or further explanation is given for this term¹⁴⁶¹.

The complexity of this analysis increases due to the large amount of DTCs concluded by Switzerland¹⁴⁶² in which the general term “*person*” appears, but in which the language is different from Art. 3 para. 1 (a) OECD Model. Thus, the present chapter aims at analyzing this term under Swiss DTC practice.

6.2.2 Definition of “Person”

The term “*person*” is defined in Art. 3 para. 1 (a) OECD Model as “*an individual, a company and any other body of persons.*” (“*natürliche Personen, Gesellschaften und alle anderen Personenvereinigungen*”; “*personnes physiques, les sociétés et tous autres groupements de personnes*”)¹⁴⁶³. According

¹⁴⁶⁰ See Chapter 6.4.

¹⁴⁶¹ See further to Art. 1, Art. 3 para. 1 (a); Art. 4; Art. 5 para. 5 and 6; Art. 6 para. 1; Art. 9 para. 1; Art. 11 para. 5 and 6; Art. 12 para. 1; Art. 24; Art. 25 para. 1 and 5; Art. 26 para. 1; Art. 27 para. 3 OECD Model.

¹⁴⁶² See Chapter 6.2.2.1.

¹⁴⁶³ Art. 3 para. 1 (a) OECD Model.

to the Commentary, that definition is non-exhaustive,¹⁴⁶⁴ and it should therefore be given a broad interpretation. Félix Alberto Vega Borrego has recognized that due to this broad definition, this requirement rarely constitutes a problem for treaty application purposes¹⁴⁶⁵. In accordance with leading scholars, thus, the term should be understood in a wider sense than simply including individuals, companies and other bodies of persons¹⁴⁶⁶.

Following this view, the 2014 OECD Commentary expressly includes foundations (“*Stiftung*”; “*fondation*”) and partnerships (“*Personengesellschaft*”; “*société de personnes*”) within the OECD Model’s personal scope of application¹⁴⁶⁷. Nonetheless, neither the OECD Model followed by most of the DTCs ratified by Switzerland, nor the OECD Commentary itself, specifically refers to CISs and trusts¹⁴⁶⁸. The only helpful guidance in this respect derives from the OECD Commentary’s inclusion of partnerships and foundations, demonstrating the wide and non-exhaustive meaning of the term “*person*”. Indeed, partnerships and foundations will also be considered as persons either because they fall within the definition of a company or, where this is not the case, because they constitute other bodies of persons¹⁴⁶⁹. Regarding the treatment of CISs, the OECD Commentary acknowledged that whether a CIS would be considered a “*person*” depends on the legal form of the CIS, which varies from one country to another¹⁴⁷⁰. The Commentary, however,

¹⁴⁶⁴ OECD Commentary 2014, nr. 2 ad. Art. 3.

¹⁴⁶⁵ BORREGO, p. 70.

¹⁴⁶⁶ OECD Commentary 2014, nr. 2 ad. Art. 3; SCHUCH, *Zeit im Recht der Doppelbesteuerungsabkommen*, p. 67; HUEMER, *Unbeschränkte Steuerpflicht natürlicher Personen*, p. 81; AIGNER, *thesis*, p. 50-51; LANG, *thesis*, p. 33.

¹⁴⁶⁷ OECD Commentary 2014, nr. 2 ad. Art. 3.

¹⁴⁶⁸ The only express references made to CISs are found in a handful of DTCs, in which a partnership is expressly included, such as the DTC with the United States, Canada and Bulgaria and in a few Memoranda of Understanding such as the DTCs with Denmark, the United Kingdom, Germany, France, Norway, Austria, Sweden and Spain. However, these Memoranda of Understanding do not specify whether a CIS is considered to be a person or not under the DTC. References to trusts are only given in a few instances, such as in Art. 3 para. 1 (a) of the Switzerland-United States DTC and in Art. 3 para. 1 (c) of the Switzerland-Canada DTC.

¹⁴⁶⁹ OECD Commentary 2014, nr. 2 ad. Art. 3.

¹⁴⁷⁰ OECD Commentary 2014, nr. 6.10 ad. Art. 1.

states that in most countries, CISs would be treated as a taxpayer, and therefore, as a “person” for DTC purposes¹⁴⁷¹. Unfortunately, the OECD Model itself does not explicitly provide guidance on whether hybrid entities such as CISs and trusts fall within the same definition. In order to answer this issue, recourse to domestic law might, as a last resort, be necessary.

This broad definition of the term “*person*” is clearly justified in light of the object and purpose of the Convention, which is to ensure extensive protection from double taxation¹⁴⁷². The US Model, for example, provides a broader definition which expressly includes estates, trusts and partnerships (“*Nachlässe, Treuhandvermögen und Personengesellschaften*”; “*successions, trusts et sociétés de personnes*”)¹⁴⁷³. In this vein, the OECD Model should be understood as following a broad interpretation of the term “*person*”¹⁴⁷⁴.

The interpretation of the terms “*individual*” and “*body of persons*” seem to have been left aside and are not expanded upon in the OECD Model¹⁴⁷⁵ or its Commentaries¹⁴⁷⁶. The term “*company*”, however, is further defined in Art. 3 para. 1 (b) OECD Model as “*any body corporate or any entity that is treated as a body corporate for tax purposes*” (“*juristische Personen oder Rechtsträger, die für die Besteuerung wie juristische Personen behandelt werden*”; “*toute personne morale ou toute entité qui est considérée comme une personne morale aux fins d’imposition*”). The narrower definition of company is relevant since, according to the OECD Model, any entity, including for present purposes CISs and trusts, may be treated as a body corporate for tax purposes¹⁴⁷⁷ as long as they are considered as tax-subjects in the sense of Art. 4 para. 1 OECD Model. The term “*person*” refers, therefore, not only to individuals, corporations and other bodies of persons, but also to

¹⁴⁷¹ OECD Commentary 2014, nr. 6.10 ad. Art. 1.

¹⁴⁷² OECD Commentary 2014, nr. 1 ad. Introduction.

¹⁴⁷³ Art. 3 para. 1 (a) US Model.

¹⁴⁷⁴ This applies also to DTCs that are based on older convention models, because the versions of the OECD Model from 1963, 1977 and 1992 - 2005 follow almost “*verbatim*” and show no deviations in terms of content to the OECD Model from 2010.

¹⁴⁷⁵ Art. 3 OECD Model.

¹⁴⁷⁶ OECD Commentary 2014, ad. Art. 3.

¹⁴⁷⁷ OECD Commentary 2014, nr. 2 ad. Art. 3.

all legal entities which under the law of one or both contracting states qualify as tax-subjects in the sense of Art. 4 para. 1 OECD Model.

The civil law concept of legal capacity is not, however, the only mechanism through which a hybrid entity may qualify as a “*person*” for tax treaty purposes¹⁴⁷⁸. Art. 3 para. 2 OECD Model refers only to the law of the country applying the DTC regarding taxes which are covered by the DTC, and not to provisions which confer legal personality. In some DTCs, the definition of the term “*corporation*” lacks a reference to other bodies of persons and the question of its scope is therefore debatable. However, the circle of those who qualify as persons in the sense of the DTC is usually broad due to the wide interpretation of the term, illustrated for example by the inclusion of partnerships and foundations. According to the OECD Commentary, it is irrelevant whether partnerships fall within the meaning of the term “*person*” because they fall within the definition of a company or, where this is not the case, because they constitute other bodies of persons¹⁴⁷⁹ without specification of any legal character or capacity. A foundation falls within the meaning of “*person*” because it is considered a body corporate for tax purposes¹⁴⁸⁰. In contrast to partnerships and foundations, the OECD Model and its Commentaries are silent on the crucial issue of whether CISs and trusts qualify as “*persons*”¹⁴⁸¹. This analysis will focus on whether these two hybrid entities fall within the meaning of the term “*person*”.

6.2.2.1 *Overview of the Connecting Criteria in Switzerland’s Double Tax Conventions*

The majority of the DTCs concluded by Switzerland refer to exactly the same criteria as Art. 3 para. 1 (a) OECD Model. A few of the Swiss DTCs, however, have additional criteria for defining the term “*person*” such as the express inclusion of partnerships, independent legal bodies which are treated as body corporate for tax purposes, estates, trusts, other entities subject to

¹⁴⁷⁸ For purposes of completeness, the OECD Commentary 2014 should add the limited partnership form in its paragraph 6.10 as in its paragraph 1. In practice, the limited partnership form is often used as a legal form for CISs. See OECD Commentary 2014, nr. 6.10 et seq. Art. 1.

¹⁴⁷⁹ OECD Commentary 2014, nr. 2 ad. Art. 3.

¹⁴⁸⁰ OECD Commentary 2014, nr. 2 ad. Art. 3.

¹⁴⁸¹ Art. 3 para. 1 (a) OECD Model.

taxation, unincorporated bodies of persons and any other entities with or without juridical personality. However, in stark contrast, the DTC with the Netherlands defines neither the term “*person*” nor the term “*company*”, and the DTC with Malaysia characterizes these terms according to domestic tax law.

The clearest criterion for defining the term “*person*” in line with the objective of the OECD Model, can be found in the DTC with the United States of America. It defines the term in a wider sense than most other DTCs concluded by Switzerland. This better illustrates the wide and non-exhaustive meaning the term should be given, in light of the object and purposes of the Convention.

Part 3 - Application of DTCs to CISs and Trusts

Figure 6.3: Comparison of Art. 3 para. 1 lit (a) + (b) OECD Model to the Relevant Swiss DTC

Comparison of Art. 3 para. 1 lit. (a) + (b) OECD MC to the relevant Swiss DTC			
DTC Country		Dev. ¹	Connecting criteria
Albania; Algeria; Argentina; Armenia; Austria; Azerbaijan; China; Côte d'Ivoire; Croatia; Czech Republic; Belarus; Denmark; Ecuador; Egypt; Estonia; Finland; France; Greece; Hungary; Iceland; Indonesia; Iran; Ireland; Israel; Italy; Jamaica; Japan; Kazakhstan; Korea; Kuwait; Kyrgyzstan; Latvia; Lithuania; Luxembourg; Macedonia; Mexico; Moldova; Mongolia; Morocco; New Zealand; Norway; Pakistan; Poland; Portugal; Rumania; Russia; Serbia and Montenegro; Slovakia; Slovenia; Spain; Sri Lanka; Sweden; Trinidad and Tobago; Tunisia; Ukraine; Uzbekistan; Venezuela; Vietnam	Art. 3 para. 1 (a) "person"	=	(a) the term "person" includes an individual, a company and any other body of persons
	Art. 3 para. 1 (b) "company"	=	(b) the term "company" means any body corporate or any entity that is treated as a body corporate for tax purposes
Australia; Belgium; South Africa	Art. 3 para. 1 (a) "person"	=	(a) the term "person" includes an individual, a company and any other body of persons
	Art. 3 para. 1 (b) "company"	Δ	<i>Additional criteria according to Art. 3 para. 1 (a) such as: body corporates or association corporate treated as entities for tax purposes</i>
Bulgaria; Canada; Germany; India; Philippines; Singapore; Thailand; United Kingdom; United States of America	Art. 3 para. 1 (a) "person"	Δ	<i>Additional criteria according to Art. 3 para. 1 (a) such as: Partnerships; independent legal bodies which are treated as body corporates for taxation purposes; estates; trusts; other entities subject to taxation; unincorporated body of persons and any other entity with or without juridical personality</i> <i>Missing criteria according to Art. 3 para. 1 (a), such as: and any other body of persons</i>
	Art. 3 para. 1 (b) "company"	=	(b) the term "company" means any body corporate or any entity that is treated as a body corporate for tax purposes
Malaysia; Netherlands	Art. 3 para. 1 (a) & (b)	Δ / –	<i>Netherlands: The terms "person" and "company" are not defined.</i> <i>Malaysia: The terms "person" and "company" is characterized according to its own tax law.</i>

¹ Deviation to the OECD Model Convention (Version: July 2008) as per April 10, 2010.

Source: Own figure

6.2.3 Do Collective Investment Schemes and/or Trusts Constitute a “Person”?

Whether a CIS or trust constitutes a “*person*” for the purpose of Swiss DTCs is more questionable than it would be for an individual, such as an investor within a CIS¹⁴⁸², or a settlor or beneficiary within a trust¹⁴⁸³. Their characterization depends either on their legal form or on whether they are a tax-subject in the sense of Art. 4 para. 1 OECD Model. The latter, though generally fails to occur. As stated by the CFA, however, there is no clear definition of what types of entities¹⁴⁸⁴ and different legal forms¹⁴⁸⁵ may be characterized as “*persons*”. Following a literal interpretation of the definition given by the OECD materials, such as the CFA Report, an entity’s legal form should not be relevant¹⁴⁸⁶.

For most Swiss DTCs it is not clear whether CISs or trusts satisfy the conditions to qualify as an “*individual*”, “*company*” or as “*any other body of persons*”¹⁴⁸⁷, since particular issues arise with regards to the characterization of a CIS or a trust as a “*person*”. Under the OECD Commentary the term “*person*” should be subject to a wide interpretation¹⁴⁸⁸. This results also from a textual interpretation of the article. It should be noted that if this were clarified in the article itself, it would have been of assistance to practitioners.

In most common law jurisdictions, trusts (or trustees) are taxpayers¹⁴⁸⁹, which would indicate that the trust’s country of establishment considers it to

¹⁴⁸² CFA Report, para. 36-40.

¹⁴⁸³ AVERY JONES, Trusts under the OECD Model, Part II, p. 66 et seq.

¹⁴⁸⁴ CFA Report, para. 11-21.

¹⁴⁸⁵ CFA Report, para. 1.

¹⁴⁸⁶ OECD Commentary 2014, nr. 6.8 ad. Art. 1. The term “*CIV*”, according to the Report, must fulfil the following three requirements: The fund must be “*widely-held*”, it must hold a “*diversified portfolio of securities*”; and the fund must be subject to “*investor-protection*” regulation in the country in which it is established. There is no explicit requirement with regard to the legal form of a CIS.

¹⁴⁸⁷ CFA Report, para. 25.

¹⁴⁸⁸ OECD Commentary 2014, nr. 2 ad. Art. 3.

¹⁴⁸⁹ The expression “*taxpayer*” requires an effective taxation to occur.

be “*resident*”. Such tax treatment would also indicate that the trust is considered to be a “*person*”¹⁴⁹⁰. However, in some jurisdictions, notably civil law countries such as Switzerland, trusts are not a recognized concept and therefore they are not considered “*persons*” in a similar way as they are in common law countries. In such cases, the access to DTC should be denied¹⁴⁹¹.

Clearly, a CIS or a trust may not be considered an “*individual*”, but could be better assimilated to a “*company*”¹⁴⁹² or to “*any other body of persons*”¹⁴⁹³. Therefore, the analysis of CISs and trusts should be performed under these two terms.

6.2.3.1 *Collective Investment Schemes or Trusts as a “Company”*

The conditions for qualifying as a “*company*” depend on either the legal structure of CISs and trusts¹⁴⁹⁴ or on their treatment for tax purposes¹⁴⁹⁵. It follows that CISs and trusts that are organized in a corporate form would easily satisfy the definition of a “*company*” because they constitute legal persons. Furthermore, even if a CIS or trust is not established as a corporation and therefore is not a legal person, they could still qualify as a “*company*”, provided that they are treated as a “*body corporate for tax purposes*” in one of the contracting states¹⁴⁹⁶. This might be possible in certain jurisdictions¹⁴⁹⁷. In most jurisdictions (including Switzerland), however, CISs and

¹⁴⁹⁰ OECD Commentary 2014, nr. 6.10 ad. Art. 1. In the OECD Model framework the conditions of person, residence, attribution of income and beneficial ownership are clearly differentiated and have to be fulfilled separately. However, in the author’s view the only decisive limitations for access to DTCs should be contained in the requirements of “*residence*”, “*attribution of income*” and “*beneficial ownership*”; therefore, the assumption that, whenever a CIS is “*resident*” it is considered as “*person*”, is totally justified. See for further details Chapter 6.2.

¹⁴⁹¹ CFA Report, para. 26.

¹⁴⁹² See Chapter 6.2.3.1.

¹⁴⁹³ See Chapter 6.2.3.2.

¹⁴⁹⁴ OECD Commentary 2014, nr. 6.10 ad. Art. 1.

¹⁴⁹⁵ OECD Commentary 2014, nr. 6.10 ad. Art. 1. Against: GRILLI, Treaty entitlement of investment funds, p. 877.

¹⁴⁹⁶ GLÄSER, thesis, p.58.

¹⁴⁹⁷ SORGENFREI, Steuerlicher Transparenzgrundsatz, p. 468.

trusts are fiscally-transparent (*“flow-through”*) entities and as they are not considered to be taxpayers, they may not be considered as a *“body corporate for tax purposes”*.

6.2.3.2 *Collective Investment Schemes or Trusts as “any Other Body of Persons”*

If based on the foregoing CISs and trusts cannot be characterized as a *“company”*, attention turns to whether they may be included within the meaning of the common law concept¹⁴⁹⁸ of *“any other body of persons”*, just as partnerships are¹⁴⁹⁹. In order for them to qualify as such, the term *“body of persons”* must be interpreted, since it is neither defined in the OECD Model nor in its Commentaries. According to Art. 3 para. 2 (a) OECD Model, the interpretation of a term that is not defined in the Convention should only be done under domestic law as a last resort, unless the context otherwise requires.

The wording *“any other body of persons”* is wide and clearly aligns with the interpretation deriving from Art. 3 para. 1 (c) OECD Model in which the term *“includes”* is used¹⁵⁰⁰. It can be seen from this that when interpreting *“body of persons”* a non-exhaustive approach must be followed¹⁵⁰¹. Construing the term in light of an autonomous international fiscal meaning¹⁵⁰², pursuant to the VCLT, and based on literal and grammatical arguments (on the meaning of the words), the term expresses a *“connection existing between a group of persons”*¹⁵⁰³ or, in other words, an association of persons. A trust relationship and a CIS organized under a contractual arrangement are not

¹⁴⁹⁸ AVERY JONES, Bodies of persons, p. 453 et seq.

¹⁴⁹⁹ LOCHER/MEIER/SIEBENTHAL, Doppelbesteuerungsabkommen, ad. B.3.1.2. In the United Kingdom, the Court of Appeal decided that a partnership could be considered as a *“body of persons”* for DTC purposes. In this vein: SCHWARZ, Tax Treaties, p. 92. Interestingly, the domestic tax and non-tax law of England does not include partnerships in body of persons. In this vein: AVERY JONES, Bodies of Persons, p. 453.

¹⁵⁰⁰ In this vein: AVERY-JONES, Bodies of Persons, p. 464.

¹⁵⁰¹ In this vein: DANON, thesis, p. 271 who refers expressly to the DTC between Switzerland and New Zealand.

¹⁵⁰² AVERY JONES, Bodies of Persons, p. 464. Against: GRILLI, Treaty entitlement of investment funds, p. 879.

¹⁵⁰³ DANON, thesis, p. 271.

necessarily excluded from this definition. However, there is no legal certainty as to whether CISs and trusts may be considered a “*body of persons*” in every case. Philip Baker confirms such uncertainty by stating that “[g]enerally, trusts and other non-corporate entities will involve associations of persons, but not necessarily a body of persons (in the sense that the entity constitutes a body distinct from its members)”¹⁵⁰⁴. A potential definition could be derived from and compared with that found in the UK Income Tax Ordinance, under Art. 1. Under such article the term is extensively defined as: “*any body politic, corporate or collegiate, and any company, fraternity, fellowship and society of persons whether corporate or not corporate*”¹⁵⁰⁵.

The idea that trusts may be considered a “*body of persons*” is supported by Walter Ryser and Carlo Garbarino, though without providing a convincing analysis¹⁵⁰⁶. According to Ineke Koele a trust with more than one trustee may clearly be considered a “*body of persons*”¹⁵⁰⁷, but a trust with only one trustee could not fall within this term¹⁵⁰⁸. Ineke Koele goes a step further than this and argues that a trust with several trustees which is a “*body of persons*” or “*body of trustees*”¹⁵⁰⁹ may be “*resident*” for DTC purposes in a contracting state if that is the place of effective management. This theory cannot find application in Switzerland as the Circular Letters 30 and 20 expressly exclude the trustee from being a tax-subject for income and wealth taxes. The trust may not, therefore, be considered resident for DTC purposes¹⁵¹⁰.

6.2.4 Conclusion

CISs and trusts should be considered “*persons*” within the scope of DTCs, following a wide and non-exhaustive interpretation of Art. 3 para. 1 (a)

¹⁵⁰⁴ BAKER, The Application of the Convention to Partnership, trusts and other Non-Corporate Entities, p. 2.

¹⁵⁰⁵ Art. 1 of the Income Tax Ordinance, 5721-1961.

¹⁵⁰⁶ RYSER, double taxation treaties, p. 313; GARBARINO, Trust, p. 392, 397.

¹⁵⁰⁷ KOELE, Trusts and the Application of the OECD Model Convention, p. 90.

¹⁵⁰⁸ KOELE, Trusts and the Application of the OECD Model Convention, p. 90.

¹⁵⁰⁹ In this vein: PALUMBO, Trust, p. 232.

¹⁵¹⁰ This is the case in Australia for fixed interest and discretionary trusts. In this vein: KOELE, Trusts and the Application of the OECD Model Convention, p. 88-90.

OECD Model, without consideration of their legal form¹⁵¹¹. This remains the case in contracting states in which trusts are not expressly included in the treaty definition of “*person*”¹⁵¹². This has also been stated in the case of trusts by Philip Baker, in a meeting for the International Tax Planning Association in 1993¹⁵¹³, and for CISs, by the General Report of the International Fiscal Association from 1997¹⁵¹⁴. A designated or particularized legal form should not be made a prerequisite for DTC access.

There seems to be a consensus among an increasing number of authors in the international tax law literature who believe that the term “*person*” should include CISs and trusts¹⁵¹⁵. The term “*person*” should not restrict the scope of application of the Convention¹⁵¹⁶. The term “*person*” only gains its meaning through the interplay with the elements of “*residence*”¹⁵¹⁷, “*beneficial ownership*”¹⁵¹⁸ and “*attribution of income*” (where applicable)¹⁵¹⁹. According to the CIV Report comments included in the OECD Commentary¹⁵²⁰, the attempt to limit the circle of those entitled to protection should be abandoned. Nevertheless, approaching the question from a legal perspective is rather complicated, not to mention inefficient, as seen in the last sentence which states: “*contracting states wishing to expressly clarify that, in these circumstances, such CIVs are persons for the purposes of their conventions may agree bilaterally to modify the definition of ‘person’ to include them*”¹⁵²¹.

¹⁵¹¹ In this vein also for CIS: BONGAARTS/ED, General report on the taxation of investment funds, p. 53.

¹⁵¹² On the contrary, countries like Canada or the United States expressly include trusts in the definition of “*person*”.

¹⁵¹³ In this vein also: JUNG, International Taxation, p. 145.

¹⁵¹⁴ BONGAARTS/ED, General report on the taxation of investment funds, p. 53-54.

¹⁵¹⁵ Amongst others: BAKER, The Application of the Convention to Partnership, trusts and other Non-Corporate Entities, p. 15. Against: MAISTO, Applicazione delle Convenzioni, p. 91.

¹⁵¹⁶ DANON, thesis, p. 271.

¹⁵¹⁷ See Chapter 6.3.

¹⁵¹⁸ See Chapter 6.5.

¹⁵¹⁹ See Chapter 6.4.

¹⁵²⁰ OECD Commentary 2014, nr. 6.11 ad. Art. 1.

¹⁵²¹ OECD Commentary 2014, nr. 6.10 ad. Art. 1.

This important question has been left unanswered and remains to be agreed upon by the contracting states.

It is incomprehensible that this question has not been approached from an economic point of view, instead of a legal point of view. A CIS or a trust is an autonomous pool of assets, which main characteristic is that they are separated from the assets of the parties involved. Following the reasoning of Tomi Viitala, it is difficult to find any justification to characterize CISs (and, by way of analogy, trusts) on the basis of their legal forms¹⁵²². The main objective of such structures is to manage assets on behalf of their beneficiaries, *“irrespective of whether this happens in a corporate or contractual form”*¹⁵²³. Therefore, from an economic point of view, they are clearly independent entities. CISs and trusts must thus be considered *“persons”* for treaty purposes irrespective of their legal forms. In the author’s opinion, which is in line with the position taken by Stefano Grilli, whether or not a CIS or trust may constitute a *“person”* should not depend on its tax treatment. Furthermore, the term *“person”* should not restrict the scope of application of the Convention¹⁵²⁴. The application of the Convention should gain its meaning only through the interplay with the elements of *“residence”*, *“beneficial ownership”* and *“attribution of income”* (where applicable)¹⁵²⁵.

6.3 The Term “Residence” under Article 4 para. 1 OECD Model

6.3.1 General Introduction

After having explored the meaning of the term *“person”*, the concept of *“residence”* will be analyzed according to Art. 4 OECD Model. This term is

¹⁵²² VIITALA, thesis, p. 82. Against: GRILLI, Treaty entitlement of investment funds, p. 876-881.

¹⁵²³ VIITALA, thesis, p. 82.

¹⁵²⁴ GRILLI, Treaty entitlement of investments funds, p. 877.

¹⁵²⁵ Chapter 6.2.4.

clearly the “*sine qua non*” condition and the the key element to determine the personal scope of application of a DTC for CISs and trusts¹⁵²⁶.

The concept of residence primarily has three functions¹⁵²⁷: (i) it determines the personal application of a DTC¹⁵²⁸, or in other words, answers the question of whether a taxpayer may have access to a DTC¹⁵²⁹; (ii) it resolves situations where double taxation occurs due to dual residency by way of a tie-breaker rule for individuals¹⁵³⁰ and corporations¹⁵³¹, definitively and ultimately determining where residence lies¹⁵³²; and (iii) it solves cases where double taxation arises as a consequence of taxation in both the state of residence and in the state of source¹⁵³³. Considering these important legal consequences and the frequent references to residence, close attention must be paid to its meaning, especially because no comprehensive definition is usually found in the relevant DTC¹⁵³⁴. The term is also used in Art. 1 OECD Model and in other articles such as those dealing with definitions¹⁵³⁵, the distributive rules¹⁵³⁶, the method article¹⁵³⁷, the prohibition of discrimination¹⁵³⁸ and in the regulations on the mutual agreement procedure¹⁵³⁹.

¹⁵²⁶ The author’s analysis on the term “*residence*” is partly based on his research in the field of “*Residence of Individual under Tax Treaties and EC Law*” led by Guglielmo Maisto. See: PFISTER/OBRIST, *Residence of Individual*, p. 541 et seq.

¹⁵²⁷ OECD Commentary 2014, nr. 1 ad. Art. 4.

¹⁵²⁸ OECD Commentary 2014, nr. 1 ad. Art. 4.

¹⁵²⁹ DANON, thesis, p. 274.

¹⁵³⁰ Art. 4 para. 2 OECD Model.

¹⁵³¹ Art. 4 para. 3 OECD Model.

¹⁵³² In this vein: REIMER, *Abkommensrechtliche Ansässigkeit*, p. 18.

¹⁵³³ OECD Commentary 2014, nr. 1 ad. Art. 4.

¹⁵³⁴ KROSCHEWSKI, *Ansässige Person*, nr. 24 ad. Art. 4.

¹⁵³⁵ Art. 3 para. 1 (a); Art. 4 para. 2 and 3; Art. 5 para. 7 OECD Model.

¹⁵³⁶ Art. 6 para. 1; Art. 8 para. 3; Art. 10 para. 1, 2, and 4; Art. 11 para. 1, 4 and 5; Art. 12 para. 1 and 3; Art. 13 para. 1, 2 and 4; Art. 14 para. 1; Art. 15 para. 1 and 2; Art. 16; Art. 17 para. 1; Art. 18; Art. 19 para. 1 and 2; Art. 20; Art. 21 para. 1 and 2; Art. 22 para. 1, 2 and 4 OECD Model.

¹⁵³⁷ Art. 23 A and B OECD Model.

¹⁵³⁸ Art. 24 para. 1, 3, 4, 5 and 6 OECD Model.

¹⁵³⁹ Art. 25 para. 1 OECD Model.

The analysis becomes more complex due to the large number of DTCs concluded by Switzerland¹⁵⁴⁰. The criteria used to define this concept may thus have important legal consequences. Beyond the difficulties that may arise from the concept of residence “*per se*”, there are additional and more complex issues when analyzing such a requirement in the case of CISs and trusts. Such issues have recently been discussed by the Federal Administrative Court of 7 September 2011 in the so-called “*Madeira*” case in relation to corporate entities¹⁵⁴¹. Moreover, Arnaud de Graaf and Frank Pötgens demonstrate in a recent article named “*Worrying Interpretation of ‘Liable to Tax’*”¹⁵⁴² the unclear meaning of this term in international tax law.

The present chapter aims to explore and analyze the basic principles applied in determining the residence of CISs and trusts in the Swiss DTC practice. The following chapter will define the term “*residence*”¹⁵⁴³ and evaluate its subsidiary conditions of being “*liable to tax*”¹⁵⁴⁴, and the closely linked condition of “*comprehensive taxation*”¹⁵⁴⁵. Then, the relevant connecting criteria to establish residence will be addressed¹⁵⁴⁶. Finally, these terms will be examined in relation to the application of DTCs to CISs and trusts¹⁵⁴⁷ in order to understand whether fiscally-transparent entities (“*flow-through*”), tax-exempt entities (“*tax-exempt*”)¹⁵⁴⁸ or even tax-subject entities (“*opaque*”) fulfill the condition of “*residence*” for DTC purposes.

6.3.2 Definition of Residence

The key element in order to determine whether a person (such as a CIS or trust) is “*resident*” in a contracting state for DTC purposes is the fulfillment

¹⁵⁴⁰ See Chapter 6.3.3.1.

¹⁵⁴¹ Federal Administrative Court of 7 September 2011 (A-813/2010).

¹⁵⁴² DE GRAAF/PÖTGENS, *Worrying Interpretation of liable to tax*, p. 169.

¹⁵⁴³ See Chapter 6.3.2.

¹⁵⁴⁴ See Chapter 6.3.2.1.

¹⁵⁴⁵ See Chapter 6.3.2.2.

¹⁵⁴⁶ See Chapter 6.3.3.

¹⁵⁴⁷ See Chapter 6.3.6.

¹⁵⁴⁸ A person may be tax-exempt owing to the use of losses, allowances for certain persons and exemptions of specific items of income, certain types of person and certain types of activity.

of the “*liable to tax*”¹⁵⁴⁹ condition under Art. 4 para. 1 OECD Model, which is closely linked to the requirement of “*comprehensive taxation*”¹⁵⁵⁰. The mechanism in place today under the OECD Model, however, neither systematically nor effectively ensures certainty for the contracting states as to the meaning of “*residence*” or, in other words, “*liable to tax*”¹⁵⁵¹. This mechanism is further problematic as the undefined term “*residence*” in the OECD Model is supposed to be given a meaning through another undefined term, “*liable to tax*”, in accordance with domestic law. The most difficult issue is precisely to determine what the terms “*liable to tax*” and “*comprehensive taxation*” mean¹⁵⁵² in relation to the “*domicile, residence, place of management or any other criterion of similar nature*” criteria under Art. 4 para. 1 OECD Model and under Swiss tax law. The ambiguous or absence of definitions and the inconsistencies therein derive from the scant amount of specific OECD guidance and the tendency of some countries, such as Canada¹⁵⁵³ and the Netherlands¹⁵⁵⁴, to interpret the “*liable to tax*” requirement as a “*subject-to-tax*” requirement¹⁵⁵⁵. This discrepancy boils down to whether the CIS or trust must be “*actually subject to taxation*” in at least one of the contracting states in order to benefit from Swiss DTCs, or whether “*effective recognition as a taxpayer*” with a locality-related or territorial attachment to the relevant contracting state is sufficient, irrespective of whether income taxes

¹⁵⁴⁹ See Chapter 6.3.2.1.

¹⁵⁵⁰ See Chapter 6.3.2.2.

¹⁵⁵¹ Art. 4 para. 1 OECD Model, headed “*Resident*” reads: “*For the purposes of this Convention, the term “resident of a Contracting State” means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein*”.

¹⁵⁵² In this vein: KLEIST, Treaty Entitlement of Tax Exempt Entities, p. 262.

¹⁵⁵³ Supreme Court of Canada, 22 Jun. 1995, nr. 23940 (Crown Forest Industries Ltd. V. Canada) (1995) 2 SCR 802. For a discussion of this case, see amongst others: LUKKIEN, nr. 3 as well as WARD, Crown Forest Industries, p. 408 et seq.

¹⁵⁵⁴ Dutch Supreme Court, 28 Feb. 2001, nr. 35557, BNB 2001/295; Dutch Supreme Court, 4 Dec. 2009, nos 07/10382-07/10384, V-N 2009/63.17; and Dutch Supreme Court, 4 Dec. 2009, nr. 08/05071, V-N 2009/62.5.

¹⁵⁵⁵ See LUKKIEN, nr. 3.

are in fact paid¹⁵⁵⁶. This was recently discussed by the Federal Administrative Court on 7 September 2011 in relation to a corporate entity in the “*Ma-deira*” case. The Court confirmed that “*effective recognition as a taxpayer*” is sufficient if residency based characteristics are given: “*(...) selbst Gesellschaften, welche aufgrund von objektiven, allgemeingültigen, generell-abstrakten Regeln keine Steuern bezahlen, aber “steuerpflichtig” sind, weil sie die ansässigkeitsbegründenden Merkmale in Portugal erfüllen, auch als dort “ansässig” im Sinne von Art. 1 i.V.m. Art. 4 Abs. 1 DBA-P zu betrachten sind*”¹⁵⁵⁷. This judgment will only have a direct impact on corporate forms of CISs such as the SICAV¹⁵⁵⁸. A fundamental difference in result between the two approaches would concern tax-exempt entities such as certain pension trusts and non-profit organizations. If the “*liable to tax*” simply requires recognition as a taxpayer, they may be regarded as tax resident (and thus able to claim entitlement to DTCs if the other conditions are met). However, if the condition requires effective taxation to have been levied, they would not be recognized as tax resident (and thus would be unable to claim entitlement to DTCs).

The first sentence of Art. 4 para. 1 OECD Model sets out the basic principle behind the article¹⁵⁵⁹. According to this principle, a person who is considered to be a “*resident of a Contracting State*” under its domestic tax law is considered a resident for DTC purposes¹⁵⁶⁰. In other words, DTCs do not offer proper rules to define the term of residence, but simply refer to the concept

¹⁵⁵⁶ Federal Administrative Court of 7 September 2011 (A-813/2010). In this vein also: DE GRAAF/PÖTGENS, Worrying Interpretation of liable to tax, p. 169.

¹⁵⁵⁷ Federal Administrative Court of 7 September 2011, cons. 7.4.2.4. (A-813/2010). It be stated that a Federal Administrative Court judgment of 29 August 2011, cons. 3.3.1. (A-1819/2011) with reference to a tax resident individual with domicile in Thailand has been rendered.

¹⁵⁵⁸ OESTERHELT, *Steuerliche Entwicklungen*, p. 38 et seq.

¹⁵⁵⁹ The principle deriving from Art. 4 para. 1 OECD Model is consistent with Art. 4 para. 1 UN Model. On the contrary, the US Model additionally introduced the criteria of nationality or citizenship according to the wording of Art. 4 para. 1 US Model.

¹⁵⁶⁰ OECD Commentary 2014, nr. 4 ad. Art. 4; RIVIER, *Droit Fiscal International*, p. 115, 123; LOCHER, *Einführung internationales Steuerrecht Schweiz*, p. 225; OBERSON/HULL, *International Tax Law*, p. 83; LOCHER/MEIER/ SIEBENTHAL, *Doppelbesteuerungsabkommen*, nr. 2, 9., ad. B.1; OBERSON, *Précis de droit fiscal international*, p. 92.

of residence set by each contracting state's domestic tax law¹⁵⁶¹. Since Art. 4 para. 1 OECD Model contains several references to domestic law, one must determine which contracting state's domestic law this article refers to. For example, Art. 6 para. 2 and Art. 10 para. 3 of the Model explicitly refer to the state of source and Art. 3 para. 2 refers to the state applying the DTC. The wording "*under the laws of that State (...) therein*" seems to indicate that Art. 4 para. 1 OECD Model refers to the law of the state in which the person is located¹⁵⁶². The CFA Report confirms that the interpretation of the term "*resident*" depends on the tax characterization of the CIS (and by analogy, to trusts) in the contracting state in which it is established¹⁵⁶³. Michael Lang concludes from the wording of Art. 4 para. 1 OECD Model that a person is considered to be a "*resident*" if the person is "*liable to tax*"¹⁵⁶⁴ in at least one of the contracting states¹⁵⁶⁵.

Following the second sentence of Art. 4 para. 1 OECD Model, "*liable to tax*" requires "*comprehensive taxation*" or, in other words, full liability to tax¹⁵⁶⁶ within the criteria listed in the first sentence of para. 1, such as "*domicile, residence, place of management or any other criterion of a similar nature*". Therefore, taxation on income in the state of source is insufficient to qualify for residence. Interestingly, Art. 4 para. 1 OECD Model, unlike Art. 2 OECD Model, does not even specify which taxes it applies to as it does not explicitly refer to taxes on income or capital.

In the author's view, it is not clear whether Art. 4 para. 1 OECD Model refers to income, capital or any other taxes, or if the second sentence of Art. 4 para. 1 only refers to income taxes. If the DTC covers income and capital taxes, it is not clear whether it remains unanswered that one of those taxes would be sufficient to gain DTC access. Another question which could arise is whether a company may be considered a "*resident*" based on Art. 4 para. 1

¹⁵⁶¹ RIVIER, National report on the residence of legal entities, p. 67.

¹⁵⁶² LANG, Besteuerung von Einkünften bei unterschiedlichen Personen, p. 527 et seq.

¹⁵⁶³ CFA Report, para. 27. This has been confirmed by OECD Commentary 2014, nr. 6.11 ad. Art. 1.

¹⁵⁶⁴ LANG, Aussensteuerrecht, Doppelbesteuerungsabkommen und EU-Recht, p. 283.

¹⁵⁶⁵ LANG, Besteuerung von Einkünften bei unterschiedlichen Personen, p. 64.

¹⁵⁶⁶ SCHLAGER, Ansässigkeit bei bloss inländischen Einkunftsquellen, p. 93 et seq.

OECD Model when, for instance, only capital (and no income) taxes are paid according to domestic tax laws. This issue is not purely theoretical, but has practical implications. Recently, the Mumbai High Court¹⁵⁶⁷ held, for instance, that the legal form of a German partnership is considered as “*resident*” based on Art. 4 of the DTC between Germany and India and fulfills the conditions to gain access to the DTC (dividend article of the DTC), even though the partnership is only subject to German trade taxes and not to any income taxes.

In principle, due to the non-exhaustive character of this clause¹⁵⁶⁸, a contracting state may define further criteria aiming at covering different forms of personal attachment that might exist between the taxpayer and a contracting state on the basis of full unlimited tax liability¹⁵⁶⁹. Some of the DTCs signed by Switzerland, for example the one with the United States, include a “*place of incorporation*” criterion (“*Ort ihrer Errichtung*”; “*lieu de son enregistrement*”)¹⁵⁷⁰. However, this additional criterion may not necessarily lead to DTC benefits if there is no territorial connection to at least one contracting state.

Therefore, whether a CIS or trust is considered to be a resident of a contracting state depends on its tax treatment in the state in which it is located or established. Further questions arise as to whether the CIS or trust must be subject to effective taxation in at least one of the contracting states in order to benefit from Swiss DTCs or whether recognition as a taxpayer is sufficient, irrespective of whether income taxes have actually been paid. If the CIS or trust is considered a “*resident*” it may claim treaty benefits in its own right. If the CIS/trust is not be recognized as a “*resident*”, the question becomes whether the investors or the settlor/beneficiaries (as appropriate), depending on the civil law in their domestic country, are entitled to any relief. This will

¹⁵⁶⁷ Mumbai High Court in the case of Chrion Behring GmbH & Co, 2013, TS-12-HC-2013, 659.

¹⁵⁶⁸ SHANNON, Definition of residence, p. 206.

¹⁵⁶⁹ OECD Commentary 2014, nr. 8 ad. Art. 4; HUEMER, Unbeschränkte Steuerpflicht natürlicher Personen, 1996, p. 85, 95.

¹⁵⁷⁰ Art. 4 para. 1 (a) DTC with the United States. It clearly follows the methodology of the US Model.

also depend on whether they qualify as “*residents*” under Art. 4 para. 1 OECD Model.

However, if one of the contracting states considers the person to be both “*liable to tax*” and to fulfill the closely linked requirement of “*comprehensive taxation*”, the other Contracting State has in principal the obligation to follow that recognition (source country follows residence country qualification). Interestingly, contrary to the problem of dual residency¹⁵⁷¹, the OECD Model does not contain any mechanism or special rules to assist any qualification conflict if the source country is unwilling to simply accept the residence state’s qualification on “*liable to tax*”.

In order to better understand the problem, let’s consider the following example: a CIS (with investors from a non-DTC country) or an irrevocable trust (with beneficiaries in a non-DTC country) is domiciled in the United Kingdom and receives dividend payments from Swiss sources. If the United Kingdom considers the CIS or trust to be “*liable to tax*”, the source country, in the present example Switzerland, will in principle follow that characterization. Nevertheless, the source country should, in the author’s view, be able to challenge the residence country’s qualification. In this sense, the source country should never accept such qualification without assessing itself the case at hand¹⁵⁷² and should only provide DTC access when the other conditions are met as well. According to Moris Lehner, there is no obligation for the source state to follow the qualification of the residence state¹⁵⁷³.

This could be compared to what occurred in a Canadian judgment, where the parent company fulfilled the “*liable to tax*” requirement, but was not granted entitlement to treaty benefits¹⁵⁷⁴. In the author’s view, such qualification made by the residence country should legitimately be challenged by the source country.

¹⁵⁷¹ Art. 4 para. 2 and 3 OECD Model.

¹⁵⁷² WHEELER, thesis, p. 24.

¹⁵⁷³ VOGEL/LEHNER, Doppelbesteuerungsabkommen 2008, nr. 87 ad. Art. 4.

¹⁵⁷⁴ For further details, see Chapter 6.3.2.2.

6.3.2.1 *The Meaning of the Expression “Liable to Tax”*

The expression “*liable to tax*” is not by its terms clearly understood. In this regard, there have been various discussions over its true meaning¹⁵⁷⁵.

In general, “*liable to tax*” means comprehensive taxation and is a synonym of full tax liability¹⁵⁷⁶ “*by reason of domicile, residence, place of management or any other criterion of similar nature*”¹⁵⁷⁷. The next chapter will explain and analyse these terms.

6.3.2.2 *The Meaning of “Comprehensive Taxation”*

When referring to the term “*liable to tax*” (“*steuerpflichtig*”; “*assujetti à l’impôt*”), the OECD Model generally assumes that an individual or corporate has to be fully taxed, such that the subject’s worldwide income and wealth are in fact subject to full tax¹⁵⁷⁸.

In the case of Switzerland, for instance, it should be under the terms of Art. 3 para. 1 LDFT; Art. 3 para. 1 LDHT, Art. 50 LDFT and Art. 20 para. 1 LDHT. If a contracting state (such as Singapore), for example, applies the principle of territoriality and the relevant individual or corporation is taxed only within that contracting state’s territory, the term “*liable to tax*” is clearly met for that person¹⁵⁷⁹. The OECD’s aim is not to exclude residents

¹⁵⁷⁵ Among others: AIGNER, thesis, p. 53; DANON, thesis, p. 285; VIITALA, thesis, p. 82 et seq.; RYSER, double taxation treaties, p. 313 et seq.; BAKER, The Application of the Convention to partnerships, trusts and other, non-corporate entities, p. 2 et seq.; GRILLI, Treaty entitlement of investment funds, 2004, p. 883 et seq.; VAN GEENEP, Dual-resident companies, p. 141; MÄUSLI, thesis, p. 115. KLEIST, Treaty entitlement of Tax Exempt Entities, p. 262.

¹⁵⁷⁶ OECD Commentary 2014, nr. 3 and 8.3 ad. Art. 4; LOCHER, Einführung internationales Steuerrecht Schweiz, p. 225, 259; LOCHER/MEIER/SIEBENTHAL, Doppelbesteuerungsabkommen, nr. 2, ad. B. 1; VIITALA, thesis, p. 83.

¹⁵⁷⁷ Art. 4 para. 1 OECD Model.

¹⁵⁷⁸ OECD Commentary 2014, nr. 3 ad. Art. 4. In this vein also: MAISTO, Residence of Individuals, p. 42.

¹⁵⁷⁹ OECD Commentary 2014, nr. 8.3 ad. Art. 4. This can illustratively be seen in the recent “*Madeira*” case, judgment of the Federal Administrative Court of 7 September 2011 (A-813/2010).

of countries applying the principle of territoriality¹⁵⁸⁰. However, it is unclear how to interpret the term in the context of Art. 4 para. 1 OECD Model.

For present purposes, the fundamental question is whether CISs and trusts which are fiscally-transparent (*“flow-through”*), partially or completely tax-exempt (*“tax-exempt”*) and/or bearing the characteristics of a tax-subject (*“opaque”*) may be considered *“liable to tax”*¹⁵⁸¹. It is unclear whether, according to a narrow interpretation¹⁵⁸², a taxpayer has to be effectively taxed on its worldwide income or whether, following a broad interpretation, mere recognition as a taxpayer is sufficient, irrespective of whether any income taxes are actually and effectively paid¹⁵⁸³. This difference is important in the context of hybrid entities such as CISs and trusts, which are fiscally-transparent under Swiss tax law. The question, in this sense, becomes, do they fulfill this criterion and may they, therefore, be considered *“resident”* for tax treaty purposes?

As previously noted, the question of residence is a purely domestic question and its answer depends on the relevant contracting state. Therefore, the interpretation of this term may vary considerably from country to country. Unlike the OECD Commentary, Swiss DTCs generally do not refer expressly or directly to the concept of full tax liability, with the exceptions of the DTCs concluded with Germany¹⁵⁸⁴ and Austria¹⁵⁸⁵, which specifically make use of this term¹⁵⁸⁶. Moreover, the DTCs with Australia¹⁵⁸⁷ and Kuwait¹⁵⁸⁸ only refer to the concept of full tax liability from a Swiss point of view. A possible

¹⁵⁸⁰ DE GRAAF/PÖTGENS, Worrying Interpretation of liable to tax, p. 169.

¹⁵⁸¹ OECD Commentary 2014, nr. 6.11, 6.12 ad. Art. 1. In this vein also: KLEIST, Treaty entitlement of Tax Exempt Entities, p. 262. See also the categorization made by GLÄSER, thesis, p. 64-65.

¹⁵⁸² OECD Commentary 2014, nr. 3 and 8.3 ad. Art. 4.

¹⁵⁸³ LANG, Taxation of Income in the Hands of Different Taxpayers, p. 598.

¹⁵⁸⁴ Art. 4 para. 1 DTC-Germany.

¹⁵⁸⁵ Art. 4 para. 1 DTC-Austria.

¹⁵⁸⁶ In this vein: MARAIA, Residence of companies under tax treaties, p. 809.

¹⁵⁸⁷ Art. 4 para. 1 DTC-Australia.

¹⁵⁸⁸ Art. 4 para. 1 DTC-Kuwait.

explanation arises when considering the origins of the concepts and expressions in these DTCs, since, in the past, the criterion of full taxation was not always required to qualify as a resident¹⁵⁸⁹.

According to tax literature, the term “*liable to tax*” does not require effective taxation as most DTCs do not expressly or directly refer to the concept of full tax liability. The same result may be deduced from a literal interpretation of the German expression: “*steuerpflichtig*”, as well as the French version: “*assujetti à l’impôt*”. Therefore, it seems it is not necessarily required that the taxpayer have effectively been taxed on its worldwide income in order to be “*liable to tax*”. In other words, recognition as a taxpayer is sufficient to satisfy this requirement, irrespective of whether any income taxes have actually been paid¹⁵⁹⁰.

This is in line with Art. 4 para. 1 OECD Model, which does not contain a general “*subject-to-tax*” clause.

Before systematically summarizing the various authors’ views on the interpretation of the term “*liable to tax*” and to conclude on the interpretation given in Switzerland, the term should be introduced in this present chapter¹⁵⁹¹. The term “*liable to tax*” and the “*subject-to-tax*” clause are clearly differentiated in the OECD Model framework¹⁵⁹². Given this, a broader meaning has to be attributed to the term “*liable to tax*” than to the term “*subject-to-tax*”. A person does not have to be effectively taxed in order to be “*liable to tax*”¹⁵⁹³. In the case of partnerships, for example, a DTC may apply even if one state does not exercise its taxing rights¹⁵⁹⁴. Michael Lang notes that a tax exemption in one contracting state does not prevent the taxpayer from accessing DTC benefits in other contracting states¹⁵⁹⁵. Indeed,

¹⁵⁸⁹ AVERY JONES et al., *The Origin of Concepts and Expressions Used in the OECD Model and their Adoption by States*, p. 220.

¹⁵⁹⁰ HELMINEN, *Distributions from Investment Funds*, p. 2163.

¹⁵⁹¹ See Chapter 6.3.4

¹⁵⁹² In this vein also: DE GRAAF/PÖTGENS, *Worrying Interpretation of liable to tax*, p. 172.

¹⁵⁹³ See in this vein also: DANON, *thesis*, p. 279; DE GRAAF/PÖTGENS, *Worrying Interpretation of liable to tax*, p. 172.

¹⁵⁹⁴ LANG, *Partnerships*, p. 37.

¹⁵⁹⁵ LANG, *Partnerships*, p. 37 et seq.

the OECD Commentary clarifies that “*pension funds, charities, and other organizations*”, which may be tax-exempt, may nevertheless be considered as “*liable to tax*”¹⁵⁹⁶. Klaus Vogel considers that entities with a public function may be considered resident so long as they show connections to the contracting state that could lead to full tax liability, regardless of whether they are fully and effectively taxed¹⁵⁹⁷. This approach illustrates that fulfillment of the “*liable to tax*” requirement does not require actual and effective taxation of the subject’s worldwide income. An abstract, potential liability is sufficient. This view was confirmed by the International Fiscal Association Congress Panel in 2004¹⁵⁹⁸.

On the other hand, contracting states have no “*obligation*” to consider such entities as being “*liable to tax*”¹⁵⁹⁹. Jurisdictions are also free to decline to tax a subject’s worldwide income without denying that the subject is “*liable to tax*” for DTC purposes¹⁶⁰⁰. This may be seen in certain jurisdictions who impose a zero rate, a subjective or objective exemption, or a reduction in the taxable base. This must be clearly distinguished from fiscally-transparent (“*flow-through*”) persons. These different systems make it extremely controversial to provide a clear answer as to when the “*liable to tax*” requirement is fulfilled.

Additional support for this wide interpretation of the “*liable to tax*” criterion is provided by the 1996 US Model Technical Explanation to Art. 4 para. 1, which states that “*certain entities that are nominally subject-to-tax but that in practice are rarely required to pay tax also would generally be treated as residents and therefore accorded treaty benefits*”¹⁶⁰¹. The 1981 US Model, by way of comparison, did not include such a wide interpretation.

¹⁵⁹⁶ OECD Commentary 2014, nr. 8.5 ad. Art. 4; VOGT/WÜSTEMANN/SCHMID, charitable giving, p. 421 et. seq.

¹⁵⁹⁷ VOGEL, Double taxation conventions, nr. 24 ad. Art. 4.

¹⁵⁹⁸ See also: DE GRAAF/PÖTGENS, Worrying Interpretation of liable to tax, p. 172.

¹⁵⁹⁹ OECD Commentary 2014, nr. 8.6 ad. Art. 4.

¹⁶⁰⁰ In theory, this may result in a zero rate, a subjective or objective exemption, or a reduction in the taxable base. This must be distinguished from fiscally-transparent persons.

¹⁶⁰¹ Technical Explanations of the United States on the United States Model of November 15, 2006, p. 13 et seq.

This inclination towards a broad interpretation is also shared by Philip Baker, who states that “*‘liable to tax’ does not mean that the person must be actually paying tax in the state; entities which enjoy a complete exemption from tax are still residents of a state so long as that state could assert jurisdiction to tax the entity on its worldwide income in accordance with one of the internationally accepted bases for full tax liability*”¹⁶⁰². The decisive factor is whether there is recognition as a taxpayer, irrespective of whether any income taxes have effectively been paid. The exemption, for instance, of income deriving from foreign permanent income or real estate¹⁶⁰³ does not deny that a person is resident in a given state. An exemption for specific categories of income does not deny residence to a taxpayer, and so does not deny access to DTCs, on the basis that no taxes are effectively paid in Switzerland. For instance, Swiss companies are generally considered resident for DTC purposes even if their income falls within an exempt category such as a cantonal holding tax regime¹⁶⁰⁴, mixed company tax status¹⁶⁰⁵ or the participation reduction¹⁶⁰⁶. In this regard, David A. Ward states that “*the definition of residence is intended to refer to the connecting factors of a person with a contracting State that are used by that state to impose unlimited taxation, but it is not a requirement that the person who has such connecting factors actually be subject to unlimited taxation if the domestic law relieves him of some or all tax on his income under special provisions*”¹⁶⁰⁷.

A Canadian judgment goes even further in respect of fiscally-transparent (“*flow-through*”) entities¹⁶⁰⁸. In this case, the “*liable to tax*” condition was considered in relation to a US limited liability company (LLC)¹⁶⁰⁹, which was treated as tax-transparent under US law and as a tax subject (“*fiscally-opaque*”) under Canadian law. The Canadian Court interpreted “*liable to*

¹⁶⁰² BAKER, The Application of the Convention to Partnership, trusts and other Non-Corporate Entities, p. 2-3.

¹⁶⁰³ KROSCHEWSKI, Ansässige Person, nr. 27 ad. Art. 4.

¹⁶⁰⁴ Art. 28 para. 2 LHDT.

¹⁶⁰⁵ Art. 28 para. 4 LHDT in connection with Art. 28 para. 3 LHDT.

¹⁶⁰⁶ Art. 28 para. 1 LHDT and Art. 69 LDFT.

¹⁶⁰⁷ WARD, Crown Forest Industries, p. 408 et seq.

¹⁶⁰⁸ Canadian Tax Court of 8 April 2010 (2008-2314).

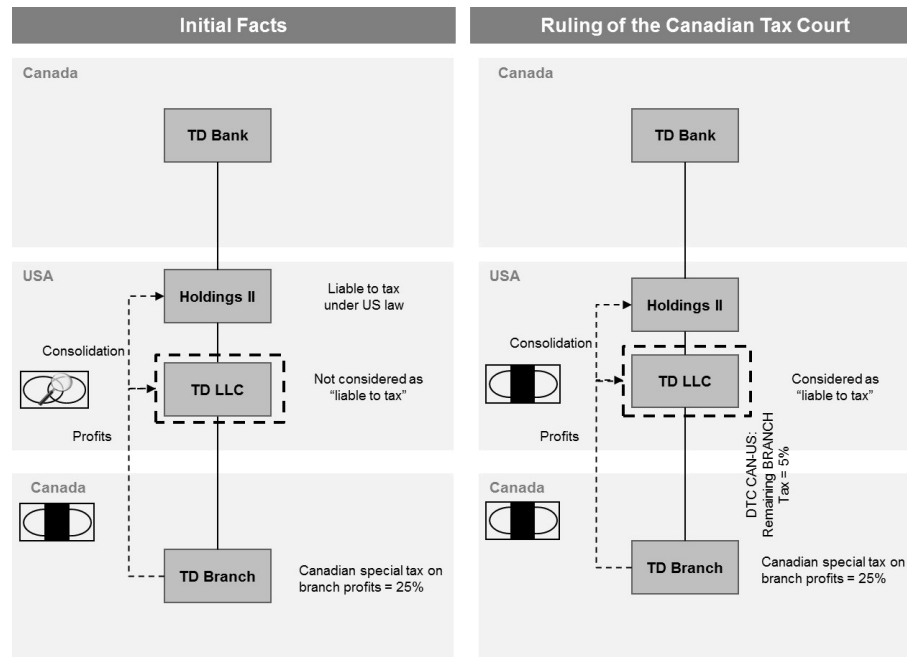
¹⁶⁰⁹ The LLC is a corporation which can be disregarded as an entity for US tax purposes, unless it makes an election to be treated as a taxable entity.

tax” by referencing the OECD Partnership Report and the OECD Commentary, as neither Canada nor the US had expressed a reservation or observation to either document. The Report considered the case where a source state’s tax laws treat a foreign partnership as a taxable entity but the partnership is tax-transparent (“*flow-through*”) under the tax laws of the partners’ country of residence¹⁶¹⁰. The OECD’s position in this case was that treaty benefits should apply to the partnership’s income on the basis that the partners are liable to tax in respect of such income. Surprisingly, the Canadian Court said that a similar conclusion should apply to a fiscally-transparent US LLC. The sole US member of the LLC was fully and comprehensively taxed under US tax laws so that the Court concluded that the member of the LLC qualified as a “*criterion of a similar nature*”, in order to found residence of the LLC under the applicable US-Canada DTC. Therefore, the LLC was considered to be within the scope of the DTC¹⁶¹¹ (notwithstanding that such taxation occurred only at the level of its US resident member, Holdings II).

¹⁶¹⁰ OECD, Partnership Report, para. 64 et seq.

¹⁶¹¹ See: LUKKIEN, nr. 5.4.2.

Figure 6.4: Canadian-US Case of 8 April 2010



Source: Own figure

In conclusion, this court's decision is not convincing under the current treaty framework as it is unanimously admitted that a LLC does not meet the residence requirement. In the present case, it is clear that only the sole partner of the LLC is entitled to treaty benefits since he is an effective resident of the United States. In this regard, Tulio Rosembuj states correctly that *"the fact that the sole partner and its sole partner pay the tax for the income derived from the entity does not transform the entity into a resident company nor transform the partners into equivalent taxpayers (by substitution)"*¹⁶¹². In the present court decision, it can be observed that even a fiscally-transparent (*"flow-through"*) entity may fulfill the *"liable to tax"* condition. However, such wide interpretation goes too far and opens the door to diverging inter-

¹⁶¹² ROSEMBUJ, Hybrid Entities, p. 316.

pretations in regard to the situations in which the DTC between both contracting states was trying to avoid double taxation. However, it should be noted that the situations as provided for in the DTC between Canada and the United States¹⁶¹³ cannot be readily compared with the OECD Model¹⁶¹⁴, because on one side the residence clause is different, and on the other side, its interpretation also differs. From a comparative Swiss view, a US LLC would not be considered to be “*liable to tax*” under the Swiss-US DTC¹⁶¹⁵. Further, from the perspective of the OECD, the tax-transparent LLC should be treated as a partnership. On this view, Canada would have to follow the residence state’s characterization of the LLC, in this case the one provided under US law¹⁶¹⁶. Access to the DTC would therefore only be granted to the members of the LLC and not to the LLC itself.

There is a body of international case law concerning the term “*liable to tax*”, which favors a wide interpretation and does not require an effective payment of taxes on a subject’s worldwide income in order for the condition to be sat-

¹⁶¹³ Art. 4 para. 1 CAN-US DTC, headed “*Resident*” reads: “*For the purposes of this Convention, the term “resident” of a Contracting State means any person that, under the laws of that State, is liable to tax therein by reason of that person’s domicile, residence, citizenship, place of management, place of incorporation or any other criterion of a similar nature, but in the case of an estate or trust, only to the extent that income derived by the estate or trust is liable to tax in that State, either in its hands or in the hands of its beneficiaries. For the purposes of this paragraph, an individual who is not a resident of Canada under this paragraph and who is a United States citizen or an alien admitted to the United States for permanent residence (a “green card” holder) is a resident of the United States only if the individual has a substantial presence, permanent home or habitual abode in the United States, and that individual’s personal and economic relations are closer to the United States than to any third state (...)*”.

¹⁶¹⁴ Art. 4 para. 1 OECD Model, headed “*Resident*” reads: “*For the purposes of this Convention, the term “resident of a Contracting State” means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein*”.

¹⁶¹⁵ See the practice of the Swiss Tax Conference regarding the tax treatment of US LLC, p. 6.

¹⁶¹⁶ Art. 1 OECD Model in connection with Art. 4 OECD Model. See: TORRIONE, *Sociétés de personnes*, p. 230.

isfied. This case law includes the Swiss Federal Administrative Court decision of 7 September 2011¹⁶¹⁷, the ruling by the Indian Authority for Advance Rulings of 14 December 2005¹⁶¹⁸, the ruling by Sweden's Supreme Administrative Court of 2 October 1996¹⁶¹⁹, the ruling by Finland's Supreme Administrative Court of 22 December 2004¹⁶²⁰, the decision by the Munich Lower Finance Court of 13 June 2003¹⁶²¹, rulings by the Paris Administrative Court of Appeal¹⁶²² and a ruling of the Paris Administrative Court of 14 January 2010¹⁶²³.

It should be noted, however, that a contrary body of case law also exists, requiring a subject to be effectively taxed in order to be "*liable to tax*". This more strict interpretation has been followed by the Supreme Court of Canada's decision of 22 June 1995¹⁶²⁴ and the Dutch Supreme Court¹⁶²⁵.

6.3.3 The Relevant Connecting Criteria to Establish "Resident" Status

Unlimited tax liability by itself is not sufficient for a subject to be considered a "*resident*" under a DTC. Additionally, it must correspond with one of a number of specific and particular criteria: "*domicile, residence, place of management or any other criterion of a similar nature*". These connecting criteria are referred to in Art. 4 para. 1 first sentence of the OECD Model, which was originally introduced in the Organisation for European Economic

¹⁶¹⁷ Federal Administrative Court of 7 September 2011 (A-813/2010).

¹⁶¹⁸ Indian's Authority for Advance Rulings (AAR), 14 December 2005, nr. 659.

¹⁶¹⁹ Sweden's Supreme Administrative Court (Regeringsrätten) of 2 October 1996, ref. 84 (6301-1994).

¹⁶²⁰ Finland's Supreme Administrative Court (Korkein hallinto-oikeus) of 22 December 2004 (KHO 2004:111).

¹⁶²¹ Munich Lower Court of 13 June 2003 (7 K 3871/00) = EFG 2004, 478.

¹⁶²² Paris Administrative Court of Appeal (Cour Administrative d'Appel) of 6 December 2007 (07-01717, 06-03370, 06-03371).

¹⁶²³ Paris Administrative Court (Tribunal Administratif) of 14 January 2010 (08-11669).

¹⁶²⁴ Canadian Supreme Court of 22 June 1995 (23940).

¹⁶²⁵ Dutch Supreme Court of 28 February 2001 (35557) = BNB 2001/295; Dutch Supreme Court of 4 December 2009 (07/10382-07/10384) = V-N 2009/63.17 and Dutch Supreme Court of 4 December 2009 (08/05071) = V-N 2009/62.5.

Cooperation's First Report in 1958¹⁶²⁶. Therefore, different criteria created by domestic tax laws, which do not correspond to the ones set forth in the Convention, would thus establish residence under the Convention¹⁶²⁷.

The important question in these regards is the way in which the criteria in Swiss tax law fall under those in Art. 4 para. 1 OECD Model, which expressly refer to domestic tax law in order to establish residence¹⁶²⁸. The interpretation of these criteria, thus, must follow the domestic law of the contracting state.

But this, however, does not mean that the content of the characteristics of residence has been totally delegated to domestic law. The article shows that, besides "*domicile, residence and place of management*", other criteria may also be taken into account in order to establish residence under the Convention, expressing its non-exhaustive character. This open and undefined list of characteristics is also clearly expressed by the wording "*any other criterion of a similar nature*".

According to leading scholars, all criteria must present a territorial nexus, or in other words, a locality-related attachment with the concerned state¹⁶²⁹. A narrower interpretation of Art. 4 para. 1 OECD Model is not possible. In this respect, only locality-related attachments which have the ability, according to domestic law, to constitute an unlimited tax liability are accepted¹⁶³⁰. In contrast, characteristics which are not locality-related do not fulfill the requirement of residence under the Convention¹⁶³¹. In some states, such as the US, tax liability depends on nationality, and so it may be considered whether Art. 4 para. 1 OECD Model also encompasses nationality. In one view, nationality does not fulfill the residence requirement under the first sentence of Art. 4 para. 1 since tax liability is not necessarily predicated on a locality-

¹⁶²⁶ AVERY JONES et al., *The Origin of Concepts and Expressions Used in the OECD Model and their Adoption by States*, p. 230.

¹⁶²⁷ WASSERMEYER/DEBATIN, *Commentary*, nr. 29 ad. Art. 4.

¹⁶²⁸ OECD *Commentary* 2014, nr. 8 ad. Art. 4; WASSERMEYER/DEBATIN, *Commentary*, nr. 25 et seq., ad. Art. 4.

¹⁶²⁹ VOGEL/LEHNER, *Doppelbesteuerungsabkommen* 2008, nr. 25 ad. Art. 4; WASSERMEYER/DEBATIN, *Commentary*, nr. 29 ad. Art. 4.

¹⁶³⁰ In this vein: SHANNON, *Definition of residence*, p. 206 et seq.

¹⁶³¹ WASSERMEYER/DEBATIN, *Commentary*, nr. 29 ad. Art. 4.

based attachment¹⁶³². To eliminate this uncertainty, the term nationality is expressly included in US DTCs, unlike in the OECD Model. However, the phrase “*any other criterion of a similar nature*” is clearly broad enough to encompass nationality as a characteristic of tax liability since it is a personal attachment to the relevant taxpayer’s contracting state. The “*other criterion of a similar nature*” catch-all element is, however, limited and does not represent a general clause encompassing all of the different tax liability characteristics which may be included in each domestic law system¹⁶³³. It is simply impossible to be considered a “*resident*” and to fulfill the requirement of unlimited tax liability without satisfying some *locality-related* attachment. Consequently, some scholars consider that “*other criterion*” could simply mean a criterion with a territorial nexus¹⁶³⁴. The term “*residence*” under Art. 4 para. 1 OECD Model would be much broader without the inclusion of the word “*similar*”. However, in 1988, Kees Van Raad disagreed with this view¹⁶³⁵.

As noted by Jean-Marc Rivier, these issues do not affect Switzerland at all since all of the criteria in Swiss domestic tax law have a territorial nexus with Switzerland and therefore comply with the “*domicile, residence, place of management or any other criterion of a similar nature*”¹⁶³⁶ criteria in Art. 4 para. 1 first sentence OECD Model.

6.3.3.1 *Overview of the Connecting Criteria in Switzerland’s Double Tax Conventions*

The majority of the DTCs concluded by Switzerland refer to exactly the same criteria included in Art. 4 para. 1, first sentence OECD Model¹⁶³⁷.

However, many Swiss DTCs include additional criteria for determining whether a subject is a “*resident of a Contracting State*”, such as the subject’s place of registration, place of incorporation, partnership, trust or estate,

¹⁶³² Art. 4 para. 1 DTC Switzerland-United-States.

¹⁶³³ WASSERMEYER/DEBATIN, Commentary, nr. 39 ad. Art. 4.

¹⁶³⁴ STARINGER, Ansässigkeit, p. 73-74.

¹⁶³⁵ VAN RAAD, Dual Residence, p. 241.

¹⁶³⁶ RIVIER, National report on the residence of legal entities, p. 77.

¹⁶³⁷ This has also been concluded by MARAIA, Residence of companies under tax treaties, p. 809.

place of main seat, place of establishment or place of permanent home and habitual abode. In contrast, the DTCs with Malaysia and Singapore simply refer to domestic tax law in order to determine residence, and the DTC with the Netherlands simply refers to domestic law in general.

The clearest criterion for the determination of residence, and the one that appears to be best in line with the objectives of the OECD Model, is found in the DTCs concluded with Austria and Germany, which directly refer to the concept of full tax liability.

The DTCs with Australia, Bulgaria and Kuwait have different rules for determining residence in each of the contracting states. For example, under the DTC with Kuwait, a person is considered Swiss resident if he is subject to full tax liability. On the contrary, a person is considered a Kuwaiti resident if he fulfills either the criteria of nationality or is domiciled in Kuwait.

Figure 6.5: Comparison of the Connecting Criteria in Art. 4 para. 1 OECD Model to Those in Swiss DTCs

Comparison of the connecting criteria in Art. 4 para. 1 OECD MC to the relevant Swiss DTC ¹			
DTC Country	Article	Dev. ²	Connecting criteria
Albania; Belarus; Belgium; Czech Republic; Ecuador; Egypt; France; Hungary; Indonesia; Italy; Jamaica; Kyrgyzstan; Luxembourg; Macedonia; Mexico; Moldova; Mongolia; Morocco; New Zealand; Norway; Pakistan; Philippines; Poland; Rumania; Russia; Serbia and Montenegro; Slovakia; Slovenia; South Africa; Spain; Sri Lanka; Sweden; Trinidad and Tobago; Uzbekistan; Venezuela; Vietnam	Art. 4 para. 1	=	<i>In accordance with MC</i> : domicile, residence, place of management or any other criterion of a similar nature
Algeria; Argentina; Armenia; Azerbaijan; Canada; China; Côte d'Ivoire; Croatia; Denmark; Estonia; Finland; Greece; Iceland; India; Iran; Ireland; Israel; Japan; Kazakhstan; Korea; Latvia; Lithuania; Portugal; Thailand; Tunisia; Ukraine; United Kingdom and Barbados	Art. 4 para. 1 / Art. 4 para. 3	+	<i>Additional criteria according to Art. 4 para. 1, such as</i> : place of registration, incorporation; partnership; main seat; place of establishment; permanent home; habitual abode
United States of America	Art. 4 para. 1 (a) + (d)	+	<i>Additional criteria according to Art. 4 para. 1, such as</i> : nationality; place of incorporation; special regimes for partnerships, trusts and estates
Austria; Germany	Art. 4 para. 1	Δ	Residence due to full tax liability
Netherlands	Art. 2 para. 1	Δ	Residence according to domestic laws
Malaysia; Singapore	Art. 4 para. 1	Δ	Residence according to domestic tax laws
Australia; Bulgaria; Kuwait	Art. 4 para. 1 (a) + (b)	Δ	<i>Separate criteria for determining residence in each of the contracting states</i> ; e.g. either has in Kuwait domicile, nationality, or is a registered company or is subject to full tax liability in Switzerland

¹ Table does not include any states, political subdivisions or local authorities thereof.

² Deviation to the OECD Model Convention (Version: July 2008) as per April 10, 2010.

Source: Own figure

6.3.4 Different Views on the Meaning of the “Liable To Tax” Requirement

This chapter aims to systematically explore and summarize different scholarly views on the interpretation of the term “*liable to tax*”. The goal is to give a clear insight into these different views in order to better understand

this concept across various jurisdictions and its inconsistencies in relation to the application of DTCs to CISs and trusts¹⁶³⁸.

This chapter will outline the following interpretations of the “*liable to tax*” requirement: (i) the literal and grammatical approach requiring simple recognition as a taxpayer without being “*subject-to-tax*”¹⁶³⁹; (ii) the literal and grammatical approach with the requirement of the taxpayer to be “*subject-to-tax*”¹⁶⁴⁰; and (iii) the teleological approach considering a locality-related or territorial attachment to a jurisdiction sufficient¹⁶⁴¹. Finally, the chapter provides a conclusion on how Switzerland interprets the “*liable to tax*” requirement¹⁶⁴².

As Margriet Lukkien has noted, the interpretation of the “*liable to tax*” requirement is prone to inconsistencies as there is, on one side, very little guidance as to the meaning and applicability of this concept to corporate and hybrid entities such as CISs and trusts. On the other side, some countries interpret this term very differently from others¹⁶⁴³. In a recent article named “*Worrying Interpretation of ‘Liable to Tax’*”¹⁶⁴⁴, Arnaud de Graaf and Frank Pötgens demonstrate the uncertainty as to the meaning of this term in international tax law.

This lack of clarity is rooted in the fact that the OECD has not unequivocally defined the terms “*resident*” or “*liable to tax*” yet, leaving the contracting states in uncertainty when having to interpret these terms. Due to the fact that the undefined term “*resident*” in the OECD Model is given its meaning through another undefined term - “*liable to tax*” - in accordance with domestic law, the risk of inconsistent definitions throughout contracting states can easily be foreseen.

¹⁶³⁸ See Chapter 6.3.6.

¹⁶³⁹ See Chapter 6.3.4.1.

¹⁶⁴⁰ See Chapter 6.3.4.2.

¹⁶⁴¹ See Chapter 6.3.4.3.

¹⁶⁴² See Chapter 6.3.5.

¹⁶⁴³ LUKKIEN, nr. 1 et seq.

¹⁶⁴⁴ DE GRAAF/PÖTGENS, *Worrying Interpretation of liable to tax*, p. 169.

6.3.4.1 *Literal and Grammatical Interpretation of the Term “Liable to Tax”: Simple Recognition as a Taxpayer without Requirement to be “Subject-to-Tax”*

Based on the OECD Commentary, the general understanding in scholarly writing seems to be that tax-exempt entities may be considered “*liable to tax*”, since the “*liable to tax*” requirement does not require an actual tax to be levied¹⁶⁴⁵. It simply implicates that the relevant entity must be recognized as a potential taxpayer in light of the domestic tax laws of its residence state¹⁶⁴⁶.

In this sense, the wording of Art. 4 para. 1 OECD Model is straightforward. By using the term “*is*” (as opposed to “*could be*”) liable to tax, it is clear that the person claiming DTC benefits must be a taxpayer according to the laws of the state of residence¹⁶⁴⁷. In addition, this provision uses the expression “*under the laws of that State*”, clearly indicating that the term “*liable to tax*” should be interpreted according to the domestic tax laws of the residence state and not according to the law of any other contracting state¹⁶⁴⁸. The “*liable to tax*” requirement would therefore be met even if the state in which the person is established does not levy taxes due to the application of a zero rate, a subjective or objective exemption, or a reduction in the entity’s taxable base.

This liberal view is demonstrated by various authors such as David Ward: “*the definition of residence is intended to refer to the connecting factors of a person with a contracting state that are used by that state to impose unlimited taxation, but it is not a requirement that the person who has such connecting factors actually be subject to unlimited taxation if the domestic law relieves him of some or all tax on his income under special provisions*”¹⁶⁴⁹. Robert Danon adopts the same view: “*this provision clearly suggests that the person claiming DTC benefits be listed as a taxpayer under the laws of*

¹⁶⁴⁵ See Chapter 6.3.4.4.

¹⁶⁴⁶ Amongst others: DANON, thesis, p. 285.

¹⁶⁴⁷ DANON/SALOMÉ, Avoidance of Double Non-Taxation, p. 397; SALOMÉ, Partnerships, p. 55; FIRLINGER, Die Personengesellschaften, p. 225.

¹⁶⁴⁸ DANON/SALOMÉ, Avoidance of Double Non-Taxation, p. 397-398.

¹⁶⁴⁹ WARD, Crown Forest Industries, p. 408 et seq.

the residence State”¹⁶⁵⁰. According to this view, effective recognition as a taxpayer, pursuant to a locality-related or territorial attachment by way of its “*domicile, residence, place of management or any other criterion of a similar nature*” is sufficient, irrespective of whether income taxes are actually paid.

This approach - but only limited to corporate entities, such as a SICAV - was expressly confirmed by the Federal Administrative Court on 7 September 2011 in the “*Madeira*” case¹⁶⁵¹. Along this line, the Swiss Federal Administrative Court also ruled that “*effective recognition as a taxpayer*” is sufficient when the general requirements for unlimited tax liability are met: “*(...) selbst Gesellschaften, welche aufgrund von objektiven, allgemeingültigen, generell-abstrakten Regeln keine Steuern bezahlen, aber “steuerpflichtig” sind, weil sie die ansässigkeitsbegründenden Merkmale in Portugal erfüllen, auch als dort “ansässig” im Sinne von Art. 1 i.V.m. Art. 4 Abs. 1 DBA-P zu betrachten sind*”¹⁶⁵².” A more recent court decision of 18 December 2013¹⁶⁵³, handed down by the Administrative Court of Zurich, reaffirms that it is irrelevant for residence purposes whether and to what extent a person is being taxed. According to the Court, effective taxation is not necessary. The only requirement is that the person has such a link to at least one of the contracting states (the residence state) that unlimited taxation is (theoretically) possible (e.g. a formal seat of a company)¹⁶⁵⁴.

In a comparative view, this interpretation has also been confirmed in a communication by the BMF regarding a Luxembourg SICAV: “*Luxembourg entities, like the “société à capital variable”, which meet the general requirements for unlimited tax liability as set out in the Luxembourg tax law are*

¹⁶⁵⁰ Amongst others: DANON, thesis, p. 285.

¹⁶⁵¹ Federal Administrative Court of 7 September 2011 (A-813/2010).

¹⁶⁵² Federal Administrative Court of 7 September 2011, cons. 7.4.2.4. (A-813/2010). It be stated that a Federal Administrative Court judgment of 29 August 2011, cons. 3.3.1. (A-1819/2011) with reference to a tax resident individual with domicile in Thailand has been rendered.

¹⁶⁵³ Administrative Court of Zurich Judgment of 18 December 2013, cons. 13, 14 (SB.2012.00088).

¹⁶⁵⁴ Administrative Court of Zurich Judgment of 18 December 2013, cons. 13, 14 (SB.2012.00088).

*treated as residents of Luxembourg and are therefore entitled to claim treaty benefits under the Austro-Luxembourg Double Taxation Convention; whether such entities are **actually made liable to tax** or are **exempted** (emphasis added by the author) therefrom in Luxembourg is not considered to be of relevance in the given context”¹⁶⁵⁵.*

Certainly, the legal opinion expressed by the BMF in relation to Luxembourg entities may not directly be transposed to the DTC signed with Switzerland since, according to Swiss domestic tax law, CISs are fiscally-transparent (“*flow-through*”) persons and are, therefore, not characterized as “*tax-exempt*”. Also, most Swiss DTCs do not explicitly have provisions for fiscally-transparent (“*flow-through*”) hybrid entities such as CISs and trusts. These entities would likely not be considered “*liable to tax*” under the Swiss DTC since they are tax-transparent entities in Switzerland.

Moreover, it results from a body of international case law that tax-exempt hybrid entities may be considered “*liable to tax*” and meet the residence requirement according to Art. 4 para. 1 OECD Model¹⁶⁵⁶. However, tax liability of an entity located outside a contracting state which arises only on the basis of income from sources within or deriving from the contracting state would not, according to the definition, qualify the recipient as resident in that contracting state under Art 4 para. 1 OECD Model. In fact, the connection between the recipient and the contracting state is not one of locality or territorial attachment by way of its “*domicile, residence, place of management or any other criterion of a similar nature*”. Therefore, the recipient would not be subject to taxation on its worldwide income in that contracting state.

¹⁶⁵⁵ Express Answer Service of the Austrian Ministry of Finance of 24.3.1997, “*Abkommensberechtigung luxemburgischer SICAV*” (EAS 1038) = SWI 1997, p. 190.

¹⁶⁵⁶ See further details in Chapter 6.3.4.4.

6.3.4.2 *Literal and Grammatical Interpretation of the Term “Liable to Tax”: Recognition as a Taxpayer with Requirement to be “Subject-to-Tax”*

Some countries, such as Canada¹⁶⁵⁷ and the Netherlands¹⁶⁵⁸, follow an alternative approach and interpret the “*liable to tax*” requirement as a “*subject-to-tax*” requirement¹⁶⁵⁹. For instance, a recent court decision of the Dutch Supreme Court¹⁶⁶⁰ stated that tax-exempt entities are not “*liable to tax*” under the DTC between the Netherlands and the United States¹⁶⁶¹. David Ward has explored the similar Canadian “*Crown Forest*” judgment¹⁶⁶². This view concerning the “*subject-to-tax*” clause is in principle not adopted by the OECD materials. As explained by Richard Vann, if that view were adopted, a large number of taxpayers, including charities, would not be considered to be residents for DTC purposes¹⁶⁶³. The Partnership Report supports this position by saying that partners are required to be “*liable to tax*” in the residence state in order to avoid situations denying them access to DTCs in respect of their partnership income on the basis that neither the partnership nor the partners are considered to be “*liable to tax*”¹⁶⁶⁴.

However, tax liability which is only based on income from sources within or deriving from a contracting state would not, according to the definition of Art. 4 para. 1 OECD Model, qualify the recipient as being resident in that contracting state. In fact, the connection between the recipient and the contracting state is not one of locality or territorial attachment by way of its

¹⁶⁵⁷ Supreme Court of Canada, 22 Jun. 1995, nr. 23940 (Crown Forest Industries Ltd. v. Canada) (1995) 2 SCR 802. For a discussion of this case, see amongst others:

LUKKIEN, nr. 3 as well as WARD, Crown Forest Industries, p. 408 et seq.

¹⁶⁵⁸ Dutch Supreme Court, 28 Feb. 2001, nr. 35557, BNB 2001/295; Dutch Supreme Court, 4 Dec. 2009, nos 07/10382-07/10384, V-N 2009/63.17.

¹⁶⁵⁹ In this vein: LUKKIEN, nr. 3.

¹⁶⁶⁰ Dutch Supreme Court, 4 Dec. 2009, nos 07/10382-07/10384, V-N 2009/63.17.

¹⁶⁶¹ DE GRAAF/PÖTGENS, Worrying Interpretation of liable to tax, p. 171.

¹⁶⁶² Crown Forest Industries Limited v The Queen (1995) 95 DTC 5389 at 5396 (Canada).

¹⁶⁶³ VANN, Liable to tax, p. 197 et seq.; OECD Commentary 2014, nr. 8.5 ad. Art. 4; COUZIN, Corporate Residence, Footnote 68; WARD, Crown Forest Industries, p. 408 et seq.

¹⁶⁶⁴ OECD, Partnership Report, para. 1.

“domicile, residence, place of management or any other criterion of a similar nature”. Therefore, the recipient is not subject to taxation on its worldwide income in that contracting state.

It is clear that the term *“subject-to-tax”* is viewed as a narrower concept than the term *“liable to tax”*. Although outside the scope of this thesis, it is worth noting that there is controversy as to whether a person may be considered to fulfil the *“subject-to-tax”* requirement when a zero rate is applied to their taxable income or profits, or where losses mean that no tax has to be actually paid¹⁶⁶⁵.

6.3.4.3 *Teleological Interpretation of the Term “Liable to Tax”: A Locality-Related or Territorial Attachment to a Jurisdiction is Sufficient*

Based on a teleological interpretation, Klaus Vogel and Michael Lang adopt a more liberal view in of the *“liable to tax”* requirement. According to them, the only requirement for a person to be considered *“liable to tax”* should be for that person to demonstrate a locally-related or territorial attachment to the contracting state by way of its *“domicile, residence, place of management or any other criterion of a similar nature”*¹⁶⁶⁶. It does not necessarily need to be recognized as a taxpayer¹⁶⁶⁷.

Under this theory, it would be irrelevant whether CISs (and, by analogy, trusts) (i) are treated as fiscally-transparent entities (*“flow-through”*); (ii) are tax-exempt entities (*“tax-exempt”*); or (iii) are considered as tax subjects (*“fiscally-opaque”*)¹⁶⁶⁸. According to this interpretation¹⁶⁶⁹, thus, it should be

¹⁶⁶⁵ For further details see: WHEELER, Persons qualifying for treaty benefits, p. 63 et seq.

¹⁶⁶⁶ LANG, Besteuerung von Einkünften bei unterschiedlichen Personen, p. 527 et seq.

¹⁶⁶⁷ VOGEL, Double Taxation Conventions, p. 229; LANG, Taxation of Income in the Hands of Different Taxpayers, p. 598; LANG, Besteuerung von Einkünften bei unterschiedlichen Personen, p. 527 et seq. LANG, Introduction to the Law of Double Taxation Conventions, p. 74 et seq. In this vein also: DE GRAAF/PÖTGENS, Worrying Interpretation of liable to tax, p. 173.

¹⁶⁶⁸ LANG, Besteuerung von Einkünften bei unterschiedlichen Personen, p. 527.

¹⁶⁶⁹ See Chapter 6.3.4.3.

irrelevant in the DTC context whether a person is first considered as a taxpayer and is then exempted from tax, or whether this person is not considered as a taxpayer at all¹⁶⁷⁰. This reasoning is consistent with the situation in which a taxpayer benefiting from a tax exemption qualifies as a “*resident*” within the meaning of Art. 4 para. 1 OECD Model¹⁶⁷¹.

Some authors have criticized this liberal position, suggesting that fiscal transparency and tax-exemption have different implications. By analyzing the meaning of “*liable to tax*”, it can be concluded that CISs and trusts which are treated as partially or completely tax-exempt entities¹⁶⁷² may nevertheless be considered “*liable to tax*”¹⁶⁷³ and thus may be able to access DTC benefits¹⁶⁷⁴. However, CISs and trusts that are treated as fiscally-transparent (“*flow-through*”) entities or as non tax-subjects cannot be considered “*liable to tax*”. Consequently, tax-exemption, as opposed to fiscal-transparency, does not prevent a subject from being qualified as a “*resident*” person.

Michael Lang has argued that the differentiation between these two methods simply derives from the technical matter of whether a contracting state’s tax provisions have a wide scope which is limited through an exemption, or whether the scope of a tax provision is narrow from the start (this is the

¹⁶⁷⁰ LANG, Taxation of Income in the Hands of Different Taxpayers, p. 598.

¹⁶⁷¹ OECD Commentary 2014, nr. 8.5 ad. Art. 4.

¹⁶⁷² FIBBE, Changes to the OECD Commentary on Collective Investment Vehicles, p. 5 points out the different degrees of tax exemption: “(...) *fully tax exempt, the base for taxation is reduced or, in fact, no tax is paid or a special low tax rate applies*”. KLEIST, Treaty Entitlement of Tax Exempt Entities, p. 263 summarizes the tax exemption as: “*partly or completely tax exempt due to specific tax exemptions*”.

¹⁶⁷³ OECD Commentary 2014, nr. 8.6 ad. Art. 4; GRILLI, Treaty entitlement of investment funds, p. 891; FIBBE, Changes to the OECD Commentary on Collective Investment Vehicles, p. 5; KLEIST, Treaty Entitlement of Tax Exempt Entities, p. 263, 267; BAKER, The Application of the Convention to Partnerships, Trusts and Other Non-Corporate Entities, p. 2-3. VIITALA, thesis, p. 87 concludes that tax exempted persons are only considered “*liable to tax*” when the term is interpreted in a broader sense. However, some countries have different approaches following which tax-exempted persons are not considered “*liable to tax*”. If these States nevertheless regard such tax-exempted persons as residents for tax treaty purposes, they must expressly regulate it in the corresponding DTC. In this vein: OECD Commentary 2014, nr. 8.6 ad. Art. 4.

¹⁶⁷⁴ OECD Commentary 2014, nr. 8.5 ad. Art. 4.

Swiss approach), as in the case of treatment of CISs and trusts as fiscally-transparent (“*flow-through*”) entities.

The resulting taxation, Michael Lang says, is inconsistent since both fiscally-transparent (“*flow-through*”) and tax-exempted (“*tax-exempt*”) persons do not pay income or capital taxes. Therefore, a technical difference as the one explained above should not have consequences for DTC purposes. In fact, the author continues his argument by saying that whether a person is regarded as a taxpayer under domestic law should not depend on a question of “*interpretative technique*”¹⁶⁷⁵.

In the author’s view, this (too) liberal reasoning is clearly not in line with the current jurisprudence of the Swiss courts and opens the door to considerable legal uncertainty. For a DTC partner, it is unclear who should be considered “*liable to tax*” and therefore a resident for DTC purposes.

In the same vein, Klaus Vogel suggests that a fiscally-transparent (“*flow-through*”) entity such as a partnership should be considered “*liable to tax*” (and therefore a “*resident*”) as soon as the locality-related attachment of Art. 4 para. 1 OECD Model has led to comprehensive taxation in that state¹⁶⁷⁶. For Ulrich Sorgenfrei, the term “*liable to tax*” should not be given its “*material sense*”¹⁶⁷⁷. These scholars consider that Art. 4 para. 1 OECD Model only requires a locality-related or territorial connection with the state of residence¹⁶⁷⁸. Based on this view, it could forcefully be argued that a CIS or trust should gain access to DTC benefits.

Lastly, Moris Lehner states that the only requirements will be: “*dass die Person zumindest zu einem der beiden Vertragsstaaten (...) diejenige Beziehung aufweist, die zu ihrer unbeschränkten Besteuerung führen kann*”¹⁶⁷⁹.

¹⁶⁷⁵ LANG, Besteuerung von Einkünften bei unterschiedlichen Personen, p. 527 et seq.

¹⁶⁷⁶ VOGEL, Double Taxation Conventions, p. 95. In this vein also: AIGNER, thesis, p. 75-76; HUEMER, Unbeschränkte Steuerpflicht natürlicher Personen, p. 107 et seq.; TOIFL, EU-Abgabenänderungsgesetz, 1996, p. 520.

¹⁶⁷⁷ SORGENFREI, Steuerlicher Transparenzgrundsatz, p. 472.

¹⁶⁷⁸ LANG, Taxation of Income in the Hands of Different Taxpayers, p. 598; LANG, Personengesellschaften mit Steuersubjektivität im Ausland, p. 716.

¹⁶⁷⁹ VOGEL/LEHNER, Doppelbesteuerungsabkommen 2008, nr. 82 ad. Art. 4.

Helmut Debatin arrives at the same conclusion. In addition, he has developed his own theory of “*assimilated residence*” (“*assimilierte Ansässigkeit*”). He argues that unlimited tax liability in a state is not required to establish residence in that state and that residence may be established whenever a locality-related or territorial attachment exists, which means that the relevant person is regarded as a taxpayer under the domestic law of the relevant state¹⁶⁸⁰.

In this regard, Klaus Vogel, for instance, has illustratively stated that, even if the partnership is not considered as a taxpayer according to domestic law, it should nevertheless be considered a resident for DTC purposes when a locality-related or territorial attachment exists¹⁶⁸¹. It is suggested that this reasoning may be extended to CISs and trusts by way of analogy¹⁶⁸².

It should be noted that Klaus Vogel’s and Michael Lang’s approach to the “*liable to tax*” requirement is more liberal than the other views outlined above. However, according to Michael Lang, a DTC should only apply when, in addition, the source state attributes the income to the person considered “*liable to tax*”¹⁶⁸³.

6.3.4.4 Excursus on “*Liable to Tax*”: Tax-Exempt Entities

The OECD Commentary expressly states in paragraph 8.6 that many states would consider tax-exempt entities such as pension funds, charities and other organisations to be residents because they are, in principle, “*liable to tax*” under their domestic laws, but are entitled to exemptions for specific categories of income if certain requirements are met in domestic law¹⁶⁸⁴. If these requirements were not met, such an entity would be subject to taxation on all or some of its income. The OECD Model also states in Art. 4 para. 1 that a resident of a contracting state for DTC purposes includes any “*state and any political subdivision thereof*”. In conclusion, the OECD materials remove any uncertainties in respect of such tax-exempt entities because otherwise, as

¹⁶⁸⁰ DEBATIN, Subjektiver Schutz unter Doppelbesteuerungsabkommen, p. 1 et seq.

¹⁶⁸¹ VOGEL, Double Taxation Conventions, nr. 24a-24b ad. Art. 4.

¹⁶⁸² DANON, thesis, p. 285.

¹⁶⁸³ LANG, Partnerships, p. 38 et seq.

¹⁶⁸⁴ OECD Commentary 2014, nr. 8.6 ad. Art. 4.

explained by Richard Vann, a large number of taxpayers, such as charities, would not be considered resident for DTC purposes¹⁶⁸⁵. The OECD Commentary explains that contracting states will usually not consider tax-exempt entities to be “*liable to tax*” under their domestic laws, unless the relevant DTC dictates otherwise¹⁶⁸⁶. However, the body of international case law concerning the term “*liable to tax*” clearly favors a wide interpretation, and does not require an effective payment of taxes on a subject’s worldwide income in order for that subject to be considered “*liable to tax*”. This case law shows the prevailing opinion, according to which a subject need not necessarily be “*subject-to-tax*” in order to be regarded as “*liable to tax*” and, therefore, qualified as resident of a contracting state under a DTC¹⁶⁸⁷.

6.3.5 Conclusion on Switzerland’s View on the “*Liable to Tax*” Requirement

The lack of clear provisions and guidance as to the meaning of the term “*liable to tax*” as well as the uncertainties resulting from the various authors’ views have lead to inconsistent practices among jurisdictions.

The author supports the Swiss view that follows the literal and grammatical interpretation of the “*liable to tax*” criterion. According to this criterion, simple recognition as a taxpayer is enough. It is not necessary that an actual tax be levied, but rather that the taxpayer is listed as a potential taxpayer in light of the domestic tax law of its state of residence.

This view is consistent with Art. 4 para. 1 of the OECD Model that does not contain a general “*subject-to-tax*” clause. This approach is crystallized in the Federal Administrative Court’s recent “*Madeira*” judgment and the recent decision from the lower court¹⁶⁸⁸ in which it is expressly stated that unlimited tax liability in a state is not required for corporate entities to establish

¹⁶⁸⁵ VANN, *liable to tax*, p. 197 et seq. OECD Commentary 2014, nr. 8.5 ad. Art. 4; COUZIN, *Corporate Residence*, Footnote 68; WARD, *Crown Forest Industries*, p. 408 et seq.

¹⁶⁸⁶ OECD Commentary 2014, nr. 8.7 ad. Art. 4. Interestingly, this can be seen in the 1992 DTC between the Netherlands and the United States.

¹⁶⁸⁷ See Chapter 6.3.2.2.

¹⁶⁸⁸ Administrative Court Zurich of 18 December 2013 (SB.2012.00088).

residence in that state¹⁶⁸⁹, and that residence may be established when the taxpayer is recognized as a taxpayer under the tax laws of the residence state¹⁶⁹⁰.

As previously noted, the question of residence is a purely domestic question that should be determined by the relevant contracting state. Therefore, each country is theoretically free, for tax policy reasons, to adopt its own view on that matter. In the author's opinion, however, the application of such a broad interpretation should be avoided. In fact, each state seems to be liable to the other contracting states with which it agreed to clarify these issues in the relevant DTC. For instance, by adopting a wide interpretation of the residence requirement, the recent Canadian judgment goes too far in terms of legal certainty¹⁶⁹¹. Such (overly) wide interpretation opens the door to diverging views about where exactly the DTC between both contracting states was trying to avoid double taxation¹⁶⁹².

The Swiss view should be challenged when considering paragraph 6.11 of the OECD Commentary on Article 1¹⁶⁹³. In this paragraph, it is clearly concluded that a CIS cannot be considered as resident for DTC purposes when the contracting state (as is the case of Switzerland) treats the investors as "*liable to tax*" on the income and wealth generated by a CIS that is considered fiscally-transparent ("*flow-through*"). Patricia Brown clarified that the definition of transparency solely focuses on which person - between the CIS and its investors - is "*liable to tax*"¹⁶⁹⁴. Non-transparent CISs that follow paragraph 6.12 of the OECD Commentary on Article 1 clearly meet the requirement of a resident, even if, in the end, no taxes are effectively paid due to a

¹⁶⁸⁹ DE VRIES REILINGH, *Tax Treaty Residence and Tax Liability*, p. 1 et seq.

¹⁶⁹⁰ Federal Administrative Court of 7 September 2011 (A-813/2010). This has recently also been confirmed by a lower instance court decision (cf. Administrative Court of Zurich Judgment of 18 December 2013, cons. 13, 14 (SB.2012.00088)).

¹⁶⁹¹ *Crown Forest Industries Limited v The Queen* (1995) 95 DTC 5389 (Canada).

¹⁶⁹² See Chapter 6.3.2.2.

¹⁶⁹³ OECD Commentary 2014, nr. 6.11 ad. Art. 1. In this vein also: BROWN, *Tax Treatment of Collective Investment Vehicles*, p. 38.

¹⁶⁹⁴ BROWN, *Tax Treatment of Collective Investment Vehicles*, p. 39.

zero tax rate, a subjective or objective exemption, or a reduction in the taxable base¹⁶⁹⁵. In all of the other scenarios, fiscally-transparent (“*flow-through*”) entities such as CISs and trusts may not be considered “*liable to tax*” (and, therefore, “*resident*” for Swiss DTC purposes) within the meaning of Art. 4 para. 1 OECD Model¹⁶⁹⁶. This view is in line with the OECD Model¹⁶⁹⁷, its Commentaries¹⁶⁹⁸ and the suggestions of the CFA¹⁶⁹⁹.

Such may also be observed in the fact that Switzerland has concluded special bilateral agreements on CISs or, in other words, Memoranda of Understanding, with a number of countries (Denmark, the United Kingdom, Germany, France, Japan, the Netherlands, Norway, Austria, Sweden and Spain¹⁷⁰⁰). According to these agreements, CISs are able to claim in their own name, but not in their own right, a refund of the withholding taxes on investments held by Swiss CISs. This demonstrates that CISs, in principle, are not fully entitled to treaty benefits in their own right.

6.3.6 OECD Interpretation of “Residency” for Collective Investment Schemes and Trusts

This second part of this chapter focuses on how the OECD has interpreted the term “*liable to tax*” in regards to CISs/trusts. In a first step, it will be explained how the general provisions of the OECD Model should be interpreted when determining whether a CIS/trust is “*liable to tax*”¹⁷⁰¹. Second, this chapter will outline how the OECD has specifically interpreted the “*liable to tax*” requirement for trusts¹⁷⁰². Third, the chapter will summarize the

¹⁶⁹⁵ OECD Commentary 2014, nr. 6.12 ad. Art. 1 in connection with OECD Commentary 2014, nr. 8.6 ad. Art. 4.

¹⁶⁹⁶ In this vein: HELMINEN, Classification of Investment Fund Distributions, p. 137 clearly states that “*investment funds may often fail to qualify for treaty benefits because of the resident person requirement*”. Moreover, she states that “*wholly-transparent entities do not qualify for treaty benefits*”.

¹⁶⁹⁷ Art. 4 OECD Model.

¹⁶⁹⁸ OECD Commentary 2014, nr. 4, 8 ad. Art. 4.

¹⁶⁹⁹ CFA Report, para. 29.

¹⁷⁰⁰ Annex III of Circular 24.

¹⁷⁰¹ See Chapter 6.3.6.1.

¹⁷⁰² See Chapter 6.3.6.2.

solution given by the OECD for CISs regarding the “*liable to tax*” requirement, focusing on the provisions of the CIV Report¹⁷⁰³. The CIV Report’s conclusions, addressing fiscally-transparent (“*flow-through*”) and tax-subject entities (“*opaque*”) separately, will also be explained in detail. Finally, the chapter will provide an overall conclusion of the above described concepts¹⁷⁰⁴. The general aim of this analysis is to assess whether fiscally-transparent entities (“*flow-through*”), tax-exempt entities (“*tax-exempt*”) ¹⁷⁰⁵ and tax-subject entities (“*opaque*”) fulfill the “*liable to tax*” condition.

6.3.6.1 *General Interpretation of “Liable To Tax” for CISs and Trusts under the OECD Model*

In order to determine whether a CIS or trust can be considered “*resident*” under Art. 4 of the OECD Model, it is necessary to assess whether CISs/trusts are “*liable to tax*”, and whether the closely linked condition of “*comprehensive taxation*” is satisfied.

As already mentioned, the meaning of “*liable to tax*” is particularly controversial in relation to hybrid entities such as CISs and trusts because of the different tax treatment of these corporate entities under the domestic laws of the contracting states¹⁷⁰⁶. In this context, the OECD Model and its Commentary are very important for the interpretation of tax treaties, since they provide a source from which courts of the different contracting states can seek a common interpretation¹⁷⁰⁷. As explained in Chapter 5, tax treaties are international agreements subject to interpretation according to international law principles as laid down in the Vienna Convention on the Law of Treaties.

¹⁷⁰³ See Chapter 6.3.6.3.

¹⁷⁰⁴ See Chapter 6.3.7.

¹⁷⁰⁵ A person may be tax-exempt owing to the use of losses, allowances for certain persons and exemptions of specific items of income, certain types of person and certain types of activities.

¹⁷⁰⁶ In some contracting states for instance, CISs and trusts are “subject-to-tax” but may be exempted if they fulfill certain conditions. Alternatively, they may be considered fiscally-transparent entities, like in Switzerland. In even other cases, they are “subject-to-tax”, but the base for taxation is decreased according to the distributions made out to investors and beneficiaries so that, in the end, no tax is actually paid.

¹⁷⁰⁷ VOGEL, Double Tax Treaties and Their Interpretation, p. 40.

Articles 31-33 of the Vienna Convention provide the framework for assessing the role of the OECD Model Convention and the OECD Commentary in the interpretation process¹⁷⁰⁸. As Vogel suggests, the interpretation by reference to the OECD Model is not inconsistent with the Vienna Convention¹⁷⁰⁹.

From a purely literal and grammatical interpretation of Art. 4 OECD Model, it must be concluded that fiscally-transparent entities (*“flow-through”*), such as certain CISs and trusts, may not be considered *“residents”*. This reasoning is in line with the OECD Partnership Report which states that, *“where a State disregards a partnership for tax purposes and treats it as fiscally transparent (...) the partnership itself is not liable to tax”*. It also adheres to the familiar principle that partnerships are not tax-exempt entities, but are instead considered to be fiscally-transparent. The same conclusion can be drawn from the CIV Report which, like the Partnership Report, excludes fiscally-transparent and totally and unconditionally exempt entities from its definition of *“resident”*¹⁷¹⁰. This interpretation, however, must critically be analyzed in the case of CISs and trusts because their tax treatment does not mirror the partnerships’ tax treatment. As mentioned above, CISs’ and trusts’ tax treatments vary from one country to another, ranging from fiscal transparency to fully taxable entities.

From a teleological interpretation¹⁷¹¹, the only requirement for a person to be considered *“liable to tax”* should be for the subject to demonstrate a locality-related or territorial attachment to the contracting state by way of its *“domicile, residence, place of management or any other criterion of a similar nature”*¹⁷¹². Under this approach, Art. 4 para. 1 OECD Model only requires a locality-related or territorial connection with the residence state¹⁷¹³.

¹⁷⁰⁸ LANG/BRUGGER, The Role of the OECD Commentary in Tax Treaty Interpretation, p. 98.

¹⁷⁰⁹ VOGEL, Double Tax Treaties and Their Interpretation, p. 40.

¹⁷¹⁰ CFA Report, para. 27 and OECD Commentary 2014, nr. 6.11 ad. Art. 1.

¹⁷¹¹ See Chapter 6.3.4.3.

¹⁷¹² LANG, Besteuerung von Einkünften bei unterschiedlichen Personen, p. 527 et seq.

¹⁷¹³ LANG, Taxation of Income in the Hands of Different Taxpayers, p. 598; LANG, Personengesellschaften mit Steuersubjektivität im Ausland, p. 716.

Based on this view, it could forcefully be argued that a CIS/trust should be granted access to DTC benefits.

As a result, tax-exempt CISs and trusts should be granted access to DTC benefits since the OECD Model does not contain a general “*subject-to-tax clause*”¹⁷¹⁴. Indeed, the OECD Commentary expressly states in paragraph 8.6 of the Commentary to Article 4, that many states would consider tax-exempt entities such as pension funds, charities and other organisations to be resident because they are, in principle, “*liable to tax*” under their domestic laws, but are entitled to exemptions for specific categories of income if certain requirements are met under domestic law¹⁷¹⁵. If these requirements were not met, such an entity would be subject to taxation on all or some of its income. Trusts are not mentioned in paragraph 8.6 of the Commentary. However, there is no indicator that if, for example, a charity was organized as a trust, such a charity could not be considered a resident for DTC purposes.

In this sense, the Technical Explanations to the US Model Tax Convention of 1996 expressly provide that certain tax-exempt entities such as pension funds and charitable organizations will be considered as “*residents*” regardless of whether they are generally liable for income tax in the state where they are established¹⁷¹⁶. The text continues by saying that the inclusion of such provision is intended to clarify the generally accepted practice of treating an entity that would be liable to tax as a “*resident*” under the internal law of a state, but it is not due to a specific exemption from tax¹⁷¹⁷. The text then specifically states that a U.S. pension trust, or an exempted organization (such as a U.S. charity) that is generally exempt from tax under U.S. law is considered a “*resident*” for all purposes of the treaty¹⁷¹⁸. The OECD Model also states in Art. 4 para. 1 that a resident of a contracting state for DTC purposes includes any “*state and any political subdivision thereof*”.

¹⁷¹⁴ OECD Commentary 2014, nr. 8.3 ad. Art. 4.

¹⁷¹⁵ OECD Commentary 2014, nr. 8.6 ad. Art. 4.

¹⁷¹⁶ Technical Explanations to the US Model Tax Convention of 1996, ad. Art. 4, para. 1.

¹⁷¹⁷ Technical Explanations to the US Model Tax Convention of 1996, ad. Art. 4, para. 1.

¹⁷¹⁸ Technical Explanations to the US Model Tax Convention of 1996, ad. Art. 4, para. 1.

In conclusion, the OECD materials remove any uncertainties in respect of such tax-exempt entities because otherwise, as explained by Richard Vann, a large number of taxpayers, such as charities, would not be considered residents for DTC purposes¹⁷¹⁹. The OECD Commentary explains that contracting states will not usually consider tax-exempt entities to be “*liable to tax*” under their domestic laws, unless the relevant DTC provides otherwise¹⁷²⁰. However, the body of international case law concerning the term “*liable to tax*” clearly favors a wide interpretation, and does not require an effective payment of taxes on a subject’s worldwide income in order for that subject to be considered “*liable to tax*”. This case law reflects the prevailing opinion, holding that a subject need not necessarily be “*subject-to-tax*” in order to be regarded as “*liable to tax*” (and therefore qualified as a resident of a contracting state under a DTC)¹⁷²¹.

6.3.6.2 *Specific Meaning of the “Liable To Tax” Requirement for Trust Relationships from an OECD Perspective*

The OECD has not released any guidance regarding the interpretation of the term “*resident*” for trusts. Therefore, the ability of trusts to claim tax treaty benefits is subject to interpretation under the general OECD rules, which may lead to legal uncertainty. As outlined above, the diverse tax treatment of entities across jurisdictions leads to inconsistencies as to the entitlement to DTC benefits. Whether a trust is seen as fiscally-transparent or as a tax-subject will determine if the trust can claim tax treaty benefits or not.

From a literal and grammatical interpretation of Art. 4 of the OECD Model, it may be concluded that fiscally-transparent trusts are considered as “*residents*” if they are at least recognized as potential taxpayers under the domestic tax laws of the residence state. This conclusion would be in line with the the “*Madeira*” case which held that “*effective recognition as a taxpayer*” with a locality-related or territorial attachment to the jurisdiction is enough

¹⁷¹⁹ VANN, *Liable to tax*, p. 197 et seq.; OECD Commentary 2014, nr. 8.5 ad. Art. 4; COUZIN, *Corporate Residence*, Footnote 68; WARD, *Crown Forest Industries*, p. 408 et seq.

¹⁷²⁰ OECD Commentary 2014, nr. 8.7 ad. Art. 4. Interestingly, this can be seen in the 1992 DTC between the Netherlands and the United States.

¹⁷²¹ See Chapter 6.3.2.2.

to find residence for DTC purposes¹⁷²². It should be noted, however, that the “*Madeira*” case holding would apply only as long as the trust is organized in a corporate form. In principle, and because trusts are not usually organized in a corporate form, the decision does not have a direct impact for trusts.

Switzerland applies the concept of full transparency (“*flow-through*”) for trusts regarding income taxation¹⁷²³. Therefore, it would be likely that trusts would not be considered “*liable to tax*” in Switzerland. This approach would be in line with Circular Letter 30/20¹⁷²⁴, according to which trusts do not qualify as residents of Switzerland for DTC purposes.

Lastly, it should be pointed out that the CIV Report can be a useful starting point to determine whether trusts fulfill the requirement of “*resident*”.

6.3.6.3 *Specific Meaning of the “Liable To Tax” Requirement for Collective Investment Schemes from an OECD Perspective*

As already mentioned, the determination of whether a CIS is a “*resident*” of a contracting state depends on the tax treatment of the CIS in the state of establishment, which may vary considerably from one country to another¹⁷²⁵.

The CIV Report outlines the different tax treatment of CISs, and distinguishes between fiscally-transparent and fiscally-opaque entities. Amongst opaque entities, the CIV Report differentiates four types of tax treatments: (i) CISs that are tax-exempt under the condition that they fulfil certain criteria; (ii) CISs that are subject to tax but whose base is reduced in proportion to distributions paid to investors; (iii) CISs subject to a low or zero tax rate;

¹⁷²² DE VRIES REILINGH, Tax Treaty Residence and Tax Liability, p. 1 et seq.

¹⁷²³ PFISTER, Rückerstattung der Verrechnungssteuer an inländische Investoren transparenter ausländischer kollektiver Kapitalanlagen, p. 19 et seq. It must be pointed out that CIVs are not treated as fiscally-transparent for Swiss withholding tax purposes, see Chapter 2.3.3. Being subject to Swiss withholding tax at the CIS level clearly has no significance for the characterization of CISs as residents for DTC purposes.

¹⁷²⁴ Para. 8.3 Circular 30/20.

¹⁷²⁵ CFA Report, para. 27 and OECD Commentary 2014, nr. 6.11 ad. Art. 1.

and (iv) CISs that are fully taxed but use mechanisms to grant credit for the investor payment to avoid double taxation¹⁷²⁶.

The CIV Report only excludes CISs that are fiscally-transparent and totally and unconditionally exempt from the definition of “*resident*”¹⁷²⁷. A CIS will be considered a “*resident*” if the contracting state treats the CIS as fiscally-opaque, even if that state does not in fact levy any tax from the CIS¹⁷²⁸.

Thus, the residence test used by the CIV Report is consistent with the definition of “*liable to tax*” contained in Paragraph 8.5 of the Commentary on Art. 4 of the OECD Model Convention. The CIV Report, however, recognizes that not all countries agree with the principles of Paragraph 8.5. Therefore, the CIV Report suggests that the issue of residency should be negotiated between contracting states in each specific case¹⁷²⁹.

6.3.7 Overall Conclusion

The line of reasoning followed in the “*Madeira*” case¹⁷³⁰ as well as the recent decision handed down by the Administrative Court of Zurich¹⁷³¹ are based on a purely literal and grammatical interpretation of Art. 4 OECD Model. In the “*Madeira*” case, the Court expressly stated that, for corporate entities such as a fiscally-transparent SICAV, “*effective recognition as a taxpayer*” with a locality-related or territorial attachment to the jurisdiction were sufficient, from a Swiss perspective, to find residence for DTC purposes. This conclusion is valid irrespective of whether any income taxes are in fact paid in that state by the corporate entity¹⁷³².

Under Swiss tax law provisions and on the basis of the cited “*Madeira*” case, it can be concluded that fiscally-transparent entities (“*flow-through*”) such as CISs and trusts may, theoretically, be considered as “*residents*”, provided that they are at least organized as corporate entities and recognized as potential taxpayers in light of the domestic tax laws of the state of residence.

¹⁷²⁶ CFA Report, para. 6.12 and OECD Commentary 2014, nr. 6.12 ad. Art. 1.

¹⁷²⁷ CFA Report, para. 29 and OECD Commentary 2014, nr. 6.12 ad. Art. 1.

¹⁷²⁸ CFA Report, para. 29 and OECD Commentary 2014, nr. 6.12 ad. Art. 1.

¹⁷²⁹ CFA Report, para. 30 and OECD Commentary 2014, nr. 6.13 ad. Art. 1.

¹⁷³⁰ Federal Administrative Court of 7 September 2011 (A-813/2010).

¹⁷³¹ Administrative Court Zurich of 18 December 2013 (SB.2012.00088).

¹⁷³² Federal Administrative Court Judgment of 7 September 2011 (A-813/2010).

Whereas in Switzerland the interpretation of the term “*liable to tax*” with respect to CISs and trusts is clearly established (as shown in the preceding detailed analysis), such interpretation is less clear in other countries. As demonstrated in this chapter, the large number of different tax jurisdictions makes it difficult (if not impossible) to determine whether or not a CIS or a trust may be considered “*liable to tax*” for DTC purposes.

From a practical point of view, knowing precisely what the requirements are and how strict their application is, would be helpful in order to determine residency for CISs and trusts on a global level, amongst the various tax jurisdictions, and amongst the diverging scholarly opinions. Since no uniform guidance has been issued in this regard, ordinary interpretative methods will continue to be applied¹⁷³³. On these grounds, the OECD should issue clear recommendations to assist lawyers and other stakeholders in understanding how Art. 4 para. 1 OECD Model should be applied to hybrid entities such as CISs and trusts.

6.4 The Term “Attribution of Income”

6.4.1 Introduction

A further requirement that must be fulfilled for taxpayers to be able to claim benefits of a DTC is that the relevant income needs to be “*attributed*” to them¹⁷³⁴. Generally, “*attribution of income*” (“*Einkünftezurechnung*”; “*attribution du revenu*”) can be understood as the element that determines who the taxpayer is, what the tax object is and the relationship existing between those two¹⁷³⁵. Thus, the aim of this requirement is to attribute a tax object (e.g. a dividend or interest payment) to a tax subject in a contracting state (e.g. a hybrid entity, individual or company).

¹⁷³³ CFA Report, para. 27-35.

¹⁷³⁴ WHEELER, Attribution of Income, p. 477; WHEELER, General report on conflicts in the attribution of income, p. 22; SALOMÉ, Partnerships, p. 62.

¹⁷³⁵ GUTMANN/DANON/SALOME, L’arrêt Société Schneider Electric du 28 juin 2002, p. 158; SALOMÉ, Partnerships, p. 62.

It should be noted that the “*attribution of income*” requirement may sometimes be linked to and included in the “*beneficial ownership*” requirement because neither of them is expressly mentioned or defined in the OECD Model. Even though the recipient of income and the beneficial owner could generally be the same person, it is the author’s opinion that both requirements should, in principle, be independently analyzed and fulfilled for entitlement to DTC access since each of them has a different field of application¹⁷³⁶. In this sense, the Final Report on BEPS Action No. 2 (Treaty Issues) proposed modifications to Article 1 of the OECD Model¹⁷³⁷, distinguishing both concepts. It has been shown in a previous chapter, however, that the OECD does not provide a systematic distinction between these two requirements, for instance with respect to CISs and partnerships¹⁷³⁸. Nevertheless, Chapter 6.4.6 outlines a systematic overview of the different possible hierarchies between the “*beneficial ownership*” and “*attribution of income*” requirements¹⁷³⁹.

The term “*attribution of income*” was extensively discussed¹⁷⁴⁰ during the 2007 IFA World Conventions in Kyoto. To date, a sizeable amount of literature continues to be published on this topic¹⁷⁴¹. Despite these controversies,

¹⁷³⁶ See Chapter 6.4.6. Among others: KOELE, *Trusts and the Application of the OECD Model Convention*, p. 91; DANON, thesis, p. 296 et seq.; BAUMGARTNER, thesis, p. 177-185.

¹⁷³⁷ OECD, Final Report on BEPS Action Nr. 2, ad Art. 1 para. 23.14 (Treaty Issues).

¹⁷³⁸ See Chapter 6.1.2.3.4 and Chapter 6.1.2.3.5.

¹⁷³⁹ See Chapter 6.4.6.

¹⁷⁴⁰ WHEELER, *Attribution of Income*, p. 477; WHEELER, General report on conflicts in the attribution of income, p. 19.

¹⁷⁴¹ Recently, in 2010, a doctoral thesis has been published by Jessica Salom on: “*l’attribution du revenu en droit fiscal Suisse et international*”. Moreover, Beat Baumgartner has compared the concept of beneficial ownership to the concept of attribution of income in its doctoral thesis in 2010 on: “*Das Konzept des beneficial owner im internationalen Steuerrecht der Schweiz*”. However, it must be stated that, in an early stage, various schools of thoughts emerged in Switzerland identifying this issue under Swiss law including papers by Hugues Salomé in 2002 (see: SALOMÉ, *Partnerships*), Robert Danon in 2003 (see: DANON, thesis, p. 296-326) and 2004 (see: DANON, *Conflicts of Attribution*, p. 210 et seq.; DANON/SALOMÉ, *double imposition internationale*, p. 337 et seq.; DANON/SALOMÉ, *Avoidance of Double Non-Taxation*, p. 381 et seq.) and Henri Torrone in the year 2005 (see: TORRIONE, *Sociétés de personnes*, p. 227 et seq.). However, in the author’s view, the concept of attribution of income appears to derive from the

neither the OECD Model, its Commentaries¹⁷⁴² nor the OECD Reports pay the proper attention to this fundamental and complex¹⁷⁴³ term. In the following paragraphs, the term “*attribution of income*” will be discussed from the perspectives of (i) the OECD Model and its Commentaries, (ii) the US Model and (iii) the OECD Reports¹⁷⁴⁴.

6.4.2 Meaning of the Term “*Attribution of Income*” in the OECD Model and OECD Commentaries

Unfortunately, the OECD Model neither includes an express provision defining the “*attribution of income*” rule, nor does it deal with cross-border conflicts of personal attribution (except for partnerships), resulting in uncertainty as to whether the “*attribution of income*” condition has to be generally fulfilled for the application of a DTC¹⁷⁴⁵. The same is true for CISs intending to claim tax treaty benefits, as the recently published CIV Report inserted into the OECD Model, is silent on this matter.

Even though the requirement of “*attribution of income*” is not expressly defined in the OECD Model, the definition may be derived from certain key terms in the OECD Model, such as “*paid to*”¹⁷⁴⁶, “*derived by*”¹⁷⁴⁷, “*owned*

articles published by Franz Wassermeyer in 1983 (see: WASSERMEYER, Die Hinzurechnungsbesteuerung als Qualifikationsproblem des nationalen und des internationalen Steuerrechts), Kees Van Raad in 1984 (see: VAN RAAD, Het Nationale Recht bij de Uitlegging van Belastingverdragen) and Klaus Vogel in 1986 (VOGEL, Double Tax Treaties and Their Interpretation).

¹⁷⁴² See Chapter 6.4.2.

¹⁷⁴³ WHEELER, The Attribution of Income in the Netherlands and the United Kingdom, p. 39-175 concluded that attribution of income is a complex issue according to her analysis.

¹⁷⁴⁴ See Chapter 6.4.4.

¹⁷⁴⁵ SALOM/SALOMÉ, Qualification of taxable entities and treaty protection, p. 803.

¹⁷⁴⁶ Art. 10 para. 1, 11 para. 1, 18, 19 para. 1 and 2 OECD Model. SALOM, thesis, p. 185-186.

¹⁷⁴⁷ Art. 6 para. 1, 5 and 10, 13 para. 1 and 4, 15 para. 1 and 2, 16 para. 1 and 17 para. 1 OECD Model.

by”¹⁷⁴⁸, “of”¹⁷⁴⁹, “receives/recipient”¹⁷⁵⁰ and “accrues to”¹⁷⁵¹. For example, Art. 10 para. 1 OECD Model on dividends¹⁷⁵² states that: “Dividends [i.e. the object, clarification by the author] paid by [i.e. the attribution of income, clarification by the author] a resident of a Contracting State [i.e. the tax-subject, clarification by the author] to a resident of the other Contracting State (...)”. Various scholars have explained that these expressions, such as the ones quoted above, contain the “personal attribution of income” requirement¹⁷⁵³. The articles denote that there must be a connection between the income and the relevant persons in order for a taxpayer to be able to claim treaty benefits¹⁷⁵⁴.

As mentioned above, the objective of the “attribution of income” requirement is to attribute a tax object to a tax subject in a contracting state. From a systematic point of view, this results in a relationship between the “attribution of income” requirement and the distributive rules. Only once the provision has determined the tax object and the tax subject, the distributive rules may be applied. If a certain object cannot be attributed to a specific subject, the distributive rules are not applicable, as the object does not fall within their scope¹⁷⁵⁵. Thus, the distributive rules from Arts. 6 to 21 OECD Model imply that a connection must be established between the treaty-protected income (object) and the resident person (subject). It is worth noting that DTCs following the OECD Model do not include rules as to when (fiscal realization) and to whom (tax subject) income should be attributed¹⁷⁵⁶.

¹⁷⁴⁸ Art. 12 para. 1 OECD Model.

¹⁷⁴⁹ Art. 6 para. 4, 7 para. 1, 13 para. 2, 21 para. 1 OECD Model.

¹⁷⁵⁰ Art. 20 and 21 para. 2 OECD Model.

¹⁷⁵¹ Art. 9 para. 1 and 2, 17 para. 2 OECD Model.

¹⁷⁵² Art. 10 para. 1 OECD Model.

¹⁷⁵³ ARNOLD/SASSEVILLE/ZOLT, Tax Treaties, p. 240; DANON/SALOMÉ, Avoidance of Double Non-Taxation, p. 388; BAUMGARTNER, thesis, p. 164-165.

¹⁷⁵⁴ Amongst others: DANON, thesis, p. 296 et seq.; WHEELER, Attribution of Income, p. 478; WHEELER, General report on conflicts in the attribution of income, p. 22 et seq.

¹⁷⁵⁵ SALOME, Partnerships, p. 63.

¹⁷⁵⁶ DANON, thesis, p. 296. In this vein also: BAUMGARTNER, thesis, p. 162.

The OECD Commentary 2014 only contains a few statements on the “*attribution of income*” concept¹⁷⁵⁷. From the OECD Commentary 2014 perspective, therefore, the “*attribution of income*” issue remains unsolved¹⁷⁵⁸. This is further demonstrated by an inherent link missing in the treaties based upon said Commentary. For this reason, Joanna Wheeler correctly points out that the missing “*keystone is the liability to tax of a person in respect of a specific item of income*”¹⁷⁵⁹.

6.4.3 Meaning of the Term “*Attribution of Income*” in the US Model

The US Model Tax Convention specifically deals with the issue of attribution of income for fiscally-transparent entities. Article 1(6) of the US Model Tax Convention of 2006 provides that: “*An item of income, profit or gain derived through an entity that is fiscally transparent under the laws of either Contracting State shall be considered to be derived by a resident of a State to the extent that the item is treated for purposes of the taxation law of such Contracting State as the income, profit or gain of a resident.*”

The US Model introduces the concept of attribution of income by stating that an item of income, profit or gain derived by a fiscally-transparent entity will be considered to be derived by a resident of a contracting state if a resident is treated under the taxation laws of that state as deriving the item of income¹⁷⁶⁰.

The Technical Explanation to the US Model provides some examples in which a conflict of attribution may arise. For instance, if a company that is a resident of the other contracting state pays interest to an entity that is treated as fiscally-transparent for U.S. tax purposes, the interest will be considered derived by a resident of the U.S. only to the extent that the taxation laws of

¹⁷⁵⁷ WHEELER, The Missing Keystone of Income Tax Treaties, p. 256.

¹⁷⁵⁸ WHEELER, The Missing Keystone of Income Tax Treaties, p. 250.

¹⁷⁵⁹ WHEELER, The Missing Keystone of Income Tax Treaties, p. 280.

¹⁷⁶⁰ US Model Tax Convention, 2006, Technical Explanation to para. 6.

the United States treat one or more U.S. residents (whose status as U.S. residents is determined, for this purpose, under U.S. tax law) as deriving the interest for U.S. tax purposes¹⁷⁶¹.

The 2006 US Model Tax Convention reproduced the language of the US Model Tax Convention of 1996, which contained an identical provision¹⁷⁶². Indeed, Article 4 para. 1 (d) of the 1996 Model stated that: “*An item of income, profit or gain derived through an entity that is fiscally transparent under the laws of either Contracting State shall be considered to be derived by a resident of a State to the extent that the item is treated for purposes of the taxation law of such Contracting State as the income, profit or gain of a resident*”.

It is interesting to note that even though both conventions contain the same provision, in the 1996 version, the provision was inserted under Article 4, which deals with the issue of “*residence*”. Article 4 sets forth rules for determining whether a person is a resident of a contracting state for purposes of the Convention. From paragraphs (a) to (d), the article clarifies what persons shall be considered “*resident*” in cases where the result may be ambiguous¹⁷⁶³.

Paragraph (d) of Article 4 deals with fiscally-transparent entities, although, interestingly, it does not determine who the “*resident*” is but rather, through which “*resident*” the income shall be considered to be derived. That is, paragraph (d) applies to any “*resident*” of a contracting state who is entitled to income derived through an entity that is treated as fiscally-transparent under the laws of either contracting state¹⁷⁶⁴. It seems, therefore, that the provision was not technically correct under the definition of “*resident*” since paragraph (d) does not determine whether fiscally-transparent entities are to be considered “*resident*”, but instead establishes that the income of such entities should be considered derived through the person that already fulfills the criterion of “*resident*”.

¹⁷⁶¹ US Model Tax Convention, 1996, Technical Explanation to art. 4 para. 1.

¹⁷⁶² US Model Tax Convention, 1996, Art. 4(1)(d).

¹⁷⁶³ US Model Tax Convention, 1996, Technical Explanation to art. 4 para. 1.

¹⁷⁶⁴ US Model Tax Convention, 1996, Technical Explanation to art. 4 para. 1(d).

It seems that the reason that made the drafters of the 2006 Convention move the provision of Article 4 para. 1(d) to Article 1 was an issue of legislative technique since Article 1 deals with the general scope of the Convention and determines that, in order to claim DTC benefits, the entity first needs to fulfill the requirement of “*resident*”. Only once this test has been passed, one should analyze through whom the income is derived. It is worth noting that the Public Discussion Draft BEPS Action Nr. 2’s proposal to introduce a paragraph to Article 1 of the OECD Model follows the organization of the 2006 US Model.

Treaties concluded between the US and other states contain provisions reflecting the above mentioned. For example, the problem of a potential conflict of attribution is clearly illustrated by the UK-US DTC and the US Technical Explanation thereto¹⁷⁶⁵. Under this treaty, in a trust relationship, if US law attributes income to the grantor and English law attributes that income to the beneficiaries, it becomes unclear how the relevant DTC should be applied, since one state may tax the trust whereas the other state may tax the beneficiaries¹⁷⁶⁶. The US Technical Explanation of the Exchange of Notes with reference to Art. 24 of the UK-US DTC, concluded on July 24, 2001, provides clarification. This treaty does not attribute the income to one taxable person but rather, allows the tax paid by the beneficiary in one contracting state to be credited to the tax payable by the settlor in the other contracting state. Only few DTCs include such explicit provisions¹⁷⁶⁷.

6.4.4 Meaning of the Term “*Attribution of Income*” in the OECD Reports

On the one hand, the Partnership Report of 1999 states that in principle, an item of income is considered “*paid to*” a resident of a contracting state if the

¹⁷⁶⁵ US Technical Explanation of the Exchange of Notes with reference to Art. 24 of the UK-US DTC concluded on 24 July 2001.

¹⁷⁶⁶ In this vein: WHEELER, *Taxation of Trusts in Common Law Jurisdictions*, p. 50.

¹⁷⁶⁷ Among others: Art. 24 Nordic Convention; Art. 20 para. 2 DTC 2010 HK-UK; Art. 21 para. 2 2000 DTC NO-UK; Art. 1 para. 6 DTC 1996 US Model; Art. 1 para. 2 2009 DTC AUS-NZ; Art. 1 para. 8 2001 DTC UK-US.

latter exercises its taxing power over the income¹⁷⁶⁸. The Partnership Report gives several examples in order to determine when a partnership or the partners are entitled to claim treaty benefits and the income should consequently be attributed to them¹⁷⁶⁹. On the other hand, the CIV Report released in 2010 is silent on this issue¹⁷⁷⁰.

Even though it was not inserted in the text of the OECD Model Tax Convention, it is important to highlight that in May 2014, the OECD released the Public Discussion Draft BEPS Action Nr. 2 suggesting changes to the OECD Model Tax Convention in order to ensure that hybrid instruments and entities are not used to unduly obtain benefits from DTCs. Amongst other changes, the Draft proposes to introduce a specific provision into Article 1 of the OECD Model dealing with the “*attribution of income*” rule involving hybrid entities¹⁷⁷¹.

Indeed, the BEPS Report suggests adding a paragraph to Article 1 of the OECD Model “*Persons covered*”, stating: “*For the purposes of this Convention, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State shall be considered to be income of a resident of a Contracting State but only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State.*”¹⁷⁷²

¹⁷⁶⁸ OECD, Partnership Report, para. 48, 56 and OECD Commentary 2014, nr .6.4 ad Art. 1.

¹⁷⁶⁹ OECD, Partnership Report, para. 47-92 and OECD Commentary 2014, nr. 6.4 ad Art. 1.

¹⁷⁷⁰ See Chapter 6.1.2.3.5.

¹⁷⁷¹ BEPS Action Plan 2: Neutralize the Effect of Hybrid Mismatch Arrangements (Treaty Issues), p. 7. The proposed Article 1 para. 2 states: “*For the purposes of this Convention, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State shall be considered to be income of a resident of a Contracting State but only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State. [In no case shall the provisions of this paragraph be construed so as to restrict in any way a Contracting State’s right to tax the residents of that State.]*”

¹⁷⁷² OECD, Final Report on BEPS Action Nr. 2, ad Art. 1 para 2.

The proposed amendment to the OECD Model, thus, aims at introducing an “*attribution of income*” provision for wholly or partly fiscally-transparent entities to deal with issues arising when states apply their domestic tax laws and allocate the same item of income to different tax-payers. As mentioned above, this becomes problematic because the OECD Model requires a connection between the income and the taxpayer to be able to benefit from treaty benefits.

Since the Final Report on BEPS Action Nr. 2 entered into force, it can be stated that in the context of hybrid entities, the OECD intends to include an express provision to ensure that an item of income is allocated to the taxpayer benefiting from a DTC, that is, that each single item of income is attributable to a “*resident*” for the purpose of benefitting from DTC access. The Final Report clarifies that when such a rule is applied to hybrid mismatch “*entities or arrangements*”, it should be clearly interpreted and seen in the context of the Partnership Report and the distributive rules of the OECD Model¹⁷⁷³.

Lastly, and from a literal interpretation of the quoted provision, it can be concluded that the “*attribution of income*” rule comes into play once the relevant taxpayer has fulfilled the conditions to be a “*resident*”, since the proposed paragraph determines how income of a “*resident*” should be treated. This interpretation is supported by the BEPS Report itself, which clarifies that the paragraph aims at ensuring that the relevant income is attributed to the “*resident*” of the contracting state¹⁷⁷⁴. This confirms that, in order to apply this attribution of income rule, the requirement of “*resident*” needs to be fulfilled first.

6.4.5 A Systematic Overview of “Attribution of Income Conflicts”

This section analyses conflicts of attribution of income in bilateral and triangular situations from the perspective of hybrid entities such as CISs and trusts. This section will consider (i) flow-through; and (ii) double attribution situations. These areas raise important questions in relation to the current

¹⁷⁷³ OECD, Final Report on BEPS Action Nr. 2, para. 26.13 (Treaty Issues).

¹⁷⁷⁴ OECD, Final Report on BEPS Action Nr. 2, para. 26.13 (Treaty Issues).

DTC framework as attribution of income is a matter of pure domestic law. Therefore, the diverse contracting states' views of how certain DTC terms are to be interpreted usually result in uncertainties¹⁷⁷⁵.

The analysis will be limited to the most frequent attribution of income mismatches¹⁷⁷⁶, based on recent court decisions rendered by OECD countries such as Italy¹⁷⁷⁷, Canada¹⁷⁷⁸ and India¹⁷⁷⁹ as explored by Michael Lang¹⁷⁸⁰. These countries provide their own solutions to this problem, departing from the recommendations of the Partnership Report¹⁷⁸¹. The solutions provided by these countries are discussed in order to provide a better understanding of how countries proceed systematically when confronted with issues related to CISs/trusts. The following discussion is based on the conclusions of the OECD Partnership Report regarding attribution of income conflicts. These conclusions may analogically be applied to CISs and trusts¹⁷⁸², depending on the relevant national court¹⁷⁸³.

6.4.5.1 *Flow-Through Situations*

6.4.5.1.1 Differential Treatment of CISs and Trusts: Fiscally-Opaque in the Residence Country of the CIS/Trust, but Fiscally-Transparent in the Residence Country of the Beneficiary/Settlor/Investor and at the Investment Level in the

¹⁷⁷⁵ See Chapter 5.2.3.

¹⁷⁷⁶ As a result of the constraints of time and space herein, income deriving from business profits will not be analysed further, despite the fact that this is explored in the Partnership Report, Example 18. Only movable capital property is considered herein. Further, residence-residence conflicts from hybrid entities are not being discussed here as they are generally considered to be fiscally-transparent.

¹⁷⁷⁷ Italian Supreme Tax Court of 26 February 2009.

¹⁷⁷⁸ Canadian Tax Court of 8 April 2010 (2008-2314).

¹⁷⁷⁹ Indian Tax Court on Income Tax Appellate Tribunal, 16 July 2010, nr. 659.

¹⁷⁸⁰ LANG, *Steuerlich transparente Rechtsträger und Abkommensberechtigung*, p. 1 et seq.

¹⁷⁸¹ For further details see LANG, *Steuerlich transparente Rechtsträger und Abkommensberechtigung*, p. 2 et seq. See further details in Chapters 0 and 0.

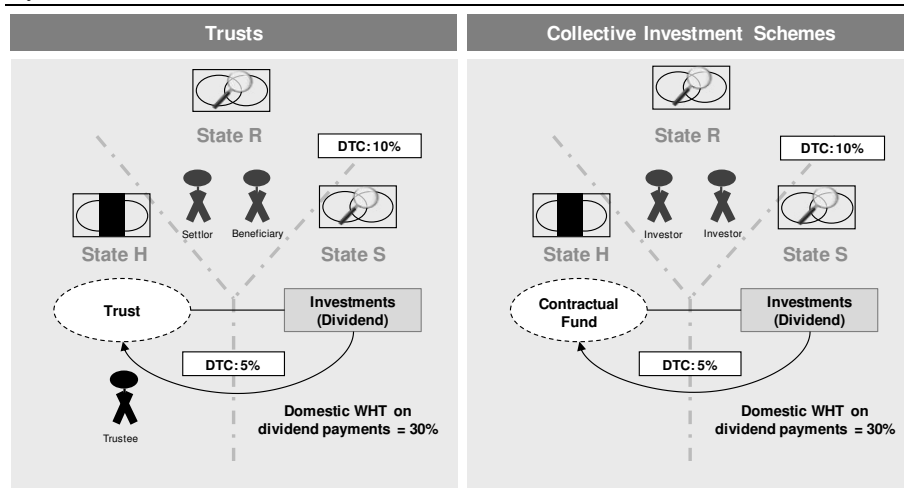
¹⁷⁸² See Chapter 6.1.2.3.

¹⁷⁸³ GLÄSER, thesis, p. 130.

Source Country

In this case, the source state (State S) considers the CIS/trust (resident of State H) to be fiscally-transparent (“*flow-through*”), and thus income from investments is attributed to and taxed at the level of the investor/beneficiary (resident of State R). The investor’s/beneficiary’s state of residence (State R) considers the CIS/trust to be fiscally-transparent (“*flow-through*”), and so investment income is attributed to and taxed at the level of the beneficiary/settlor/investor.

Figure 6.6: Differential Treatment of CISs and Trusts: Fiscally-Opaque in the Residence Country of the CIS/Trust, but Fiscally-Transparent in the Residence Country of the Beneficiary/Settlor/Investor and at the Investment Level in the Source Country.



Source: Own figure

According to the OECD Partnership Report¹⁷⁸⁴, the relevant questions here are: (i) who could benefit from the DTC; and (ii) whether they may in fact benefit from the DTC. From an OECD perspective, only the characterizations under the laws of the states of residence (States H and R) are relevant,

¹⁷⁸⁴ OECD, Partnership Report, para. 63 et seq.

and not the characterization in the state of source (State S)¹⁷⁸⁵. If the CIS/trust is considered to be a tax-subject (opaque) by the trust's state of residence (State H), it is considered a "*resident*" there and may benefit from the DTC between states of source and residence (States H and S). If the investors'/beneficiaries' state of residence (State R) considers the CIS/trust to be fiscally transparent ("*flow-through*"), and so it attributes the investment income to the investor/beneficiary, the DTC between states of source and residence (States R and S) may be applied. It is therefore possible that both of the source states' (State S) DTCs may be applied¹⁷⁸⁶.

It is clear, however, that the taxation at the source level cannot be reduced twice. For example, if an investor resident in Germany indirectly holds a qualifying participation in a Swiss company through a foreign CIS, he should be entitled to obtain a full refund of the withholding tax. In a first step, a refund of 20% of the 35% Swiss withholding tax may be obtained by the CIS¹⁷⁸⁷. In a second step, the investor could obtain a refund of the remaining 15% rate in his own name¹⁷⁸⁸.

¹⁷⁸⁵ The legal grounds for this may be found in: OECD Commentary 2014, nr. 6.3 ad. Art. 1 as well as OECD, Partnership Report, para. 53 et seq. The source state must follow the attribution of income rules from the residence state: "*One broadly based approach would be to recognize as implicit in the structure of the Convention the principle that the source State, in applying the Convention where partnerships are involved, should take into account, as part of the factual context in which the Convention is to be applied, the way in which an item of income arising in its jurisdiction is treated in the jurisdiction of the taxpayer claiming the benefits of the treaty as a resident.*" Against: Decision of the Indian Tax Court on Income Tax Appellate Tribunal, 16 July 2010, nr. 659 according to which every legal entity that is a tax subject under the laws of the source state may also be considered a resident for the purpose of the source state. However, the decision requires that the DTC access depends on whether the entity is being taxed (on corporate or other level) in its state of incorporation. This position is also expressed in the decision of the Canadian Tax Court of 8 April 2010 (2008-2314).

¹⁷⁸⁶ OECD, Partnership Report, para. 74 et seq. The Partnership Report expressly states that if two treaties apply, the most favorable one may be chosen, i.e. the one which allows the largest reduction of the withholding tax in the Source State. In this vein: LANG, *Steuerlich transparente Rechtsträger und Abkommensberechtigung*, p. 1 et seq.

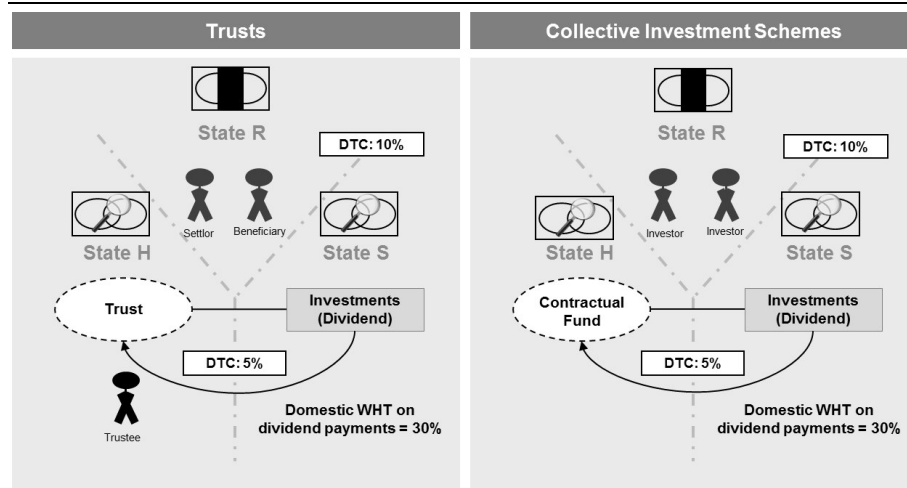
¹⁷⁸⁷ Art. 10 para. 2 (c) DTC Switzerland-Germany. HEUBERGER/OESTERHELT, *Collective Investment Vehicles*, p. 36, Footnote 22.

¹⁷⁸⁸ Art. 10 para. 3 DTC Switzerland-Germany. HEUBERGER/OESTERHELT, *Collective Investment Vehicles*, p. 36, Footnote 22.

6.4.5.1.2 Differential Treatment of CISs and Trusts: Fiscally-Opaque in the Residence Country of the Investor/Beneficiary, but Fiscally-Transparent at the Investment Level in the Source Country and in the Residence Country of the CIS/Trust

In this case, both the source state (State S) and the CIS/trust's state of residence (State H) consider the CIS/trust (resident of State H) to be fiscally-transparent ("*flow-through*"), and thus income from investments is attributed to and taxed at the level of the investor/beneficiary (resident of State R). The investor's/beneficiary's state of residence (State R) considers the CIS/trust to be opaque, and State R attributes investment income to the CIS/trust, and not to the investors/beneficiaries.

Figure 6.7: Differential Treatment of CISs and Trusts: Fiscally-Opaque in the Residence Country of the Investor/Beneficiary, but Fiscally-Transparent at the Investment Level in the Source Country and in the Residence Country of the CIS/Trust.



Source: Own figure

In this case and following the solution provided by the Partnership Report, conversely, no DTC may be applicable. If the trust's state of residence (State H) considers the CIS/trust to be fiscally-transparent ("*flow-through*"), and the investors'/beneficiaries' state of residence (State R) considers the CIS/trust to be fiscally-opaque, the investment income cannot be directly attributed to the investor/beneficiary. For this reason, none of the state of source's (State S) DTCs can be applied. The consequence is that dividend payments from an investment in the state of source (State S) paid to a

CIS/trust resident of State H will be subject to full withholding tax without any reduction under the relevant DTCs¹⁷⁸⁹.

According to Michael Lang, the only relevant question is how the state of source (State S) considers the income to be attributed, and not the attribution afforded by the states of residence (States H and R)¹⁷⁹⁰. Whether or not the states of residence (States H and R) consider the CIS/trust to be fiscally-opaque is therefore irrelevant. When the source state (State S), attributes the income to State H according to its domestic tax law, it must be checked whether the CIS/trust fulfils the requirement of residence in State H.

According to a recent Italian judgment¹⁷⁹¹, which did not expressly refer to the principles of the Partnership Report, a refund of the withholding tax paid would have been possible if Michael Lang's view had been applied. In this sense, according to the Italian domestic tax law, the income from Italian source (dividends) received by a US L.P. should be attributed to the US L.P. According to US tax law, this legal entity is considered to be tax-transparent. However, according to Michael Lang's approach, the entity would also be considered a resident under Art. 4 para. 1 OECD Model, by way of its "*domicile, residence, place of management or any other criterion of a similar nature*", because the locality/territoriality-related attachment is sufficient¹⁷⁹².

6.4.5.2 Double Attribution of Income Situations

Under this scenario, if the state of source (State S) attributes income that originated from its territory the investor/beneficiary resident of State R (i.e. the income is attributed to State R instead of State H), the state of source (State S) will apply its DTC with the state of residence (State R) to eliminate double taxation.

If, further, the state of source (State S) additionally attributes the income to another resident (i.e. income is attributed to a third state), it would comply

¹⁷⁸⁹ In this vein: LANG, *Steuerlich transparente Rechtsträger und Abkommensberechtigung*, p. 1 et seq.

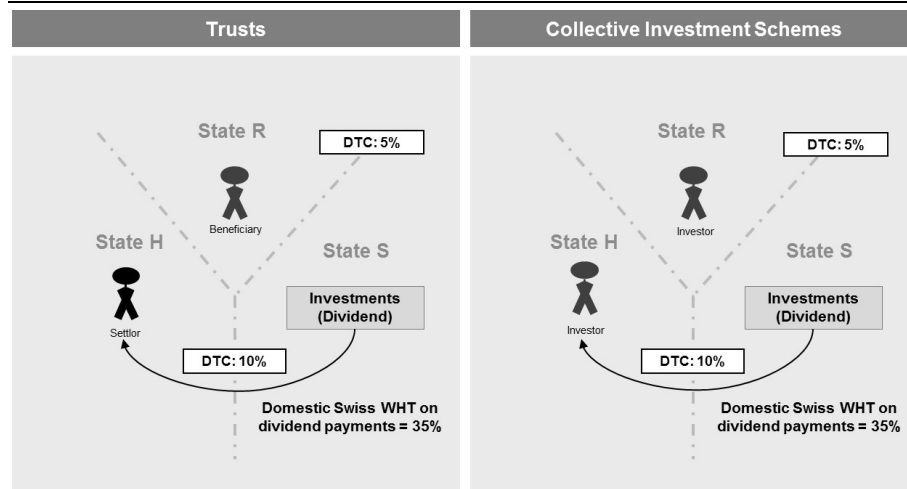
¹⁷⁹⁰ LANG, *Partnerships*, p. 38 et seq.

¹⁷⁹¹ Italian Supreme Tax Court of 26 February 2009.

¹⁷⁹² For further details : LANG, *Steuerlich transparente Rechtsträger und Abkommensberechtigung*, p. 3.

with its obligations under both DTCs by imposing the lower rate¹⁷⁹³. It must be ensured that any such “*residence-residence*” conflicts, deriving from diverging allocation rules (double attribution of income situations), do not result in economic double taxation.

Figure 6.8 Double Attribution of Income Situations



Source: Own figure

6.4.6 Excursus on the Relationship between “Beneficial Ownership” and “Attribution of Income”

Another relevant question concerns the relationship between the “*beneficial ownership*” and the “*attribution of income*” requirement. These requirements have different fields of application and, therefore, should apply independently from each other¹⁷⁹⁴. In the author’s view, this remains true even if

¹⁷⁹³ DANON, thesis, p. 326.

¹⁷⁹⁴ See Chapter 6.4. See therein also amongst others: DANON, thesis, p. 328; BAUMGARTNER, thesis, p. 176-177.

the original function of the “*beneficial ownership*” requirement was to import an “*attribution of income*” rule and therefore was originally intended to have the same field of application¹⁷⁹⁵.

In a first step, in order to gain access to a DTC, it is necessary to examine whether, according to Art. 3 para 2 OECD Model, the relevant income is “*attributed to*” a resident person according to the domestic law of the state in which that person is resident¹⁷⁹⁶. If this first criteria is satisfied, it must be considered, in a second step, whether the person is also the “*beneficial owner*” of the relevant income¹⁷⁹⁷. These two steps, therefore, work independently. This outcome is also mirrored in the Discussion Draft on BEPS Action 2 addressing situations aimed at ensuring that transparent entities are not used to obtain DTC benefits unduly¹⁷⁹⁸. Also, the concepts of “*attribution of income*” and “*beneficial ownership*” are different since the attribution of income requirement is satisfied under domestic law¹⁷⁹⁹, whereas the beneficial ownership requirement must be given an autonomous (international fiscal) meaning¹⁸⁰⁰. As demonstrated by Beat Baumgartner¹⁸⁰¹, the confusion concerning the hierarchy between the “*beneficial ownership*” and “*attribution of income*” requirements is rooted in the relationship between

¹⁷⁹⁵ WALSER, p. 17-19. As Martín Jiménez has analyzed in detail, in the past no anti-treaty shopping mechanism was included within the concept of “*beneficial ownership*”. The original function aimed at analyzing via a formal legal approach rather than an economic (substance-over-form) approach. See JIMENEZ, *Beneficial Ownership*, Part I, nr. 3.4. This can also be seen from the Partnership Report in which it is suggested that the beneficial owner concept is identical to the attribution of income concept. See also AVERY JONES/VANN/WHEELER, *Response to the OECD Discussion Draft*, p. 2. On this view, the pragmatic approach of the *Prévost Car Case* must be understood. The Canadian Court analysed whether income could be attributed under a formal legal and not an economic (substance-over-form) approach.

¹⁷⁹⁶ BAUMGARTNER, thesis, p. 171-176 and 185. DANON, thesis, p. 323; LISSI, thesis, p. 220, Footnote 827.

¹⁷⁹⁷ DANON, thesis, p. 328-329; BAUMGARTNER, thesis, p. 185.

¹⁷⁹⁸ OECD, *Final Report on BEPS Action 2*, ad Art. 1 para 26.14.

¹⁷⁹⁹ See Chapter 6.4.

¹⁸⁰⁰ See Chapter 6.5.2.2.

¹⁸⁰¹ BAUMGARTNER, thesis, p. 177-185.

them¹⁸⁰² as well as whether these requirements have to be met by the same person¹⁸⁰³. This issue will be analyzed in a separate paragraph.

As will be demonstrated, uncertainty in this field is caused by a number of factors, including a lack of clear and purposive guidance from the language of the relevant DTC and the OECD materials, as well as differing views on the meanings of the “*beneficial ownership*” and “*attribution of income*” requirements.

6.4.6.1 *Hierarchy between the “beneficial ownership” and “attribution of income” Requirements*

Beat Baumgartner has presented a systematic overview of the different possible hierarchies between the “*beneficial ownership*” and “*attribution of income*” requirements in his doctoral thesis¹⁸⁰⁴. With regard to the relationship between the “*beneficial ownership*” and “*attribution of income*” requirements, it may be assumed that, from one point of view, the concept of beneficial ownership is subsumed within the attribution of income requirement¹⁸⁰⁵. From another point of view, if income is attributed to the resident person according to the laws of the state of residence, the resident is “*per se*” the beneficial owner¹⁸⁰⁶. From a third point of view, which is followed in this thesis, it may be concluded that both concepts are conditions that must be independently fulfilled in order to gain access to a DTC (i.e. the two concepts are distinct and independent from each other)¹⁸⁰⁷.

Leading scholars such as Robert Danon consider that the requirement of the “*attribution of income*” must be differentiated from that of “*beneficial ownership*” as the latter is “*of a different nature and pursues another goal, namely to tackle the improper use of tax treaties and more specifically treaty*

¹⁸⁰² See Chapter 6.4.6.1.

¹⁸⁰³ See Chapter 6.4.6.2.

¹⁸⁰⁴ BAUMGARTNER, thesis, p. 177-185.

¹⁸⁰⁵ BAUMGARTNER, thesis, p. 177-178.

¹⁸⁰⁶ BAUMGARTNER, thesis, p. 178.

¹⁸⁰⁷ BAUMGARTNER, thesis, p. 178-179.

shopping schemes adversely affecting the source state”¹⁸⁰⁸. He argues that in a first step, the distributive rules of a DTC attribute the item of income to a person and, in a second step, the person to whom the attribution is made must be the beneficial owner¹⁸⁰⁹.

6.4.6.2 *Do the Requirements of “beneficial ownership” and “attribution of income” have to be met by the same person?*

Considering the graphic illustrated below the theoretical question of whether the “*beneficial ownership*” and “*attribution of income*” requirements have to be met by the same person may arise. It is theoretically possible that, in the case of a conduit company (e.g. a company that has no power of disposition over dividends, interest and royalties, a mere fiduciary or an administrator acting on account of interested parties), the “*beneficial owner*” requirement is to be met not by the conduit company but by the interested party domiciled in the same country, based on an autonomous (international fiscal) meaning.

On the other hand, however, according to domestic law, income is generally attributed to the conduit company. Such domestic law generally follows a pure civil law characterization of the state in which that person is a resident (in accordance with Art. 3 para. 2 OECD Model)¹⁸¹⁰. A literal interpretation of the dividend distributive rules¹⁸¹¹, determines that such dividends must be paid to “*a resident of the other Contracting State*”. There is, at first sight, no explicit obligation, under the OECD materials, that the person must be exactly the same¹⁸¹². In the author’s view, there are two possible scenarios, as

¹⁸⁰⁸ DANON, Conflicts of Attribution, p. 211. In this vein also according to his analysis: BAUMGARTNER, thesis, p. 179 et seq. The author has a different view with regard to the taxation of trusts. It must be stated that, based on the Circular Letter 30/20 on trusts, trust relationships are subject to a look-through approach for tax purposes. In particular, the beneficial owner of the income rather than the legal owner becomes taxable based on an economic (substance-over-form) approach. See for further details Chapter 3.3.7.1.

¹⁸⁰⁹ DANON, thesis, p. 347-349. BAUMGARTNER, p. 176-177.

¹⁸¹⁰ BAUMGARTNER, thesis, p. 182-185.

¹⁸¹¹ Art. 10 para. 1 OECD Model.

¹⁸¹² BAUMGARTNER, thesis, p. 183.

shown in Figure 6.¹⁸¹³ Scenario 1 refers to a situation in which the person seeking DTC benefits must fulfil both requirements, whereas in Scenario 2 the requirements need not be fulfilled by the same person.

On the basis of literal and grammatical arguments (based on the meaning of the words) of Art. 10 para. 1 and para. 2 OECD Model it is not expressly required that the person trying to obtain DTC benefits must fulfil both requirements¹⁸¹⁴. On the basis of systematic arguments (based on the contract as a whole) as well as teleological arguments (based on the object and purpose of avoiding double taxation), both requirements pursue the objective of identifying the person rightfully entitled to DTC benefits¹⁸¹⁵. In other words, they aim at tackling the improper use of tax treaties as well as avoiding treaty shopping. In order to achieve that aim and for the system to be effective, the person applying for the benefits of a DTC must fulfil both and each requirement independently¹⁸¹⁶. If the person is only considered to be a “*beneficial owner*” and the income is not “*attributed to*” this person, that person does not fulfil all the conditions to have DTC access.

Since the modification to Article 1 proposed by the Final Report on BEPS Action 2, it seems clear that the “*attribution of income*” requirement is becoming more relevant in the context of a DTC entitlement. In such context, there is an inherent risk of mismatches between the requirements of “*beneficial ownership*” and “*attribution of income*”, as outlined in the example below concerning DTC access. In the author’s view, it is advisable and pragmatic to include a mechanism in the OECD Commentary to avoid such mismatches between the “*beneficial ownership*” and the “*attribution of income*” requirements. The mismatches between these two requirements could be eliminated in two ways: In the first option, only the attribution of income requirement is met, by admitting that the beneficial ownership requirement is equally fulfilled despite the fact that this requirement is fulfilled by a third

¹⁸¹³ See Figure Figure 6.9: Beneficial Ownership and Attribution of Income in the Context of Conduit Companies.

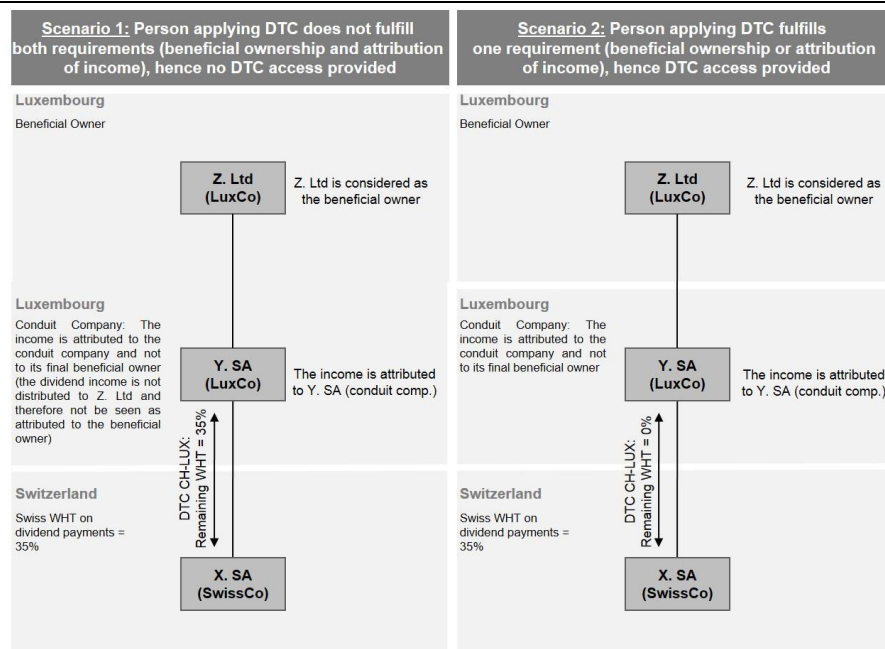
¹⁸¹⁴ BAUMGARTNER, thesis, p. 184.

¹⁸¹⁵ This statement is only correct if the “*attribution of income*” requirement does not follow the pure civil law characterization of the state in which the person is a resident. See for further discussions in Chapter 6.4.6.2.

¹⁸¹⁶ DANON, thesis, p. 328.

person¹⁸¹⁷. In the second option, comparable to the solution under a purely Swiss domestic scenario, in order to eliminate inherent risks of mismatches, certain Swiss authors point out that the lawmaker should only require the fulfillment of the “*right to use*” requirement, which corresponds to the “*beneficial ownership*” requirement in an international context¹⁸¹⁸. Under this option and for the case that only the beneficial ownership requirement is met, one can presume that a certain income is attributed to this person, even though the income is not effectively attributed to the person in question¹⁸¹⁹.

Figure 6.9: Beneficial Ownership and Attribution of Income in the Context of Conduit Companies



Source: Own figure

¹⁸¹⁷ Comments by Robert Danon on the OECD, Discussion Draft on BEPS Action 2, nr. 26.3-26.16 ad Art. 1.

¹⁸¹⁸ See MISTELI, Dividenden-Stripping, nr 305.

¹⁸¹⁹ In a comparative view see also: Commentary of the United Nations 2010, nr. 13 ad. Art. 10; nr. 18 ad. Art. 11; nr. 5 ad. Art. 12.

As pertains to CISs and trusts, the inherent risk of mismatches between the requirements of "*beneficial ownership*" and "*attribution of income*" only result for trusts, where both requirements apply. As the requirement of "*attribution of income*" does not apply to CISs, risks of mismatches are not an issue.

6.5 The Term "Beneficial Ownership"

6.5.1 General Introduction

The concept of beneficial ownership ("*Nutzungsberechtigung*"; "*bénéficiaire effectif*") is crucial when determining the personal scope of application of a DTC¹⁸²⁰. This concept is the most widely known mechanism to eliminate access to DTCs for artificial structures and prevent misuse by benefitting individuals and corporations (anti-treaty-shopping mechanism¹⁸²¹).

Apart from these measures, various other responses to artificial structures have been developed by way of the interpretation of DTCs and through the

¹⁸²⁰ OLIVER/LIBIN/VAN WEEGHEL/DU TOIT, *Beneficial Ownership*, p. 311 lists the direct English translation of the term used in 20 states. In the present thesis, reference will be made to the OECD term "*beneficial owner*" and not to the direct English translation "*entitlement to use*".

¹⁸²¹ The term "*treaty-shopping*" has neither been properly defined by the OECD Model nor in its Commentaries. A very general and introductive description can be gathered with regard to Limitation-of-Benefits provisions in the OECD Commentary on Article 1. According to this Article the Limitation-of-Benefits provisions are "*aimed at preventing persons who are not residents of either Contracting States from accessing the benefits of a Convention through the use of an entity that would otherwise qualify as a resident of one of these States*". See in this vein: OECD Commentary 2014, nr. 20 ad. Art. 1. The term "*treaty-shopping*" is thought to have originated in the US, deriving from the US civil procedure which uses the term "*forum shopping*". David Rosenbloom described the phenomenon as "*the practice of some investors 'borrowing' a tax treaty by forming an entity (usually a corporation) in a country having a favourable tax treaty with the country of source – that is, the country where the investment is to be made and the income in question is to be earned*". See in this vein: ROSENBLOOM, *US treaty Policy*, p. 83 and ROSENBLOOM, *Tax Treaty Abuse*, p. 766. A quasi-definition of this term can also be derived from the US TECHNICAL EXPLANATION, p. 63 as explored by Reuven S. Avi-Yonah and Christiana HJI Panayi. See in this vein: AVI-YONAH/PANAYI, *Treaty Shopping*, p. 3.

introduction of targeted anti-avoidance rules¹⁸²². The domestic legislation against the improper use of DTCs¹⁸²³, enacted by the Swiss Federal Council in 1962¹⁸²⁴, for example, responds to this initiative. The advantages of withholding tax limitations, accordingly, are only granted if the recipient of the income is considered, among other conditions, the beneficial owner. It is consequently not surprising that, in the field of international taxation, enormous attention has been paid to this term¹⁸²⁵, although it still lacks a clear definition, leading to legal uncertainty¹⁸²⁶.

The case law developed in recent years has sadly offered confusion instead of clarity and certainty in relation to the “*beneficial ownership*” requirement¹⁸²⁷. For example, the most recent decision of the Swiss Federal Administrative Tribunal in relation to entitlement to a refund of Swiss withholding tax, on 7 March 2012¹⁸²⁸, is controversial. The issue discussed in this case was whether a Danish bank which had entered into total return swaps with counterparties in the US and Europe (e.g. France, Germany and the UK) on equity baskets (including Swiss equities) could be considered as the beneficial owner of investment income and; therefore, obtain a refund of Swiss withholding tax based on the DTC between Switzerland and Denmark¹⁸²⁹.

¹⁸²² In this vein: DUFF, Responses to Tax Treaty Shopping, p. 2.

¹⁸²³ In this vein also: DE BROE, thesis, p. 440.

¹⁸²⁴ Swiss Federal Decree of 14 December 1962 on Measures against the Improper Use of DTCs Concluded by the Swiss Confederation (RS 672.202).

¹⁸²⁵ Recently, in 2010 a doctoral thesis has been published by Beat Baumgartner on:

“*Das Konzept des beneficial owner im internationalen Steuerrecht der Schweiz*”.

¹⁸²⁶ Amongst others: DU TOIT, thesis; DANON, thesis, p. 326 et seq.; VIITALA, thesis, 87 et seq.; VAN WEEGHEL, thesis, p. 64; VOGEL, Double Tax Conventions, p. 561 et seq.; OLIVER OLIVER/LIBIN/VAN WEEGHEL/DU TOIT, Beneficial Ownership, p. 310 et seq.; LI, Beneficial Ownership in Tax Treaties, p. 187 et seq.; WHEELER, Attribution of Income, p. 478-479; DE BROE, thesis, p. 654 et seq.

¹⁸²⁷ See the analysis in the chapter titled The Meaning according to Case Law (Chapter 6.5.2.2.7).

¹⁸²⁸ Federal Administrative Court of 7 March 2012 (“*Swap-Entscheid*”, A-6537/2010), Swiss Federal Supreme Court decision of 5 May 2015 (2C_364/2012, 2C_377/2012, 2C_895/2012).

¹⁸²⁹ See Chapter 6.5.2.2.7. Further landmark court decisions have since been handed down by the Federal Administrative Courts on 23 July 2012 (A-1246/2011) and 13

The OECD Committee on Fiscal Affairs tried to clarify the meaning of “*beneficial ownership*”. In this sense, a discussion draft has been released in April of 2011 on the clarification of the meaning of beneficial ownership¹⁸³⁰. This draft will be analyzed in relation to CISs and trusts.

Whether literal or economic interpretative norms should be applied in defining “*beneficial ownership*” is still uncertain, although the latter is often preferred. The crucial and decisive question that will be analyzed in this chapter is whether and under what conditions a CIS or trust may qualify as the “*beneficial owner*” of the income arising in the source state. In order to respond to this question, a series of preliminary analyses must first be made in Swiss domestic and international law. Although the preceding analysis as to the interpretation of ambiguous DTC terms supports the view that an autonomous international interpretation should be preferred, this chapter also refers to some domestic law interpretations of “*beneficial ownership*” for reference and comparative purposes. This is not intended to undermine the general methodology used in the preceding analysis¹⁸³¹. It should be borne in mind that preference is given to the “*International Law Theory*” in order to ensure the most autonomous and uniform interpretation of DTC terms. Consequently, interpretation does not follow the domestic rules applying to ordinary domestic statutes. Recourse to domestic law is only admissible if an agreement expressly refers to it or as a last resort, if the general principles of interpretation which the VCLT lays down in Arts. 31 to 33 do not provide a definitive and clear meaning of the relevant term.

This analysis involves four steps. First, the definition and main components of the term will be examined according to the domestic law meaning pursuant to Art. 3 para. 2 OECD Model, and from the perspective of the source

March 2013 (A-4794/2012). These decisions have been excluded due to time constraints.

¹⁸³⁰ Discussion Draft on Clarification of the meaning of “*beneficial owner*”. On 19 October 2012 a revised discussion draft on the meaning of “*beneficial owner*” was published.

¹⁸³¹ See Chapter 5.

state¹⁸³². Second, the term will be interpreted according to an autonomous international meaning for treaty purposes¹⁸³³. Subsequently, a comparison between the two interpretations will be conducted¹⁸³⁴. Finally, the central question will be considered, namely whether CISs and trusts meet the conditions of “*beneficial ownership*”¹⁸³⁵. If this question is answered in the negative, it should be further analyzed whether an investor within a CIS, or the settlor, beneficiary or trustee within a trust structure, may be considered the beneficial owners of the income. As a result of the constraints of time and space herein, such analysis will not be conducted in this chapter.

6.5.2 Definition of “Beneficial Ownership”

Despite the obvious need for contracting states to have a uniform understanding of the concept of “*beneficial ownership*”, this “*is probably the most well-known undefined treaty term*”¹⁸³⁶. The concept was first inserted in the 1977¹⁸³⁷ OECD Model in paragraph 2 of Article 10, regarding dividends, and paragraph 2 of Article 11, in relation to interest¹⁸³⁸ with the aim of identifying the true recipient of the relevant income¹⁸³⁹. To this day, there is no express and globally recognized definition of the term¹⁸⁴⁰, although a definition may be deduced from the 1989 DTC between Italy and Germany, which

¹⁸³² See Chapter 6.5.2.1.

¹⁸³³ See Chapter 6.5.2.2.

¹⁸³⁴ See Chapter 6.5.2.3.

¹⁸³⁵ See Chapter 6.5.3.

¹⁸³⁶ DU TOIT, *The Evolution of the Term Beneficial Ownership*, p. 1.

¹⁸³⁷ However, the concept of beneficial ownership substituted the “*subject to tax*” requirement, as already demonstrated in the 1966 protocol to the DTC UK-US, the 1967 DTC UK-NE and the 1996 DTC UK-CA. In this vein: AVERY JONES, *The Origins of Concepts and Expressions Used in the OECD Model and their adoption by States*, p. 220 et seq and BAKER, *Economic and Social Council*, p. 6. Moreover, it was already contained in the Draft of the 1974 OECD Model.

¹⁸³⁸ Furthermore, the concept of “*beneficial ownership*” has been inserted in paragraph 1 of Article 12 OECD Model regarding royalties. As previously indicated, the royalty article is outside the scope of the present thesis.

¹⁸³⁹ AVERY JONES/VANN/WHEELER, *Response to the OECD Discussion Draft*, p. 2.

¹⁸⁴⁰ LUTZ, thesis, p. 35 with a detailed list of all DTCs Switzerland has entered into; DANON, *bénéficiaire effectif*, p. 39; LOCHER, *Einführung internationales Steuerrecht Schweiz*, p. 152; OBERSON, *Précis de droit fiscal international*, p. 87.

states: “*the recipient of the dividends, interest and royalties is the beneficial owner within the meaning of Article 10, 11 and 12 if he is entitled to the right upon which the payments are based and the income derived there from is attributable to him under the tax laws of both States*”¹⁸⁴¹. Recently, and due to the forces of increased globalization, however, contracting states have noticed the need to precisely define and interpret this term. For instance, the question was extensively discussed during IFA conferences in London in 1998 and Israel in 1999¹⁸⁴². John Avery Jones, among other leading authors, has already come to the conclusion in 1989 that “*there seems little chance of there being an accepted universal meaning*”¹⁸⁴³. Today, neither the OECD Model and its Commentaries, nor any other national reports¹⁸⁴⁴ have specifically defined this term¹⁸⁴⁵. Philip Baker has even felt the need to ask in a recent article: “*what does the term ‘beneficial owner’ mean in a tax treaty?*”¹⁸⁴⁶

Moreover, no commonly accepted meaning has emerged amongst scholars and practitioners¹⁸⁴⁷. Beat Baumgartner, for instance, defines the term “*beneficial ownership*” as follows: “*Beneficial owner is the person who at the time of payment of the relevant income is not only able to take minor decisions as pertains to the use of said income, but may take at least certain relevant decisions in this regard independently. This decision power criteria is not met where a person is, at the time of payment of the income, under contractual obligation to forward the received income to a third party or under other*

¹⁸⁴¹ DTC between Italy-Germany, Protocol para. 9.

¹⁸⁴² See DANON, thesis, p. 327.

¹⁸⁴³ AVERY JONES, Trusts under the OECD Model, Part I, p. 69.

¹⁸⁴⁴ OECD Commentary 2014 on Art. 10 para. 12; Art. 11 para. 8; OECD, Partnership Report, para. 65. CFA Report does not define the term “*beneficial owner*” generally, but rather focuses on the question whether a CIS meets the requirement of the term “*beneficial owner*”. Only a few States have defined this term in their DTCs, such as the DTC USA-Germany (Art. 10 Protocol), DTC Germany-Norway (Art. 4 Protocol); DTC Germany-Sweden (Art. 43 para. 2); DTC Italy-Turkey (Art. V Protocol); DTC Belgium-Turkey (Art. 5 Protocol); DTC Sweden-Turkey (Art. 3 Protocol), DTC Romania-Turkey (Art. 3 (j)); DTC Pakistan-Turkey (Art. 4 Protocol); DTC France-Turkey (Art. 3 Protocol).

¹⁸⁴⁵ KRISHNA, Using Beneficial Ownership to Prevent Treaty Shopping, p. 548.

¹⁸⁴⁶ BAKER, Beneficial Ownership: After Indofood, p. 15.

¹⁸⁴⁷ AVERY JONES, Trusts under the OECD Model, Part I, p. 69.

*factual restrictions such as intense control through a legal entity, requiring the income to be forwarded to a third party and specifically where the receipt of said income depends on the receiving person's obligation to forward said income to a third party*¹⁸⁴⁸". As observed by David B. Oliver, Jerome B. Libin, Stef Van Weeghel and Charl Du Toit, the OECD's progress in finding a consensus between the contracting states has been very slow¹⁸⁴⁹: "*the OECD should find a way of saying something more by way of expanding the Commentary*"¹⁸⁵⁰. Leading scholars have even questioned the basic significance of the term. Recently, for example, Robert Danon has questioned whether the "*beneficial ownership*" requirement even derives from the dividend¹⁸⁵¹ and interest¹⁸⁵² Articles of the OECD Model as is more commonly supposed. Robert Danon pointed out that this requirement could derive instead from the first Article of the OECD Model in the context of "*improper use of the Convention*"¹⁸⁵³. Regardless of where this "*virtual*" and "*implicit*" concept derives from, the Federal Tax Administration considers that this requirement must be satisfied even in the absence of an explicit DTC

¹⁸⁴⁸ BAUMGARTNER, thesis, p. 157, translated from German: "*Beneficial owner ist diejenige Person, die im Zeitpunkt der Zahlung der massgeblichen Einkünfte hinsichtlich der Verwendung dieser Einkünfte nicht nur sehr begrenzte Entscheidungen, sondern zumindest gewisse Entscheidungen selbständig treffen kann. Diese Entscheidungsbefugnis ist einer Person abzusprechen, wenn sie die Gesamtheit der empfangenen Einkünfte aufgrund bereits im Zeitpunkt der Zahlung der Einkünfte bestehenden vertraglichen Weiterleitungsverpflichtungen oder tatsächlichen Einschränkungen wie intensiver gesellschaftsrechtlicher Beherrschung in Form einer Zahlung an eine andere Person weiterleiten muss und die Erzielung der Einkünfte von der Pflicht zur Weiterleitung dieser Einkünfte und die Pflicht zur Weiterleitung der Einkünfte von der Erzielung dieser Einkünfte abhängig ist. Eine intensive gesellschaftsrechtliche Beherrschung liegt vor, wenn die Geschäftsführung einer Gesellschaft über die Verwendung der massgeblichen Einkünfte und damit über die Weiterleitung derselben nicht unter Berücksichtigung der Interessen der Gesellschaft, sondern ausschliesslich nach dem Willen des beherrschenden Gesellschafters entscheiden kann*".

¹⁸⁴⁹ OLIVER/LIBIN/VAN WEEGHEL/DU TOIT, Beneficial Ownership, p. 325.

¹⁸⁵⁰ OLIVER/LIBIN/VAN WEEGHEL/DU TOIT, Beneficial Ownership, p. 325.

¹⁸⁵¹ Art. 10 OECD Model.

¹⁸⁵² Art. 11 OECD Model.

¹⁸⁵³ DANON, bénéficiaire effectif, p. 40. In this view also: DE BROE/FRENCKELL, Swap Case, 262-263.

provision¹⁸⁵⁴. The lack of a clear definition also raises the question as to whether the “*beneficial ownership*” concept should be extended to Articles other than Articles 10, 11 and 12 of the OECD Model, such as Article 13. The answer should in principle be “*no*”. Philip Baker has recently considered whether the beneficial ownership requirement should be extended in the context of other Articles of the UN Model¹⁸⁵⁵. Based on his analysis, he informed the UN about the danger of extending the “*beneficial ownership*” requirement to other Articles in an unsystematic way without first refining a clear definition of the term. The concept of “*beneficial ownership*” is expressly referred to in relation to Article 13 of the Switzerland–Israel DTC¹⁸⁵⁶. That being said, the notion of “*beneficial ownership*” is not referred to at all in most tax treaties ratified by Switzerland. Nevertheless, there is no basis why the concept should be applicable, in the absence of express treaty reference, to the capital gains provisions in Article 13 of the OECD Model. Express confirmation of the scope of the “*beneficial ownership*” requirement would bring a measure of much needed clarity in this area.

The aforementioned examples emphasize the urgent need in the international tax community for a proper definition and a clear interpretation of the term. In addition, it has yet to be clarified whether a legal or economic approach should be followed for interpretative purposes. In this regard, the proposed additions to the Commentary recommended by the CFA Report¹⁸⁵⁷ are certainly to be welcomed, in order to at least gain some legal certainty and clarity for CISs and, by way of analogy, for trusts.

¹⁸⁵⁴ Federal Tax Administration Guidelines of 15 July 2005, EC-Switzerland Savings Tax Agreements, nr. 10(a) ad. Art. 15. In this vein see, among others: MÄUSLI, thesis, p. 224; DANON, *bénéficiaire effectif*, p. 40. This has also been stated in: Federal Administrative Court of 7 March 2012 (“*Swap-Entscheid*”, A-6537/2010), para. 3.3.2. In the author’s opinion, this view may violate the “*pacta sunt servanda*” principle and therefore impact upon the legal certainty of the agreement, whose original intention may not be fulfilled.

¹⁸⁵⁵ BAKER, Economic and Social Council, n. 75.

¹⁸⁵⁶ DTC between Switzerland and Israel, Art. 13 para. 5.

¹⁸⁵⁷ OECD Commentary 2014, nr. 6.14 ad. Art. 1 reads: “*Accordingly, a vehicle that meets the definition of a widely-held CIV will also be treated as the beneficial owner of the dividends and interest that it receives, so long as the managers of the CIV have discretionary powers to manage the assets generating such income (unless an individual*

6.5.2.1 Domestic Law Meaning of “Beneficial Ownership”

Ross Raser and J. D. B. Oliver analyzed the interpretation of the term “*beneficial ownership*” in the United Kingdom. These authors stated that since no definition exists in the DTCs signed by the United Kingdom, following the method of Art. 3 para 2 OECD Model (“*lex fori*”), the term must be interpreted according to domestic tax law¹⁸⁵⁸. The US Treasury came to the same conclusion: “*The term ‘beneficial ownership’ is not defined in the Convention, and is, therefore, defined under the internal law of the State of source*”¹⁸⁵⁹. Charl Du Toit¹⁸⁶⁰ also shares this view and refers specifically to common law jurisdictions, as the term has its origin in those common law countries¹⁸⁶¹. However, his reasoning goes even further. According to this author, the meaning of “*beneficial ownership*” under the common law is only the starting point of an autonomous interpretation, as a coherent uniform meaning does not even exist across most common law countries. Surprisingly, the discussion draft proposed by the OECD follows this direction even though the international fiscal meaning of the “*beneficial ownership*” concept is widely accepted¹⁸⁶², stating that the domestic law meaning of “*beneficial ownership*” is not automatically irrelevant for interpretative purposes¹⁸⁶³. Interestingly, the OECD deleted this statement¹⁸⁶⁴. However, it would be preferable to refer to the domestic law meaning, particularly where that meaning essentially follows a substance-over-form approach which is not defined in a narrow technical sense and does

who is a resident of that State who would have received the income in the same circumstances would not have been considered to be the beneficial owner thereof”.

¹⁸⁵⁸ FRASER/OLIVER, *Beneficial Ownership*, p. 50-51.

¹⁸⁵⁹ US TECHNICAL EXPLANATION, p. 33.

¹⁸⁶⁰ DU TOIT, thesis, p. 178.

¹⁸⁶¹ DU TOIT, thesis, p. 178. The term „*beneficial owner*“ is only used in common law countries where it is more or less defined in doctrine. See DANON, thesis, p. 332. This term has also been used in most DTCs between Switzerland and common law countries. See DANON, thesis, p. 332. More detailed: BAUMGARTNER, thesis, p. 85 et seq.

¹⁸⁶² See Chapter 6.5.2.2.

¹⁸⁶³ OECD, Discussion Draft on Beneficial Owner, para. 12.1 and OECD Commentary 2014 ad Art. 10 para 12.1.

¹⁸⁶⁴ OECD, Revised Discussion Draft on Beneficial Owner, para. 12.1 and OECD Commentary 2014 ad Art. 10 para 12.1.

not contradict the international fiscal meaning of the term¹⁸⁶⁵. In order to be able to clarify the application of the “*beneficial ownership*” requirement with respect to complex arrangements such as CISs and trusts, a uniform definition leaving no room for ambiguity or uncertainty is required.

In the author’s view, the term “*beneficial ownership*” is not defined in any of the DTCs signed by Switzerland, and so no meaning can be derived from the current treaty context. There are, in this sense, only a few exceptions, for example para. 3 (b) of the protocol to the 6 June 1980 New Zealand-Switzerland DTC¹⁸⁶⁶. This protocol states: “(...) *dividends, interest or royalties in respect of which a trustee is subject to tax in New Zealand shall be treated as being beneficially owned by that trustee*”. Also, the DTC between Italy and Germany defines the “*beneficial ownership*” requirement in Art. 9 of the protocol of 18 October 1989 as follows: “*the recipient of the dividends, interest and royalties is the beneficial owner within the meaning of Articles 10, 11 and 12 if he is entitled to the right upon which the payments are based and the income derived therefrom is attributable to under the tax laws of both States*”.

This analysis addresses whether a meaning of the term can be deduced, according to Art. 3 para. 2 OECD Model (“*lex fori*”), from Swiss domestic law¹⁸⁶⁷. Swiss law possesses three concepts comparable to that of “*beneficial ownership*”: the concept of the “*beneficial owner*” (“*wirtschaftlich berechtigte Person*”; “*ayant droit économique*”) under Art. 4 of the Anti-Money Laundering Act (AMLA)¹⁸⁶⁸; the concept of the “*right to use*” (“*Recht zur Nutzung*”; “*droit de jouissance*”) under Art. 21 para. 1 (a) WTL¹⁸⁶⁹; and the concept of the “*right to use*” under Art. 1 para. 2 (a) of the Swiss Federal Decree of 14 December 1962 on Measures against the Improper Use of DTCs concluded by the Swiss Confederation (1962 Abuse Decree)¹⁸⁷⁰. This analysis will not be carried out on similar terms deriving from the European Union’s directive on the taxation of savings income in the form of interest

¹⁸⁶⁵ Comments by Avellum Partners on the Revised Discussion Draft on Beneficial Owner, para. 12.1.

¹⁸⁶⁶ See Chapter 6.5.3

¹⁸⁶⁷ See Chapter 5.2.3.5.

¹⁸⁶⁸ See Chapter 6.5.2.1.1.

¹⁸⁶⁹ See Chapter 6.5.2.1.2.

¹⁸⁷⁰ The latter of these three points will not be considered in detail herein.

payments¹⁸⁷¹ and the directive on the taxation applicable to interest and royalty payments¹⁸⁷².

6.5.2.1.1 Concept of “Beneficial Ownership” in the Field of Money Laundering

Theoretically, the concept of “*beneficial ownership*” (“*wirtschaftlich berechnete Person*”; “*ayant droit économique*”) could be derived from Art. 4 of the Anti-Money Laundering Act (AMLA)¹⁸⁷³. However, according to Art. 3 para. 2 OECD Model, the meaning under tax law should always prevail over the significance given to the term in other areas of internal law¹⁸⁷⁴. In this line, Maurizio Lupoi has recognized that the term as contained in Art. 4 AMLA cannot be put on the same level as the concept of “*beneficial ownership*” deriving from the DTCs signed by Switzerland¹⁸⁷⁵. This argument was also raised in the *Prévost Case*, in which the appellant argued that the references to “*beneficial ownership*” related only to “*anti-money laundering and bank regulatory issues and were intended to determine who was ultimately ‘behind the funds’ in an account*” and not to the concept of “*beneficial ownership*” relevant to tax matters¹⁸⁷⁶. In conclusion, the meaning deriving from the AMLA is completely irrelevant for tax issues as it refers to a very specific concept, that being money laundering¹⁸⁷⁷.

6.5.2.1.2 Concept of the “Right to Use” under Art. 21 para. 1 (a) WTL

The concept of the “*right to use*” (“*Recht zur Nutzung*”; “*droit de jouissance*”) in Art. 21 para. 1 (a) WTL or, in other words, the domestic “*beneficial ownership*” requirement is a condition for the reimbursement of Swiss

¹⁸⁷¹ Council Directive 2003/48/EC on taxation of savings income in the form of interest payments, 3 June 2003.

¹⁸⁷² Council Directive 2003/49/EC on taxation applicable to interest and royalty payments, 3 June 2003.

¹⁸⁷³ Federal Act on Combating Money Laundering and Terrorist Financing in the Financial Sector of 10 October 1997 (RS 955.0).

¹⁸⁷⁴ Amongst others: UCKMAR, Double Taxation Conventions, p. 160; BAUMGARTNER, thesis, p. 40–41.

¹⁸⁷⁵ LUPOI, Trust nel diritto civile, p. 16 et seq.

¹⁸⁷⁶ In this vein: *Prévost Car case*, nr. 26.

¹⁸⁷⁷ DE BROE, thesis, p. 668 with regard to Footnote 1000.

withholding tax. Its objective is to identify¹⁸⁷⁸ the person entitled to the benefit, ensuring that reimbursement is directed towards the effective domestic beneficial owner and that it is granted only once¹⁸⁷⁹. Therefore, the “*right to use*” aims at preventing misuse (i.e. the non-declaration of Swiss income) and to ensure proper taxation of domestic securities and their revenues. The first interpretative question to address is how the concept of the “*right to use*” is to be understood, since it could theoretically be understood in either a purely civil or an economic normative context¹⁸⁸⁰. This question may be answered by reference to a judgment of 26 July 1985 in which the Federal Tribunal concluded that Art. 21 para. 1 (a) WTL “*nicht [ein] zivilrechtliche[r], sondern [ein] wirtschaftliche[r] Anknüpfungspunkt [ist] und [...] dementsprechend in wirtschaftlicher Betrachtungsweise (emphasis added by the author) auszulegen [ist]*”¹⁸⁸¹. The Federal Supreme Court also expressed this view in a subsequent decision of 18 May 1993, stating that the “*right to use*” should be understood in an economic context¹⁸⁸².

However, the Federal Tax Administration still follows a very formal interpretation of the “*right to use*”. This is illustrated by the situation in which Swiss residents are investors of a transparent foreign CIS, which itself holds Swiss securities¹⁸⁸³. According to the Federal Tax Administration a refund of Swiss withholding tax based on Art. 22 para. 1 WTL and Art. 23 para. 2 WTO is not possible as the Swiss resident investors do not fulfill the domestic “*beneficial ownership*” requirement. The Swiss investors have the right to use the

¹⁸⁷⁸ BAUER-BALMELLI, thesis, p. 115; BAUER-BALMELLI, Commentary WHT, nr. 7 ad. Art. 21.

¹⁸⁷⁹ BAUER-BALMELLI, thesis, p. 115; BAUER-BALMELLI, Commentary WHT, nr. 7 ad. Art. 21.

¹⁸⁸⁰ DANON, thesis, p. 241.

¹⁸⁸¹ Swiss Federal Supreme Court Judgment of 26 July 1985 (A.328/38) = STOCKAR/HOCHREUTENER, Praxis WTL, nr. 35 ad. Art. 21 para. 1 (a).

¹⁸⁸² Swiss Federal Supreme Court Judgment of 18 May 1993, cons. 4 = ASA 62, p. 705.

In this vein also: DANON, thesis, p. 242; BAUMGARTNER, thesis, p. 44-45.

¹⁸⁸³ See in detail: PFISTER, Rückerstattung der Verrechnungssteuer an inländische Investoren transparenter ausländischer kollektiver Kapitalanlagen, p. 19-28.

fund units, but not the Swiss shares constituting the fund assets¹⁸⁸⁴. This must clearly be criticized in relation to fiscally-opaque funds. In the case of Swiss resident investors in a foreign CIS constituted in the form of a legal entity (SICAF or SICAV) holding Swiss securities, the Federal Tax Administration should, in principle, allow the refund of Swiss withholding tax to the Swiss resident investors if the foreign CIS is not entitled to benefit under a DTC¹⁸⁸⁵. However, the Federal Tax Administration does not follow this practice¹⁸⁸⁶.

The “*right to use*” has been discussed in various recent decisions¹⁸⁸⁷ of the Federal Tribunal, the Federal Commission of Appeal in Tax Matters, and the Federal Administrative Court¹⁸⁸⁸ as also explored by Beat Baumgartner¹⁸⁸⁹. The Federal Tax Administration and the Federal Commission of Appeal in Tax Matters described the “*right to use*” resp.¹⁸⁹⁰: “*Gegenstand einer*

¹⁸⁸⁴ See Federal Tax Administration 16 April 1991, praxis federal taxes, Second Part, Art. 26 s. 3 Withholding Tax Act nr. 2: “*Die inländischen Besitzer von Anteilen an einem luxemburgischen Anlagefonds sind nicht berechtigt, eine (anteilmässige) Rückerstattung der zu Lasten des Fonds anfallenden Verrechnungssteuer zu beanspruchen*”.

¹⁸⁸⁵ See Federal tax administration 29 March 2007, praxis federal taxes, Second Part, Art. 21 para. 1 (a) Withholding Tax Act nr. 77: “*Ausländische kollektive Kapitalanlagen in Form einer Gesellschaft (SICAF oder SICAV) gelten für die Rückerstattung der VSt als transparent, sofern die betroffene Gesellschaft keine eigenständige Anspruchsberechtigung nach DBA erhält. Demzufolge wird das Recht zur Nutzung an durch solche kollektive Kapitalanlagen realisierten Erträgen bei Fehlen eines anwendbaren DBA direkt den Anlegern zugesprochen. Investiert somit ein Inländer in einen luxemburgischen SICAV, der seinerseits Anlagen in einen schweizerischen Thesaurierungsfonds tätigte, liegt das Recht zur Nutzung an den Erträgen des Thesaurierungsfonds beim inländischen Anleger*”.

¹⁸⁸⁶ See: Federal Tax Administration 1 February 2011, praxis federal taxes, Second Part, Art. 21 para. 1 (a) Withholding Tax Act nr. 88. Against an unanimous doctrine: OESTERHELT/WINZAP, kollektive Kapitalanlagen, Part III, nr. 9.2.4.3; HEUBERGER/OESTERHELT, Collective Investment Vehicles, nr. 4.1.3.2; OESTERHELT, Basler Kommentar, Kollektivanlagengesetz, nr. 342; HESS, thesis, p. 488; PFISTER, Rückerstattung der Verrechnungssteuer an inländische Investoren transparenter ausländischer kollektiver Kapitalanlagen, p. 19-28.

¹⁸⁸⁷ Swiss Federal Supreme Court Judgment of 25 October 2004, cons. 3.5.2 (2A.572/2003); Swiss Federal Supreme Court Judgment of 8 June 2007, cons. 4.1 = ASA 77, p. 555 = StR 2008, 643.

¹⁸⁸⁸ Among others: BAUER-BALMELLI, thesis, p. 172.

¹⁸⁸⁹ BAUMGARTNER, thesis, p. 44 etc.

¹⁸⁹⁰ Federal Administrative Court of 5 November 2008, cons. 5.3.2. (A-4084/2007).

*Nutzung sind Sachen oder nutzbare Rechte, die Früchte abwerfen. Neben dem Eigentümer der Sache, der in den Schranken der Rechtsordnung über sie nach seinem Belieben verfügen kann und auch das Eigentum an ihren natürlichen Früchten hat (...) haben eine derartige Nutzung diejenigen Personen, denen sie nach Zivilrecht oder nach öffentlichem Recht zusteht oder denen sie vom Eigentümer oder seinem Rechtsnachfolger übertragen worden ist (...). So hat das Recht zur Nutzung eines zinstragenden Guthabens derjenige, der darüber **ausschliesslich „effektiv“ verfügungsberechtigt ist, d.h. den umfassenden Anspruch auf jeden möglichen Nutzen, den der Vermögenswert in irgendeiner Form abwirft, hat (...).** Das verrechnungssteuerlich relevante Nutzungsrecht darf weder **bloss vorgegeben noch lediglich von vorübergehender Dauer sein.** Es muss nicht dinglich, sondern kann auch bloss **obligatorisch** sein, weshalb nicht unbedingt entscheidend ist, ob der den steuerbaren Ertrag abwerfende Vermögenswert im Eigentum des Antragstellers stand (...). Demnach hat derjenige, der – wie z.B. der blosse Verwalter eines Vermögens – vertraglich verpflichtet ist, den Nettoertrag einem Dritten zuzuwenden, nicht das Recht zur Nutzung des betreffenden Stammrechtes. Insoweit enthält Art. 21 Abs. 1 Bst. a VStG mit der Umschreibung „Recht zur Nutzung“ **nicht einen zivilrechtlichen, sondern einen wirtschaftlichen Anknüpfungspunkt und ist demzufolge in wirtschaftlicher Betrachtungsweise auszulegen (...).***

*Dementsprechend ist es durchaus möglich, dass das Recht zur Nutzung einem andern als dem Eigentümer des Vermögenswerts zusteht, etwa wenn dieser **vertraglich verpflichtet** ist, den Kapitalertrag **an Dritte weiterzuleiten**, ja sogar wenn zwar **keine formelle Verpflichtung** zur Weiterleitung des Ertrags besteht, sich aber aus der **Gesamtheit der Umstände** schliessen lässt, dass der **Kapitalertrag dem Eigentümer nicht verbleibt (...).** Insbesondere wer bloss treuhänderisch Eigentümer eines Vermögenswertes ist, hat nach der gegebenen Umschreibung des Rechts zur Nutzung keinen Anspruch auf Rückerstattung der Verrechnungssteuer, die vom Ertrag der treuhänderisch übereigneten Werte abgezogen wurde. Die Steuer kann nur zurückerstattet werden, wenn die Voraussetzungen zur Rückerstattung beim Treugeber erfüllt sind, denn dieser ist der ‘wirtschaftliche Herr der Sache’, während der Treuhänder als solcher nie ein Recht zur Nutzung der übereigneten Werte hat. (...). Zusammenfassend kann somit festgehalten werden, dass nur derjenige zur Nutzung des den besteuerten Ertrag abwerfenden Vermögenswertes berechtigt ist, welcher den um die Verrechnungssteuer gekürzten Nettoertrag bezieht und **über diesen frei verfügen, ihn insbesondere behalten kann und als solchen nicht an einen Dritten weiterzuleiten hat** (emphasis added by the author) (...).”*

It may be concluded that a person satisfies the “*right to use*” requirement where it holds the obligatory right to receive income from the concerned assets (“*der obligatorische Anspruch auf den Ertrag, den der betreffende Vermögenswert abwirft*”)¹⁸⁹¹. According to the analysis by Beat Baumbartner¹⁸⁹² based on the relevant case law, this depends on the intensity of the relationship between the person asking for the reimbursement of the withholding tax (subject)¹⁸⁹³ and the person’s income on which the withholding tax was levied (object)¹⁸⁹⁴. Thus, the essential condition for a person to qualify as the domestic beneficial owner that comes into play in establishing the “*right to use*” is the power of disposition (“*Verfügungsberechtigung*”; “*pouvoir de disposition*”)¹⁸⁹⁵. A person holds the power of disposition over the income of the assets when it can freely dispose of the revenue, thus possessing an unlimited right to use upon it¹⁸⁹⁶. Besides this condition, other elements must be taken into account when establishing the “*right to use*”, such as the utilization of the income in one’s own interest¹⁸⁹⁷ and the bearing of the risks¹⁸⁹⁸. These two criteria are essential indicators when assessing the potential application of the domestic “*beneficial ownership*” requirement.

¹⁸⁹¹ Swiss Federal Supreme Court Judgement of 15 January 1985 = ASA 54, p. 395.

¹⁸⁹² BAUMGARTNER, thesis, p. 48 et seq.

¹⁸⁹³ Art. 22 para. 1 WTL; Art. 24 para. 2 and 3 WTL.

¹⁸⁹⁴ Art. 21 para. 1 lit. a and b WTL.

¹⁸⁹⁵ Swiss Federal Supreme Court Judgment of 18 May 1993, cons. 4 = ASA 62, p. 705.

In this vein also: Federal Administrative Court of 5 November 2008, cons. 5.3.2: “*Zusammenfassend kann somit festgehalten werden, dass nur derjenige zur Nutzung des den besteuerten Ertrag abwerfenden Vermögenswertes berechtigt ist, welcher den um die Verrechnungssteuer gekürzten Nettoertrag bezieht und über diesen frei verfügen, ihn insbesondere behalten kann und als solchen nicht an einen Dritten weiterzuleiten hat (...)*”.

¹⁸⁹⁶ Swiss Federal Supreme Court Judgment of 18 May 1993, cons. 4 = ASA 62, p. 705.

¹⁸⁹⁷ See the analysis of BAUMGARTNER, thesis, p. 51-52.

¹⁸⁹⁸ See the analysis of BAUMGARTNER, thesis, p. 53-56.

Moreover, the attribution of income to the person¹⁸⁹⁹ and the effective taxation of this person for the income¹⁹⁰⁰ are not “*sine qua non*” conditions in order to determine whether the person is the domestic beneficial owner. Jonas Misteli points out that the lawmaker only requires the fulfillment of the “*right to use*” and does not go further in requiring that the income is also attributed to the person receiving reimbursement of the Swiss withholding tax¹⁹⁰¹. However, if no taxation has occurred, a further analysis must be conducted in order to determine whether the person is the domestic beneficial owner¹⁹⁰². Furthermore, subjective elements such as personal motives are clearly irrelevant¹⁹⁰³. A person will not be considered as having the power of disposition (and hence the right to use) if they are under the obligation to further distribute the income, without such distribution being of its own free decision¹⁹⁰⁴. Such distribution will negatively affect a person’s power of disposition and right to use only if the obligation to distribute follows certain specific requirements¹⁹⁰⁵ - not every distribution will have such an effect. For a distribution to negatively affect a person’s power of disposition it must rely on a contractual obligation¹⁹⁰⁶ or on a factual obligation (“*faktische Verpflichtung*”; “*obligation de fait*”)¹⁹⁰⁷, such as a company that possesses

¹⁸⁹⁹ BAUMGARTNER, thesis, p. 58. This result is also in line with the objective of the Swiss withholding tax aiming at ensuring compliance with direct tax reporting requirements. In this vein: Swiss Federal Supreme Court Judgment of 26 March 1999 = ASA 68 = RDAF 2000, p. 65; Swiss Federal Supreme Court Judgment of 29 October 1992, ASA 62, p. 280 and p. 285; BAUER-BALMELLI, thesis, p. 115; BAUER-BALMELLI, Commentary WHT, nr. 7 ad. Art. 21.

¹⁹⁰⁰ BAUER-BALMELLI, Commentary WHT, nr. 18 ad. Art. 21.

¹⁹⁰¹ MISTELI, Dividenden-Stripping, nr. 305.

¹⁹⁰² BAUER-BALMELLI, Commentary WHT, nr. 18 ad. Art. 21.

¹⁹⁰³ BAUER-BALMELLI/KÜPFER/HOCHREUTENER, Commentary WHT, nr. 25 ad. Art. 21 para. 1 (a).

¹⁹⁰⁴ BAUMGARTNER, thesis, p. 61.

¹⁹⁰⁵ In this vein also: BAUMGARTNER, thesis, p. 61.

¹⁹⁰⁶ BAUER-BALMELLI/KÜPFER/HOCHREUTENER, Commentary WHT, nr. 8 ad. Art. 21 para. 1 (a): “*Kauft ein Schweizer mit Geldern, die ihm sein im Ausland wohnhafter Sohn zur Verfügung stellt, schweizerische Wertschriften, richtet er dem Sohn die Erträge dieser Wertschriften in Form von Darlehenszinsen aus und ist aus den Umständen zu schliessen, dass der Vater blosser Treuhänder des Sohnes ist, so steht ihm mangels eines Rechts zur Nutzung (...)*”.

¹⁹⁰⁷ BAUMGARTNER, thesis, p. 62-63.

“*de facto*” control over the majority of the shares in another company¹⁹⁰⁸. In this case, the “*controlled*” company may have a factual obligation to distribute the revenues, characterized (for example) by the impossibility to take into consideration the best interests of the company because of the obligation to align its decisions with the interests of the dominant shareholder. In a causal context, a distribution will only be considered “*negative*” if there is a reciprocal dependency between the source of the income and the duty to distribute that income¹⁹⁰⁹. On this basis, it could theoretically be concluded that a holding company with a contractual or factual obligation to distribute revenues to its shareholders may not, therefore, be considered as the domestic beneficial owner of those revenues. The unclear and broad definition of the “*right to use*” could lead to taxpayer challenges. The OECD Discussion Draft clarifies that beneficial and ultimate “*beneficial ownership*” are not to be equated. An entity to which income is paid may well be regarded as the beneficial owner even if other persons (typically shareholders) exercise “*ultimate effective control*” over the entity¹⁹¹⁰.

6.5.2.2 *Autonomous Meaning of “Beneficial Ownership” for Treaty Purposes*

Among academics, the international fiscal meaning of the “*beneficial ownership*” concept is widely accepted, for multiple reasons¹⁹¹¹. The term has now been introduced in the work of the OECD Council regardless of whether a country is or is not familiar with the concept¹⁹¹². The first and foremost reason for this is that the laws of most OECD member states do not offer a pre-

¹⁹⁰⁸ BAUMGARTNER, thesis, p. 63.

¹⁹⁰⁹ In this vein: Federal Commission of Appeals in Tax Matters of 19 February 2001, cons. 3b (SRK 1999-130) = VPB 65.112.

¹⁹¹⁰ OECD, Discussion Draft on Beneficial Owner, para. 12.6. See Chapter 6.5.2.2.6.

¹⁹¹¹ Amongst others: DU TOIT, thesis, p. 172, 178; ECOSOC, Beneficial Ownership, p. 9; VAN WEEGHEL, thesis, p. 68; PREBBLE, Trusts and Double Tax Conventions, p. 80; DE BROE, thesis, p. 668 et seq.; KREVER, Beneficial Ownership, p. 141; OLIVER/LIBIN/VAN WEEGHEL/DU TOIT, Beneficial Ownership, p. 323; OBERSON, Régime d'imposition des dividendes, interest et redevances, p. 167-168. Against: CRETTI, thesis, p. 152; LUTZ, thesis, p. 37.

¹⁹¹² In general, only common law and not civil law countries are familiar with the concept of “*beneficial ownership*”.

cise definition of the concept. Moreover, referring to contracting states' domestic laws would have the potential to give rise to infinite double taxation¹⁹¹³ or double non-taxation, both contrary to the OECD's objectives¹⁹¹⁴. For this reason, contracting states applying a DTC should interpret the "*beneficial ownership*" requirement on the basis of its ordinary meaning and in light of the object and purpose of the DTC. These states should also follow the general rules of international law for treaty interpretation, as laid down in Arts. 31 to 33 VCLT. Courts, however, are still in disagreement as to whether the term should be interpreted according to domestic law (see: *Prévost Car Case*) or whether it should be granted an international fiscal meaning (see: *Indofood Case*)¹⁹¹⁵. One may question how an OECD member state with a civil law tradition would actually interpret such a term, since a definition is completely absent from the domestic laws of most such legal systems. Moreover, recourse to domestic law should be dismissed in itself, as the context leading to the use of a DTC discourages this approach¹⁹¹⁶. In the following chapters, the international fiscal meaning of the "*beneficial ownership*" concept is explained through various sources of international interpretation.

6.5.2.2.1 Literal and Grammatical Meaning

Relying on a literal and grammatical interpretation, the "*beneficial ownership*" requirement, found in the distributive rules for dividends¹⁹¹⁷ and for interest¹⁹¹⁸, exclusively refers to the characteristics of the "*owner*" (subject) with regards to "*dividends and interests*" (object)¹⁹¹⁹. The concept refers to the extent of the relationship between the person (subject) and the income (object)¹⁹²⁰. The German ("*Nutzungsberechtigte*"), French ("*bénéficiaire effectif*") and Italian ("*effettivo beneficiario*") terms translate comparably to

¹⁹¹³ See Chapter 4.1.2.

¹⁹¹⁴ See Chapter 4.1.4.

¹⁹¹⁵ See Chapter 6.5.2.2.7.

¹⁹¹⁶ According to the view expressed by Daniel Lüthi at the 52nd IFA Congress in 1998 in London.

¹⁹¹⁷ Art. 10 para. 2 OECD Model.

¹⁹¹⁸ Art. 11 para. 2 of the OECD Model.

¹⁹¹⁹ DANON, thesis, p. 336.

¹⁹²⁰ DU TOIT, thesis, p. 217.

the English (“*beneficial owner*”) term and thus, do not provide further insight¹⁹²¹. Following these literal and grammatical arguments, the object only relates to dividends and interest and does not extend to other types of income¹⁹²². As to the concept of “*beneficial ownership*”, only the nexus of the person (subject) to the income (object) is pertinent¹⁹²³. Therefore, it is irrelevant whether the person (subject) has a sufficient personal attachment to the residence state¹⁹²⁴, whether he/she is effectively taxed in that state¹⁹²⁵ or whether the subject fulfills any other requirements in relation to the object. The concept of “*beneficial ownership*” has an objective character and is, thus, not comprised of any subjective element.

6.5.2.2.2 Autonomous Common Law Meaning according to Charl Du Toit

The “*beneficial ownership*” concept is clearly derived from the common law distinction between legal and economic ownership. Therefore, it is understandable that scholars should try to find a definition from its common law meaning. Charl Du Toit¹⁹²⁶ shares this point of view and specifically refers to common law jurisdictions from which the term originated even before it was introduced into the OECD Model in 1977¹⁹²⁷. The reasoning of Charl du Toit

¹⁹²¹ From a literal standpoint, a difference exists between the English and the German term. The German term “*Nutzungsberechtigter*” refers to the person entitled to use, while the English term of “*beneficial owner*” refers to the real beneficiary.

¹⁹²² DANON, *bénéficiaire effectif*, p. 41.

¹⁹²³ This has already been explored by Charl Du Toit in 1999. See DU TOIT, thesis, p. 217. Many Swiss authors follow this view, such as, among others: DANON, *bénéficiaire effectif*, nr. 2.3.1 et seq. and Baumgartner, thesis, p. 115. This has recently been confirmed, in March 2012, by the Federal Administrative Court in the “*Swap*” case. See the Federal Administrative Court of 7 March 2012 (“*Swap-Entscheid*”, A-6537/2010) as well as the Swiss Federal Supreme Court decision of 5 May 2015 (2C_364/2012, 2C_377/2012, 2C_895/2012).

¹⁹²⁴ BAUMGARTNER, thesis, p. 130.

¹⁹²⁵ BAUMGARTNER, thesis, p. 130.

¹⁹²⁶ DU TOIT, thesis, p. 178.

¹⁹²⁷ DU TOIT, thesis, p. 178. The term “*beneficial owner*” is only used in common law countries where it is more or less defined in doctrine. See DANON, thesis, p. 332; BAUMGARTNER, thesis, p. 85 et seq. For instance, this concept can already be found in a DTC for inheritance taxes between the United Kingdom and the United States from 1945. See DU TOIT, thesis, p. 180.

goes even further; according to him, the meaning of “*beneficial ownership*” in the common law is only the starting point towards discovering an autonomous interpretation, since a coherent unanimous meaning does not even exist across most common law countries. For this reason, Charl du Toit conducted an analysis of the case law of different common law states (England¹⁹²⁸, the United States¹⁹²⁹, Australia¹⁹³⁰ and Canada¹⁹³¹) in an effort to search for a uniform common law definition.

In this vein, the term “*beneficial ownership*” may be characterized as follows: First, beneficial ownership may coincide with legal ownership, or may completely differ from it. Possession of the legal title without having the right to use the object to a certain degree is, however, insufficient. Second, beneficial ownership must be legally recognized and legally enforceable. Third, the purchase of an object with a duty to transfer it to a third party is not constitutive of beneficial ownership. Fourth, courts refer to ownership rights and ownership attributes as command and economic benefits or as benefits and burdens of ownership. Fifth, uncertainty remains with regards to the number and degree of ownership attributes that a person must have in order to be characterized as the beneficial owner. However, only one person may be the beneficial owner of an object or its value. Therefore, the person considered the beneficial owner is the one bearing the majority of the ownership attributes¹⁹³². In this context, Charl Du Toit defines the beneficial owner as the “*person whose ownership attributes outweigh that of any other person*”¹⁹³³. Ownership attributes include the right to “*possess, use or manage the income or the capital (including the power to alienate and the liberty to consume, waste or destroy and the risk of depreciation and the hope of appreciation)*”¹⁹³⁴. The meaning of “*outweigh*” clarifies that the weight of the ownership attributes is decisive (rather than simply the number) in order to determine the beneficial owner¹⁹³⁵.

¹⁹²⁸ DU TOIT, thesis, p. 99 et seq.

¹⁹²⁹ DU TOIT, thesis, p. 117 et seq.

¹⁹³⁰ DU TOIT, thesis, p. 126 et seq.

¹⁹³¹ DU TOIT, thesis, p. 128 et seq.

¹⁹³² DU TOIT, thesis, p. 201.

¹⁹³³ DU TOIT, thesis, p. 319.

¹⁹³⁴ DU TOIT, thesis, p. 201.

¹⁹³⁵ DU TOIT, thesis, p. 201.

6.5.2.2.3 Irrelevance of the Common Law Meaning

The term “*beneficial ownership*” is not primarily interpreted according to DTCs alone, but also in accordance with the domestic laws of common law countries. On the other hand, it is contradictory to follow the interpretation of common law states; since in the present context it is clearly a concept deriving from DTCs and therefore, cannot be interpreted according to the common law¹⁹³⁶. The view that the interpretation of “*beneficial ownership*” should align with the interpretation given by common law countries is properly rejected, primarily by civil law countries and specifically by most leading scholars in Switzerland¹⁹³⁷.

6.5.2.2.4 The Meaning under the OECD Model and Commentary

The OECD Model and its Commentaries offer little guidance as to the definition of “*beneficial ownership*”. This concept first appeared in the draft of the OECD Model in 1974 and in 1977. The Commentary on the 1977 OECD Model stated, in connection with the improper use of the Convention, that: “(...) *the extension of the network of double taxation conventions still reinforces the impact of such maneuvers as they make it possible, through the creation of usually artificial legal constructions, to benefit both from the tax advantages available under certain domestic laws and the reliefs from tax provided for in double taxation conventions*¹⁹³⁸. *This would be the case, for example, if a person acted through a legal entity created in a State essentially to obtain treaty benefits which would not be available directly to such person (...)*¹⁹³⁹. *Some of these situations are dealt with in the Convention, e.g. by the introduction of the concept of ‘beneficial owner’ (in Articles 10, 11 and 12)*”¹⁹⁴⁰. Moreover, the Commentary provided in relation to the Articles relating to dividends and interest states that “*the limitation of tax in the state of source is not available when an intermediary, **such as an agent or nominee, is interposed between the beneficiary and the payer, unless the***

¹⁹³⁶ BAUMGARTNER, thesis, p. 88-89.

¹⁹³⁷ LISSI, thesis, p. 177 et seq.; DANON, bénéficiaire effectif, p. 43.

¹⁹³⁸ OECD Commentary 1977, nr. 8 ad. Art. 1.

¹⁹³⁹ OECD Commentary 1977, nr. 9 ad. Art. 1.

¹⁹⁴⁰ OECD Commentary 1977, nr. 10 ad. Art. 1.

beneficial owner is a resident of the other Contracting State (emphasis added by the author)¹⁹⁴¹.

Furthermore, the OECD Council issued a Report on Double Taxation Conventions and the Use of Conduit Companies on 27 November 1986¹⁹⁴² in which the “*beneficial owner*” concept was broadened, no longer following a legal approach, but rather taking an economic approach (substance-over-form). This is expressed in the following statement of the 2003 OECD Commentary: “*It would be equally inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption where a resident of a Contracting State, otherwise than through an agency or nominee relationship, simply acts as a conduit for another person who in fact receives the benefit of the income concerned. For these reason, the report from the Committee on Fiscal Affairs entitled “Double Taxation Conventions and the Use of Conduit Companies” concludes that a conduit company cannot normally be regarded as the beneficial owner if, though the formal owner, it has, as a practical matter, very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties*”¹⁹⁴³. Accordingly, the residence of the beneficial owner is decisive and not the residence of the person actually receiving the payment.

6.5.2.2.5 Excursus: The Meaning under the US Model and Technical Explanation

To better understand the term “*beneficial ownership*” and in an attempt to find an accurate definition, it is helpful to consider its meaning under the US Model. According to the 1996 US Technical Explanation, the beneficial owner is: “*any person resident in Contracting State to whom that State attributes the dividend for purpose of its tax*”¹⁹⁴⁴. Thus, according to US tax

¹⁹⁴¹ OECD Commentary 1977, nr. 12 ad. Art. 10 para. 2; nr. 8 ad. Art. 11 para. 2.

¹⁹⁴² OECD, Report Conduit Companies.

¹⁹⁴³ OECD Commentary 1977, Art. 10 para. 2 and Art. 11 para. 1.

¹⁹⁴⁴ US Technical Explanation 1996, ad. Art. 10 para. 2.

principles, the person to whom the income is attributed for tax purposes under the laws of the source state is considered the beneficial owner¹⁹⁴⁵. As observed in the US Technical Explanation, the conditions of “*attribution of income*” and “*beneficial owner*” are generally treated as one and the same¹⁹⁴⁶. From a systematic point of view, however, both concepts refer to the intensity of the relationship between the subject and the object¹⁹⁴⁷. Accordingly, these two concepts must be distinguished as they have different scopes of application¹⁹⁴⁸.

6.5.2.2.6 OECD Reports

In the present chapter, the different OECD Reports will be listed and discussed in a chronologic order, from the oldest to the most recent. At this stage, it is only referred to the OECD Reports as such, irrespective of whether they were included in the OECD Commentaries of the relevant years.

6.5.2.2.6.1 OECD Conduit Companies Report of 27 November 1986¹⁹⁴⁹

The requirement that residents of contracting states must “*beneficially own*” dividends, interest or royalties in order to qualify for the reduction or elimination of the withholding tax perceived by the source jurisdiction on these payments was first introduced by Art. 10, 11 and 12 of the 1977 OECD

¹⁹⁴⁵ US Technical Explanation 1996, ad. Art. 10 para. 2; VAN WEEGHEL, thesis, p. 78-79; DOERNBERG/VAN RAAD, The 1996 United States Model Income Tax Convention, p. 85. This definition is identical to the definition of “*beneficial owner*” according to the US rules on Qualified Intermediaries: “*the person who is required under US tax principles to include the income in gross income on a tax return. A person is not a beneficial owner of income, however, to the extent that the person is receiving income as a nominee, agent, or custodian, or to the extent the person is a conduit whose participation in a transaction is disregarded*”.

¹⁹⁴⁶ SALOME, Partnerships, p. 63 et seq.

¹⁹⁴⁷ In this vein: BAUMGARTNER, thesis, p. 103.

¹⁹⁴⁸ LISSI, thesis, p. 179; DANON, thesis, p. 327: “*the beneficial ownership*” test has a scope of its own compared to the personal attribution of income requirement. BAUMGARTNER, thesis, p. 104 compares the functioning of the concepts of beneficial ownership to the concept of attribution of income.

¹⁹⁴⁹ OECD Double Taxation Conventions and the Use of Conduit Companies, 1986.

Model¹⁹⁵⁰. At that time, this concept of “*beneficial ownership*” aimed at combating treaty shopping practices and, more specifically, preventing non-residents from taking advantage of DTC networks through the interposition of entities located within their scope¹⁹⁵¹.

The OECD Conduit Companies Report essentially deals with this issue¹⁹⁵². Treaty shopping may be described as the situation in which a person acts indirectly through a legal entity, for example a trust or CIS, with the main, often sole, purpose of obtaining DTC benefits that would otherwise be unavailable to such persons directly¹⁹⁵³. In practice, such a resident company is organized in a contracting state in order to benefit from a DTC in that state and, subsequently, to distribute the profits to the initial person, i.e. the beneficial owner¹⁹⁵⁴.

The beneficial ownership concept is defined negatively within the Report¹⁹⁵⁵: “*Articles 10 to 12 of the OECD Model deny the limitation of tax in the State of source on dividends, interest and royalties if the conduit company is not its “beneficial owner”. Thus the limitation is not available when, economically, it would benefit a person not entitled to it who interposed the conduit company as an intermediary between himself and the payer of the income (...) the Commentaries mention the case of a nominee or agent. The provisions would, however, apply also to other cases where a person enters into contracts or takes over obligations under which he has a similar function to those of a nominee or agent. Thus a conduit company can normally not be regarded as the beneficial owner if, though the formal owner, it has **very narrow powers** (emphasis added by the author) which render it a mere fiduciary or an administrator acting on account of the interested parties.*” In order for its DTC access to be limited, a conduit company’s powers of decision must therefore be significantly limited. A limitation in itself is not sufficient; rather, a strong restriction in its decision-making is necessary for “*beneficial ownership*” to be imputed to another party.

¹⁹⁵⁰ DUFF, *Beneficial Ownership: Recent Trends*, p. 1.

¹⁹⁵¹ OECD Commentary 1977, nr. 12 Art. 10.

A contrario sensu, a conduit company that only some limitation in its power of disposition over dividends, interest and royalties will still be considered the beneficial owner of these funds¹⁹⁵⁶.

Since 1987, the more specific term “*treaty shopping*”, with a narrower significance, has been used in the introduction of the Conduit Company Report¹⁹⁵⁷, which tries to eliminate artificial structures.

6.5.2.2.6.2 OECD Discussion Draft on the Clarification of “Beneficial Owner” in the OECD Model Tax Convention of 29 April 2011 and Revised OECD Discussion Draft on the Clarification of “Beneficial Owner” of 19 October 2012

Working Party 1 has developed more general guidance with regard to the interpretation of the “*beneficial owner*” term. The first Discussion Draft on “*beneficial ownership*” was released on 29 April 2011, with the aim of clarifying the meaning of beneficial owner in the OECD Model Convention. Then, at a later stage, a second Revised Discussion Draft on this issue has been published on 19 October 2012. It should be noted that in the later Discussion Draft of 2012 some references have been made to the CFA Report mentioned above. This Report has been inserted into the 2010 version of the OECD Commentary, ensuring that the conclusion from the CFA Report is respected.

In its first Discussion Draft, the OECD proposed a general definition of the “*beneficial owner*” term¹⁹⁵⁸: “*The recipient of a dividend is the “beneficial owner” of that dividend where he has **the full right to use and enjoy the dividend unconstrained by a contractual or legal obligation to pass the payment received to another person** (emphasis added by the author). Such an obligation will normally derive from relevant legal documents but may also be found to exist on the basis of facts and circumstances showing that, in substance, the recipient clearly does not have the full right to use and enjoy*

¹⁹⁵⁸ OECD, Discussion Draft on Beneficial Owner, para. 12.4.

the dividend; also, the use and enjoyment of a dividend must be distinguished from the legal ownership, as well as the use and enjoyment, of the shares on which the dividend is paid”.

The OECD proposal aimed at defining the “*beneficial owner*” as the person who has the “*full right to use and enjoy*” the income¹⁹⁵⁹ and introduced a substance-over-form approach to the analysis. In the OECD’s view, the “*beneficial owner*” must be the full owner of the income. If the “*beneficial ownership*” criterion is defined in this way, a person who is not full owner of the income, for instance a company with an obligation to pay a certain dividend, is arguably not to be considered the “*beneficial owner*” of such amount.

In the author’s view, the “*full right to use and enjoy*” proposed definition goes too far. To clearly delimit the scope of beneficial ownership, it should be determined and specified under which circumstances or degrees of ownership a person may be considered the “*beneficial owner*”. Otherwise, this definition does not solve the problem. As a result of these types of criticism, the OECD changed the “*full right to use and enjoy*” test in its revised version and in its Commentary to a “*right to use and enjoy*” test¹⁹⁶⁰. In the revised draft, the OECD again provided a negative definition of the concept of “*beneficial owner*”. The OECD, however, correctly points out that the recipient of a dividend is considered as the beneficial owner as long as he is (...) “*unconstrained by a contractual or legal obligation to pass on the payment received to another person*”¹⁹⁶¹. The Revised Discussion Draft and the OECD Commentary distinguish cases but do not provide clear examples. This Draft differentiates between those cases in which the payment received is seen as directly forwarded to another person (“*related*”) and therefore the recipient cannot be regarded as the beneficial owner, and those cases in which the payment is not seen as forwarded to another person (“*unrelated*”) and therefore the recipient can be regarded as the beneficial owner. The use of the terms “*related*” and “*unrelated*” creates uncertainty. The scope of

¹⁹⁵⁹ AVERY JONES/VANN/WHEELER, Response to the OECD Discussion Draft, p. 1.

¹⁹⁶⁰ OECD, Revised Discussion Draft on Beneficial Owner, para. 12.4 and OECD Commentary 2014 ad Art. 10 para 12.4.

¹⁹⁶¹ OECD, Revised Discussion Draft on Beneficial Owner, para. 12.4 and OECD Commentary 2014 ad Art. 10 para 12.4.

“*unrelated*” obligations must be clearly defined and delineated with specific examples. For instance, how are the distribution obligations under CISs to be treated? The term “*unconstrained*” should also be defined or described in order to provide guidance for the interpretation of the “*beneficial ownership*” requirement in respect of CISs and trusts¹⁹⁶².

The Discussion Draft also clarifies that beneficial and ultimate beneficial ownership are not to be equated - an entity to which income is paid may well be regarded as the beneficial owner even if other persons (typically shareholders) exercise “*ultimate effective control*” over the entity¹⁹⁶³. The beneficial ownership test therefore detects the intensity of the subject’s ownership over the item of income on the basis of a substance-over-form approach. The tax status (ordinary taxation or privileged taxation), substance requirement (offices, number of personnel, etc.) as well as the legal ownership of the assets have no effect in determining whether a subject is the beneficial owner. This is somewhat surprising since the Discussion Draft refers to domestic law for interpretation of the term¹⁹⁶⁴. This clearly opens the door to diverging interpretations and double taxation, which the OECD aims to avoid with the Report¹⁹⁶⁵. In order to provide some help, the most recent version of the Revised Discussion Draft and the OECD Commentary have deleted the reference to domestic law¹⁹⁶⁶. However, it could pragmatically refer to the domestic law meaning of “*beneficial owner*” when the term is essentially defined, using a substance-over-form approach which is not limited in a narrow technical sense and which does not contradict the international fiscal meaning of the term¹⁹⁶⁷.

¹⁹⁶² See the recommendation in Chapter 8.2.3

¹⁹⁶³ To the same conclusion comes the Prévost Case. See Chapter 6.5.2.2.7.

¹⁹⁶⁴ OECD, Discussion Draft on Beneficial Owner, para. 12.1: “(…) *does not mean, however, that the domestic law meaning of ‘beneficial owner’ is automatically irrelevant for the interpretation of that term in the context of the Article: that domestic law meaning is applicable to the extent that it is consistent with the general guidance included in this Commentary*”.

¹⁹⁶⁵ In this vein also: DANON, Clarification of the Meaning of “Beneficial Owner” in the OECD Model Tax Convention, p. 438-439.

¹⁹⁶⁶ OECD, Revised Discussion Draft on Beneficial Owner, para. 12.1 and OECD Commentary 2014 ad Art. 10 para 12.1.

¹⁹⁶⁷ Comments by Avellum Partners on the Revised Discussion Draft on Beneficial Owner, para. 12.1.

The sufficiency of the definition proposed by the Discussion Draft need not be further discussed herein. However, it should be noted that, in the Discussion Draft, the OECD gives little, if any, clarification to the meaning of “*beneficial ownership*” in the context of trusts¹⁹⁶⁸. On one hand, all trustees are under a fiduciary obligation to disburse trust income according to the trust deed, and so they are in this sense excluded from being beneficial owners¹⁹⁶⁹. On the other hand, the trustees of a discretionary trust may also be beneficial owners of trust income¹⁹⁷⁰. However, it may be said that trustees of a fixed interest trust who have an obligation to distribute trust income to ascertained beneficiaries do not satisfy the “*beneficial ownership requirement*”, as expressed in the Discussion Draft.

Some trustees under fixed interest trusts, which have a fiduciary obligation to disburse trust income according to the trust deed, clearly do not have full discretion and enjoyment (in the manner of ultimate ownership) of the income and must, therefore, be excluded from being regarded as the beneficial owner of such¹⁹⁷¹. The beneficial owner would be the person or persons having discretion over and enjoyment of the income. To the contrary, under discretionary trusts where the trustee has full discretion over and enjoyment of the income, limited by the trust deed and its obligations to the beneficiaries, the trustee must clearly be considered to be the beneficial owner¹⁹⁷².

The OECD Discussion Draft should expressly distinguish these two categories of trustees when determining who the beneficial owner is. Doing so would make the definition more concrete in order to avoid ambiguity or uncertainty. The distinction between these two categories is crucial in light of the situation which frequently arises where parties pretend to set up a trust, when in reality the settlor maintains control over the trust (directly or indirectly).

¹⁹⁶⁸ OECD, Discussion Draft on Beneficial Owner as well as OECD, Revised Discussion Draft on Beneficial Owner.

¹⁹⁶⁹ OECD, Discussion Draft on Beneficial Owner, para. 12.4 and OECD Commentary 2014 ad Art. 10 para 12.4.

¹⁹⁷⁰ OECD, Discussion Draft on Beneficial Owner, para. 12.1 and OECD Commentary 2014 ad Art. 10 para 12.1.

¹⁹⁷¹ OECD, Discussion Draft on Beneficial Owner, para. 12.4.

¹⁹⁷² OECD, Discussion Draft on Beneficial Owner, para. 12.1.

Generally, the characterization of the trust should depend on who receives the economic benefit from the trust and whether the settlor retains control over the trust. The defining factor is the issue of definitive alienation (“*Veräußerung*”; “*aliénation*”) of the trust assets and income¹⁹⁷³, according to the true economic reality of the situation (“*wirtschaftliche Betrachtungsweise*”; “*contenu économique*”). This may differ from the strict legal position. This line of reasoning is analagous to the “*substance over form*” concept in international tax law. In order to be able to clarify the application of the “*beneficial ownership*” requirement with respect to trusts, it is submitted that Article 1 of the Commentary should be amended to include a uniform definition leaving no room for ambiguity or uncertainty¹⁹⁷⁴.

6.5.2.2.7 The Meaning according to Case Law

Only a few court decisions have provided insight as to the interpretation of the “*beneficial ownership*” concept. Since the OECD Model and its Commentaries remain unclear and unsatisfactory in providing guidance and certainty to taxpayers¹⁹⁷⁵, these confusing rulings¹⁹⁷⁶ remain relevant in this present study in order to outline the common, essential, components of the concept. Below, five leading decisions will be briefly analyzed in order to explore a case law-based definition of “*beneficial ownership*”. In order to grasp the complexity of the subject matter and to demonstrate whether this concept give a precise and a more narrow technical meaning or in light of a broad interpretation in light of international fiscal considerations¹⁹⁷⁷ the difficulty of defining the concept with respect to hybrid entity.

¹⁹⁷³ NOSEDA, Taxation of Trusts, p. 10.

¹⁹⁷⁵ Royal Dutch case of 6 April 1994 (Case Nr. 28 638, reported in BNB 1994/217); Swiss Luxembourg case of 28 February 2001 (Case Nr. JAAC 65.86); Austrian Supreme Administrative Court case of 26 July 2000 (reported in 2000 2 ITLR 884); Indofood case of 7 October 2005 (reported in 2005 8 ITLR 236); Indofood case of 2 March 2006 (reported in 2006 8 ITLR 1-32); Bank of Scotland case of 29 December 2006 (Case Nr. 283314, reported in 2006 9 ITLR 683-714); Prévost Car case of 22 April 2008 (reported in 2008 10 ITLR 736-770); Federal Administrative Court of 7 March 2012 (“*Swap-Entscheid*”, A-6537/2010) and Swiss Federal Supreme Court decision of 5 May 2015 (2C_364/2012, 2C_377/2012, 2C_895/2012).

¹⁹⁷⁶ AVERY JONES/VANN/WHEELER, Response to the OECD Discussion Draft, p. 1.

¹⁹⁷⁷ DUFF, Beneficial Ownership: Recent Trends, p. 4.

6.5.2.2.7.1 V SA Case (the “Swiss-Luxembourg Case”) of 28 February 2001¹⁹⁷⁸

This case, decided by the Swiss Federal Commission of Appeals in Tax Matters, involved a Luxembourg company that acquired 100% of the capital of a Swiss company. The purchase was financed by a loan from one of its shareholders. Dividend payments from the Swiss company were used to pay back the loan to the shareholder. The shareholders of the Luxembourg company were two British companies, one a resident of the UK and the other of the Isle of Man. The Swiss company paid dividends to the Luxembourg company upon which the 35% Swiss withholding tax was levied. Subsequently, the Luxembourg company claimed a refund following the lower rate provided for in the 1993 DTC between Switzerland and Luxembourg. However, the Federal Commission concluded that, based on an international fiscal meaning of “*beneficial ownership*”, the Luxembourg company was not the “*beneficial owner*” of the dividends it received as it was not the “*beneficiary*” of all of the income. In fact, it received the dividends without having full power to decide how to dispose of them¹⁹⁷⁹. Therefore, the Luxembourg company was refused both partial and full treaty relief from Swiss withholding taxes under Articles 10 para. 2 (a) (i) and Art. 10 para. 2 (b). The Luxembourg company was clearly regarded as a conduit company and not as the beneficial owner. The dividends were entirely employed to pay interest on the shareholders’ loan, among other charges, and, consequently, the Swiss income really economically benefited the UK and Isle of Man residents who were not entitled to DTC relief under the Swiss-Luxembourg DTC.

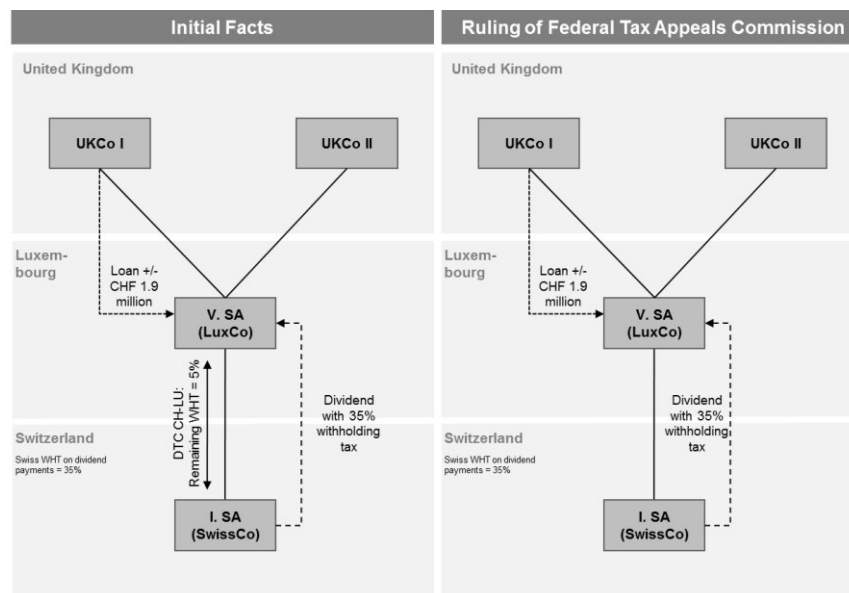
The Commission stated that the person receiving the dividend in its shareholder capacity did not necessarily coincide with the person economically

¹⁹⁷⁸ Federal Court of Appeal in Tax Matters, V SA, 28 February 2001, VPB 65.86 = International Tax Law Reports 4 (2002), pp. 191-214.

¹⁹⁷⁹ Robert Danon has criticized this court decision as, according to his view, the “*beneficial ownership*” criteria do not require that the recipient of the income has, in addition to the common law requirements, the legal, economical or factual power to control and enjoy the economic benefits of the income. According to Robert Danon’s view, only agents, nominees and conduit entities with narrow powers should be excluded from the scope of DTCs and not be considered as “*beneficial owners*”. See: DANON, *bénéficiaire effectif*, p. 45-46.

benefiting from the income. Thus, the beneficial owner was not automatically the formal shareholder; instead, it was the party who in reality and effectively benefits from the payment. Switzerland, therefore, clearly applies a substance-over-form approach in order to determine the beneficial owner and makes a clear differentiation between the person who is legally entitled to the income and the person who is effectively attributed the income. Consequently, based upon the particular facts of the *V SA* Case, the Luxembourg company was not entitled to the treaty benefits granted under the DTC between Switzerland and Luxembourg¹⁹⁸⁰.

Figure 6.10: Swiss-Luxembourg Case of 28 February 2001



Source: Own figure

¹⁹⁸⁰ BUSIN/VOCK, *Abkommensberechtigung*, p. 629-630 questions the decision of 28 February 2001. In this regard, also Luc De Broe questions the Commission's conclusion on the interpretation of the term "*beneficial owner*". See DE BROE, *thesis*, p. 704-706.

6.5.2.2.7.2 *Indofood* Case of 2 March 2006¹⁹⁸¹

This landmark decision has led to extensive discussion and has raised many important questions in international tax law, as it is one of the few cases explicitly referring to the term of “*beneficial ownership*”. One major concern has been the potential consequences that this court decision could have on the “*beneficial ownership*” concept should the international fiscal meaning arising from it be adopted by tax administrations around the world¹⁹⁸². The issue itself did not, in fact, arise in a tax case but a civil law case, which may be concerning since tax authorities were neither represented nor involved in this important and fundamental question of international tax law¹⁹⁸³. That a question of such importance would come before a court with little or no expertise in international tax law has been a common fear among international tax lawyers for many years¹⁹⁸⁴. Indeed, the term “*beneficial ownership*” could be muddled and lead to a meaning that countries could not or would not follow.

The background of the case is relatively complicated, but may be simplified as follows. An Indonesian trading company (Indofood) wanted to raise a loan to the public for financing its business activities. The loan was issued through a Mauritian financing subsidiary with JP Morgan acting as trustee for the bondholders, and not directly through Indofood for tax reasons. In this sense, in the case of a Mauritian financing subsidiary, the withholding tax rate could be reduced to 10% based on the DTC between Indonesia and Mauritius; in the case of an Indonesian company, a domestic withholding tax at the rate of 20% would have applied.

The Indonesian government decided to terminate the DTC between Indonesia and Mauritius starting 1 January 2005. Therefore, after notice of termination was given, the domestic withholding tax of 20% would have applied. Due to these circumstances, including the high interest rate on the loan,

¹⁹⁸¹ High Court, Chancery Division, *Indofood International Finance Ltd. v. JP Morgan Chase Bank N.A.*, 7 October 2005 = *International Tax Law Reports* 8 (2005), pp. 235; Court of Appeal, *Indofood International Finance Ltd. v. JP Morgan Chase Bank N.A.*, 2 March 2006, EWCA Civ 158 = *International Tax Law Reports* 8 (2006), pp. 1-32.

¹⁹⁸² GIBERT/OUAMRANE, *Beneficial Ownership*, p. 3-4; BAKER, *Beneficial Ownership: After Indofood*, p. 27.

¹⁹⁸³ BAKER, *Beneficial Ownership: After Indofood*, p. 22.

¹⁹⁸⁴ BAKER, *Beneficial Ownership: After Indofood*, p. 22.

Indofood intended to redeem the notes early, under the relevant terms and conditions. JP Morgan, acting as trustee, refused to accept an advanced redemption due to the fact that Indofood had not taken reasonable measures to prevent it. According to the trustee, one such measure could have been the setting up of a Dutch structure benefiting from the DTC between Indonesia and the Netherlands. The judgment discussed whether the replacement of the Mauritian company with a Dutch company was a reasonable measure. The trustee's argument succeeded before the High Court of Justice, Chancery Division (first instance). According to this court decision, the Dutch SPV was recognized as the beneficial owner.

Indofood appealed. For this reason, one of the technical questions discussed by the Court of Appeals was whether the Dutch company could be seen as the beneficial owner and, therefore, whether it could benefit from the reduced withholding tax granted under the DTC between Indonesia and the Netherlands. Indeed, it was not clear whether the Indonesian tax authorities would qualify the Dutch company as the beneficial owner, whether they would reject the application of the treaty and if so, how the Indonesian Courts would respond. Hence, the issue was one of Indonesian law and practice. The litigation came to London, however, because the loan agreement contained a forum selection clause in favor of the English High Court. The Court of Appeal reversed the High Court's decision and decided the question of "*beneficial ownership*" in favor of Indofood. Its members unanimously considered that the Dutch company was not the beneficial owner of the interest.

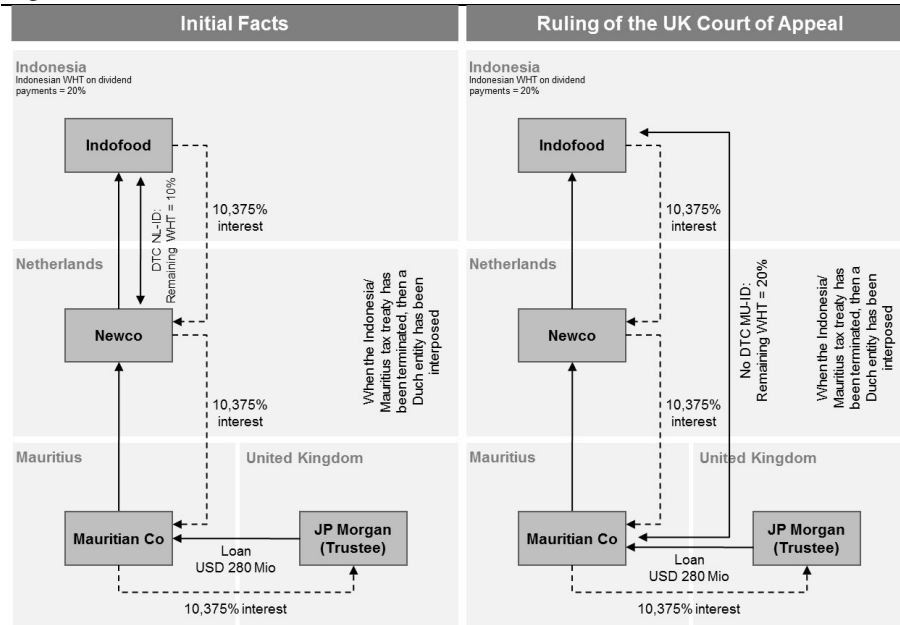
This decision had far reaching implications since it meant that, for the first time, an English court had to provide a definition of the term "*beneficial owner*". Unfortunately, the result provides little clarity to its meaning. Interestingly, the issues of these two decisions are very different even though both judgments were largely based on the OECD Model and its Commentaries.

The Court of Appeals needed to decide whether the interposition of the Dutch company was reasonable for the borrower to establish "*beneficial ownership*". It might have been sufficient to simply state that the Indonesian tax authorities had decided that they would not regard such an interposed company as the beneficial owner. However, the Court decided to take on the question of the meaning of "*beneficial ownership*". If one were to approve of any point made in the Court of Appeals' judgment, it would be the decision that the meaning of "*beneficial ownership*" should not be interpreted

according to the domestic law of the United Kingdom. Rather, the Court correctly considered that it should be given an “*international fiscal meaning*”. In other words, its meaning should not vary and should remain identical across all countries. In this task, the Court correctly referred to the VCLT and to the OECD Commentary and appeared to endorse the meaning set forth in the latter. However, some unfortunate references were made to statements of the Indonesian Director General of Income Tax, which described “*beneficial ownership*” as “*the full privilege to directly benefit from the income*”. This phrase gives, in the word of Philip Baker, little, if any, clarification to the meaning of the term¹⁹⁸⁵. The Court of Appeals also considered that a technical and legal approach should be rejected. Instead, the Court addressed the “*substance of the matter*”, adopting the substance-over-form approach of the Indonesian Directorate-General for Taxation. In this author’s view, on a closer look, this conclusion may be reached based on the fact that the Dutch Company (and the Mauritian Company) transferred all of the interest received by the bondholders to the Indonesian Company (Indofood) without retaining a spread that could fully justify the inherent risks undertaken. It is clear that the Dutch Company (and the Mauritian Company) did not have any right over the income.

¹⁹⁸⁵ BAKER, Beneficial Ownership: After Indofood, p. 24.

Figure 6.11: Indofood Case of 2 March 2006



Source: Own figure

6.5.2.2.7.3 Bank of Scotland Case of 29 December 2006¹⁹⁸⁶

In this case, the French Supreme Administrative Court had to consider the following situation. An American corporation (Merrell Dow Pharmaceuticals Inc.) concluded a three-year usufruct of the non-voting preferred shares in a French company (Merrell Dow SA) to a British bank (Bank of Scotland). The conditions of this deal were that the acquisition price was paid by the French company, by way of dividend payments, to the Bank of Scotland over a three-year period. Under this usufructuary contract, the US company guaranteed the return and agreed to indemnify the Bank of Scotland against non-payment of the dividends. Pursuant to an acceleration clause, the Bank was entitled to sell the shares back to the US parent company in the event of relevant legislative changes in the applicable tax law. In accordance with the DTC between France and the UK, the US parent guaranteed advance payment of the dividends to the Bank, partial reimbursement of the French

¹⁹⁸⁶ Bank of Scotland case of 29 December 2006, Case Nr. 283314 = International Tax Law Reports 9 (2006), pp. 683-714.

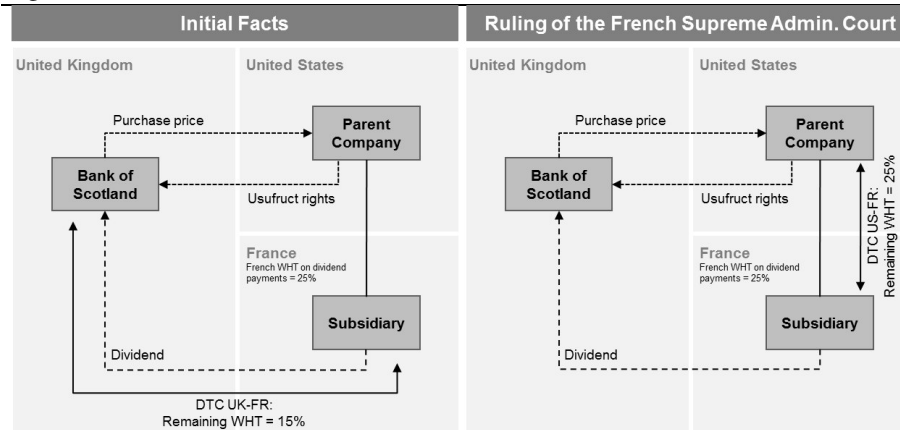
source tax, as well as the reimbursement of tax credits with respect to the dividend payments (“*avoir fiscal*”). The US company also committed to provide sufficient financial aid to the French company such that it could execute the dividend payments. Merrell Dow USA further granted the Bank of Scotland the right to terminate the contract if Merrell Dow France failed to achieve specific profit objectives. In summary, the Bank of Scotland did not assume any risk. The transaction may be compared to dividend stripping in order to take advantage of a lower withholding tax rate on the distribution of dividends.

At the time of the dividend payment from Merrell Dow France, the Bank claimed the payment of a dividend tax credit based on the DTC of 22 May 1968 between the United Kingdom and France, according to which a lower withholding tax applies to the distribution of dividends, at the rate of 15%, rather than the 25% domestic rate. The French Tax Administration rejected the application of the DTC between the United Kingdom and France due to the fact that the Bank could not be considered the beneficial owner of the dividends paid by the French subsidiary. The French tax authorities characterized this transaction as a case of treaty shopping by interpreting Art. 9 para. 7 of the DTC between the United Kingdom and France, and held that: “*a resident of the United Kingdom receiving dividends from a French company could not benefit from the provisions of (...) Article 9 (7) unless it is the beneficial owner of these dividends*”¹⁹⁸⁷. The Administrative Supreme Court determined that the “*beneficial ownership*” concept was not limited to cases in which the immediate recipient transfers the relevant benefits to a third party as part of a broader “*fraud on the law*” in relation to taxation. Consequently, the taxpayer company was not deemed to be the beneficial owner of the dividend and it could not benefit from the DTC between the United Kingdom and France. The Supreme Administrative Court based its analysis on the payment arrangement and the question of risk. Particular attention was paid to the facts that the return to the Scottish Bank was predetermined and guaranteed in advance and, therefore, it undertook very little risk of default. Several other factors are in favour of this result¹⁹⁸⁸.

¹⁹⁸⁷ GIBERT/OUAMRANE, *Beneficial Ownership*, p. 8

¹⁹⁸⁸ BAUMGARTNER, *thesis*, p. 389-390.

Figure 6.12: Bank of Scotland Case of 29 December 2006



Source: Own figure

6.5.2.2.7.4 *Prévost Car Case* of 22 April 2008 and 26 February 2009¹⁹⁸⁹

The *Prévost Car Case*, decided by the Canadian Tax Court, is one of the most recent significant rulings on the meaning of “*beneficial ownership*”. In this case, a Dutch Holding company (Prévost Holding BV) owned 100% of the capital of a Canadian company (Prévost Car Inc.). Prévost Holding BV was owned 51% by a Swedish company (Volvo Bussar A.B) and 49% by a UK company (Henlys Group PLC). Volvo had acquired all of the shares of Prévost Car in 1995 and transferred them to the Netherlands holding company; Volvo then transferred 49% of the shares of the Netherlands holding company to Henley. The office of Prévost Holding BV was registered with a Dutch fiduciary company¹⁹⁹⁰ but it did not have any employees in the Netherlands¹⁹⁹¹. The only significant assets on its balance sheet related to its participation in Prévost Car Inc.¹⁹⁹². Dividends were paid by Prévost Car Inc. to

¹⁹⁸⁹ Court of Appeal, *Prévost Car Inc. v. The Queen*, 22 April 2008, TCC 231 = International Tax Law Reports 10 (2008), pp. 736-770; Canadian Federal Court of Appeal, *The Queen v. Prévost Car Inc.*, 26 February 2009.

¹⁹⁹⁰ *Prévost Car case*, nr. 24.

¹⁹⁹¹ *Prévost Car case*, nr. 25.

¹⁹⁹² *Prévost Car case*, nr. 25.

Prévost Holding BV, and these dividends were later paid to its two shareholders in accordance with a shareholders' agreement. This shareholders' agreement between Volvo and Henlys stated that at least 80% of the profits of Prévost Car and the Netherlands holding company were to be distributed to Volvo and Henlys. It is important to note that the Netherlands holding company had not been included in this agreement. The applicable distribution norm under the DTC between Canada and the Netherlands contains an explicit beneficial ownership requirement¹⁹⁹³. The Canadian tax authorities refused to apply the DTC between Canada and the Netherlands due to the non-fulfillment of this requirement by Prévost Holding BV.

The Tax Court, however, declared that Prévost Holding BV was the beneficial owner of the dividend payments¹⁹⁹⁴ and so was entitled to the benefit of the reduced rate of tax on dividends under the DTC between Canada and Netherlands. According to this decision the beneficial owner of dividends is *"(...) the person who receives the dividends for his or her **own use and enjoyment** and assumes the **risk and control** of the dividend he or she received. The person who is beneficial owner of the dividend is the person who enjoys and assumes all the attributes of ownership. In short the dividend is for the **owner's own benefit** and this person is **not accountable to anyone** for how he or she deals with the dividend income (...). Where an agency or mandate exists or the property is in the name of a nominee, one looks to find on whose behalf the agent or mandatary is acting or for whom the nominee has lent his or her name. **When corporate entities are concerned, one does not pierce the corporate veil unless the corporation is a conduit for another person and has absolutely no discretion** (emphasis added by the author) as to the use or application of funds put through it as conduit, or has agreed to act on someone else's behalf pursuant to that person's instructions without any right to do other than what that person instructs it, for example, a stock-broker who is the registered owner of the shares it holds for clients"*¹⁹⁹⁵.

Prévost Holding BV received the dividends for its own use and enjoyment and assumed the risk and control of the dividends it received¹⁹⁹⁶. There was

¹⁹⁹³ Prévost Car case, nr. 1, nr. 27.

¹⁹⁹⁴ Prévost Car case, nr. 100 et seq.

¹⁹⁹⁵ Prévost Car case, nr. 100.

¹⁹⁹⁶ Prévost Car case, nr. 13.

no evidence that Prévost Holding BV served as a mere conduit for the eventual recipients of the payments - its two shareholders, Volvo and Henlys - by agency or mandate. The fact that Prévost Holding BV had neither offices nor employees in the Netherlands was not decisive when determining whether it was the beneficial owner. In particular, there was no evidence that the dividend payments were pre-determined to be subsequently distributed to its shareholders. The receipt of dividend payments by the two shareholders was entirely dependent on the approval of the distribution of interim payments by the business directors of Prévost Holding BV, and so there was no automatic and pre-determined flow of dividend payments from Prévost Car Inc. through Prévost Holding BV to Volvo and Henlys. This was especially the case since there was evidence that representatives of Henlys attempted to accelerate the payment of dividend payments, which it would not likely have done if such payments were automatic. Prévost Holding BV had no obligation (according to its deed of incorporation and its shareholders' agreements) to distribute dividends to its shareholders. Therefore, the retained dividend payments from Prévost Car Inc. belonged exclusively to Prévost Holding BV and its creditors.

The government appealed the decision of the Tax Court on the basis that the term "*beneficial owner*" should be understood as "*the person who can, in fact, ultimately benefit from the dividend*". Such appeal was rejected by the Federal Court of Appeals under the consideration that the government's position did not have any support in the applicable OECD documents¹⁹⁹⁷.

After referring to the facts and decision of the Prévost Case, some conclusion may be drawn from the solution given by the Canadian courts.

In the first place, even when the Tax Court considered the definition of beneficial owner under the law of Netherlands (the residence country) and under international law, ultimately the Tax Court based its decision on domestic law, which is at some point understandable given that Canadian judges are more familiar with Canadian law.

Now, analyzing the case from a Canadian practical and political perspective, the ruling in the Prévost Case is consistent with Canadian tax treaty policy¹⁹⁹⁸.

¹⁹⁹⁷ See 1977 and 2003 OECD Commentaries on Article 10 and the OECD Conduit Companies Report.

¹⁹⁹⁸ In this vein: ARNOLD, The Concept of Beneficial Ownership under Canadian Tax Treaties, p. 43.

By the time Canada entered into the second Protocol with the Netherlands, the Canadian government had already signed other treaties with the United Kingdom and Sweden, for example, in which the tax rate on dividends was 15% and 10% respectively. Therefore, when entering into the second Protocol with the Netherlands and lowering the direct rate on dividends from 10% to 5%, the Canadian tax authorities should have known that Netherlands holding companies would become an attractive vehicle for European residents wishing to hold investments in Canada¹⁹⁹⁹.

Also, Canadian government - when negotiating the tax treaty with the Netherlands - must have known that the Netherlands provided a preferential tax regime for holding companies and that the Netherlands holding companies were an instrument widely used for tax planning purposes²⁰⁰⁰.

However, when entering in the second Protocol with the Netherlands, Canada did not negotiate the inclusion of a limitation-on-benefits clause, or any provision in order to prevent Netherlands holding companies to be used for treaty shopping²⁰⁰¹.

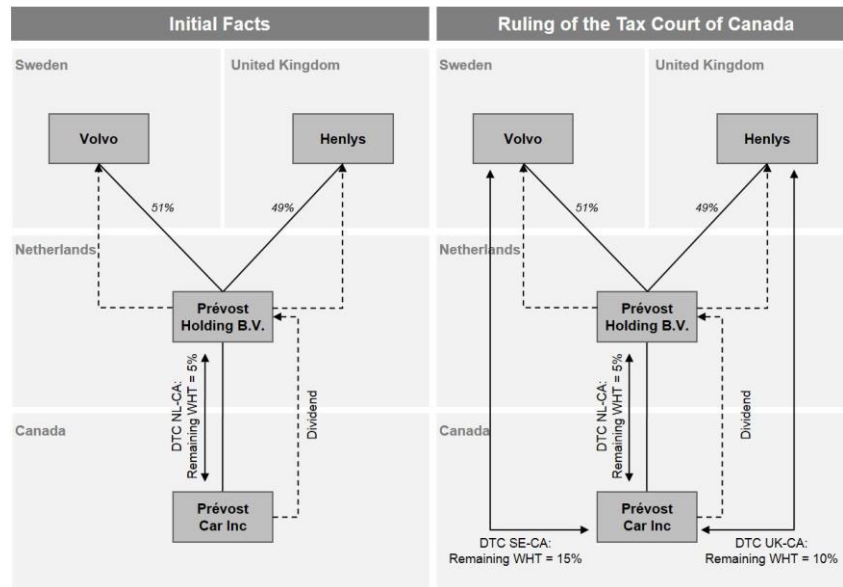
As a consequence, Canada's Tax Court resolution in the *Prévost* Case is consistent with the country's tax policy at the time the amendment of the tax treaty with the Netherlands was signed in order to reduce the withholding tax on dividends to 5%.

Figure 6.13: *Prévost Car* Case of 22 April 2008 and 26 February 2009

¹⁹⁹⁹ ARNOLD, *The Concept of Beneficial Ownership under Canadian Tax Treaties*, p. 43.

²⁰⁰⁰ ARNOLD, *The Concept of Beneficial Ownership under Canadian Tax Treaties*, p. 43.

²⁰⁰¹ ARNOLD, *The Concept of Beneficial Ownership under Canadian Tax Treaties*, p. 43.



Source: Own figure

6.5.2.2.7.5 Danish Swap Case of 5 May 2015²⁰⁰²

The Danish Swap case, first decided by the Swiss Federal Administrative Court and subsequently reversed by the Swiss Federal Supreme Court, is the most recent significant Swiss judgment on “*beneficial ownership*” in the context of DTCs. The author understands the judgment to be the first in the world to deal with such issues in the context of a “*total return swap*”.

In this case, a Dutch bank entered into total return equity swaps with counterparties resident in the United States and Europe (e.g. Germany, France and the United Kingdom) on equity baskets (including amongst others Swiss equities). As a preliminary comment, a total return swap is a contract transferring the credit risk and the market risk of an underlying asset. Under the

²⁰⁰² Federal Administrative Court of 7 March 2012 (“*Swap-Entscheid*”, A-6537/2010) = LANG, Grundsatzurteil zum Beneficial Owner nach DBA-Recht, p. 226-230; DE BROE/FRENCKELL, Swap Case, p. 257-317; DESAX/BUSENHART, Total Return Swaps, p. 557 et seq., see also Swiss Federal Supreme Court decision of 5 May 2015 (2C_364/2012, 2C_377/2012, 2C_895/2012).

total return swap, the Danish bank was to receive a set rate over the swap term.

The Danish bank was obliged to pay to the counterparty an amount equal to the income generated by the assets (including for instance any dividends generated by the Swiss securities to the counterparties) as well as the benefit if the price of the underlying asset increased over the life time of the swap. To hedge against the corresponding risks, the Danish bank proceeded to acquire the underlying securities from stockbrokers as the price of the securities fell over the term of the swap, as the Danish bank was required to pay the counterparty the amount by which the securities fell in price.

Over time, the Swiss companies distributed dividends to the Danish bank, which were subject to the 35% Swiss withholding tax. Based on the DTC between Switzerland and Denmark, a full refund of the Swiss withholding tax was granted for 2006 as the Danish bank was considered a resident. For the years 2007 and 2008, the Swiss Federal Tax Administration denied the refund, arguing that because the bank had entered into swap transactions it was obliged to pass on the Swiss dividends it received to the swap counterparties. As a consequence, the Tax Administration argued that the bank did not qualify as the beneficial owner of the dividends and, therefore, could not benefit from the DTC between Switzerland and Denmark.

Upon a complaint filed by the Danish bank, the Swiss Federal Administrative Court granted the refund, finding that the bank – despite having entered into the swap transactions – retained beneficial ownership of the Swiss dividends received, since the Danish bank conducted a proper commercial business activity and had to make payments for its own offices, personnel and infrastructure. Further, the DTC between Switzerland and Denmark lacked an explicit anti-abuse clause. According to the Swiss Federal Administrative Court, there was no malicious forwarding of income, as there was no mutuality or reciprocity between the receipt of the relevant amounts and the contractual obligation to transfer on the relevant amounts (the interdependence doctrine)²⁰⁰³.

²⁰⁰³ Swiss Federal Administrative Court decision of 7 March 2012 (“*Swap-Entscheid*”, A-6537/2010), cons. 3.4.2. See: BAUMGARTNER, thesis, p. 409-411.

In its decision of 5 May 2015, the Swiss Federal Supreme Court reversed the decision of the Swiss Federal Administrative Court and found that the Danish bank was not to be considered as the beneficial owner of the underlying assets, i.e. dividends, and therefore could not benefit from the relevant DTC. The Court reasoned that a bank's claim to beneficial ownership is weaker the greater its transfer obligation for the underlying assets is²⁰⁰⁴. In analyzing the swap-contracts, the Court found that the bank was indeed obliged to a transfer of 100% of the assets, thus excluding any claim of beneficial ownership²⁰⁰⁵. Further, the Court found that with decreasing risk exposure for the bank in connection with its transfer duty, any claim of beneficial ownership is weakened correspondingly. Conversely, a claim to beneficial ownership has increased credibility where the bank in question's transfer duty toward the other party bears significant, real risks (e.g. dividend risk, credit risk, price loss risk), particularly the risk to not receive any dividends²⁰⁰⁶. The Court concludes that in this particular case, the bank in question could fulfill its transfer duties without any risk exposure²⁰⁰⁷.

The Swiss Federal Supreme Court's reasoning in this case appears to be justified, as the Danish bank transferred both the credit risk and the market risk of the underlying assets and was obliged to pass on amongst others Swiss dividends received to the swap counterparties.

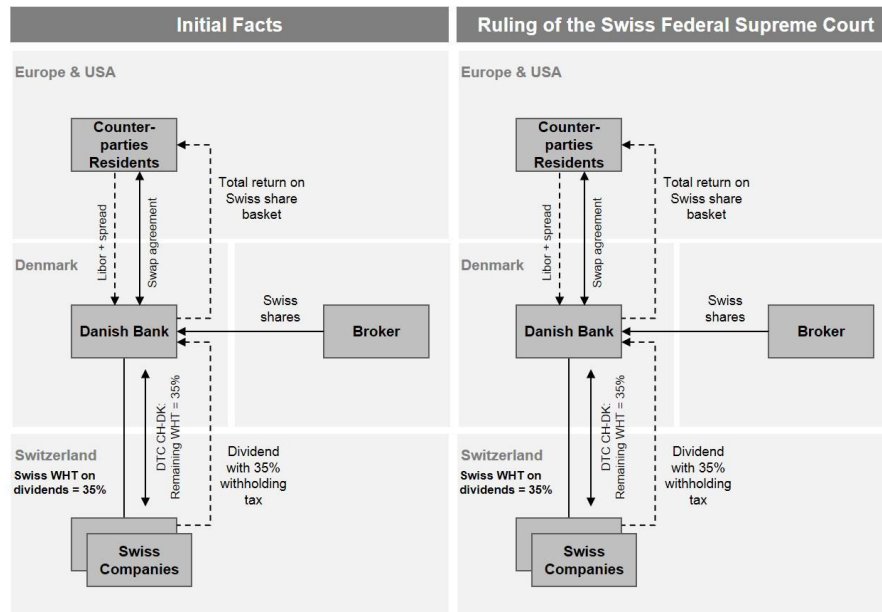
Figure 6.14: Danish Swap Case of 7 March 2012

²⁰⁰⁴ Swiss Federal Supreme Court decision of 5 May 2015 (2C_364/2012, 2C_377/2012, 2C_895/2012), cons. 5.2.4.

²⁰⁰⁵ Swiss Federal Supreme Court decision of 5 May 2015 (2C_364/2012, 2C_377/2012, 2C_895/2012), cons. 6.4.2.

²⁰⁰⁶ Swiss Federal Supreme Court decision of 5 May 2015 (2C_364/2012, 2C_377/2012, 2C_895/2012), cons. 5.3.

²⁰⁰⁷ Swiss Federal Supreme Court decision of 5 May 2015 (2C_364/2012, 2C_377/2012, 2C_895/2012), cons. 6.3 – 6.4.



Source: Own figure

6.5.2.2.7.6 Case Law Developments: Conclusions

The above analysis of case law, tracking the few court decisions in this field²⁰⁰⁸, clearly shows that the OECD materials remain unjustifiably unclear as to the meaning of “*beneficial ownership*” and that there remains significant legal uncertainty and inconsistency regarding the concept²⁰⁰⁹. For the same reasons, this issue has been discussed by the UN Committee of Experts²⁰¹⁰. As a general conclusion, the tax courts seem willing, in principle, to take a “*substance-over-form*” approach. In other words, when determining the beneficial owner of certain income, the facts of the particular case should be understood in their wider economic context and the analysis of those facts

²⁰⁰⁸ In this vein also: AVERY JONES/VANN/WHEELER, Response to the OECD Discussion Draft, p. 1.

²⁰⁰⁹ ARNOLD, Tax Treaty News, p. 176.

²⁰¹⁰ United Nations Committee of Experts on International Cooperation in Tax Matters. Information retrieved from www.un.org/esa/ffd/tax/sixthsession/Report_AUV.pdf on 6 November 2011.

should not be limited to a purely legal analysis of their formal characterizations (although the “*Prévost Case*” stands as a notable exception)²⁰¹¹. This wide, economic, practical view is clearly in line with the definitions suggested by Charl P. Du Toit²⁰¹², Robert Danon²⁰¹³ and Klaus Vogel²⁰¹⁴.

In the “*Swiss-Luxembourg*” and “*Indofood*” cases the intermediary company was held not to be the beneficial owner. The analysis of these selected cases demonstrates the spectrum of different possible interpretations of “*beneficial ownership*”. The range vacillates between “*legal analysis and a wide economic or practical construction*”²⁰¹⁵. However, each of the decisions seem to have followed a “*case-by-case*” approach, taking into account the precise factual circumstances of each case, including factors such as the location and extent of ownership, risk and discretion²⁰¹⁶. The two decisions in the “*Indofood*” line of cases as well as the “*Danish Swap*” case demonstrate how courts can, when faced with the same facts, interpret the meaning of “*beneficial ownership*” differently and still remain in line with the OECD Model and its Commentary²⁰¹⁷. This is exemplified by the “*Danish Swap*” case in particular, where the higher court arrived at a completely different conclusion compared to the lower court, although both decisions were based on identical facts. Through the “*Prévost*” case it can be seen that the term

²⁰¹¹ Against: JIMENEZ, Beneficial Ownership, Part II, nr. 4. He clearly points out that “*a legal approach to the concept seems to be preferable and will reduce the existing confusion*”.

²⁰¹² DU TOIT, thesis, p. 249 who defines the beneficial owner as the person whose ownership attributes outweighs that of any other person.

²⁰¹³ DANON, thesis, p. 339-340 who defines the beneficial owner as the person who legally, economically or factually has the power to control the attribution of the income.

²⁰¹⁴ VOGEL, Double Taxation Conventions, p. 562 who defines the beneficial ownership as: “*the beneficial owner is he who is free to decide whether or not the capital or other assets should be used or made available for use by others or on how the yields therefrom should be used or both*”.

²⁰¹⁵ In this vein also: DE BROE, thesis, p. 713.

²⁰¹⁶ AVI-YONAH/PANAYI, Treaty Shopping, p. 20.

²⁰¹⁷ High Court, Chancery Division, *Indofood International Finance Ltd. v. JP Morgan Chase Bank N.A.*, 7 October 2005, EWHC 2103 = International Tax Law Reports 8 (2005), pp. 235 versus Court of Appeal, *Indofood International Finance Ltd. v. JP Morgan Chase Bank N.A.*, 2 March 2006, EWCA Civ 158 = International Tax Law Reports 8 (2006), pp. 1-32.

should take its meaning from the domestic law of the contracting state rather than an international meaning of the concept²⁰¹⁸. Generally speaking, these court decisions illustrate the reasons why the application of a DTC may be denied. For example, the “*Swiss-Luxembourg*” case stated that such denial will occur “*where there is a sham or where taxpayers do not respect the legal consequences of their structures*”²⁰¹⁹. Specifically, income should be attributed to the person who effectively owns it, i.e. has effective control over the income in question. But one must not confuse this with the ultimate beneficial owner²⁰²⁰. The “*Swiss-Luxembourg*” and “*Bank of Scotland*” cases starkly demonstrate that tax courts are willing to take a “*substance-over-form*” approach when determining the beneficial owner of the income.

6.5.2.3 *Comparison of the Right to Use Concept under Art. 21 para. 1 (a) WTL resp. Art. 1 para. 2 (a) 1962 Abuse Decree and the Concept of “Beneficial Ownership” following an Autonomous Interpretation*

Although they are not identical, the domestic concept of the “*right to use*” under Art. 21 para. 1 (a) WTL resp. Art. 1 para. 2 (a) 1962 Abuse Decree and the concept of “*beneficial ownership*” under DTCs present several similarities. In this light, the question arises as to whether Art. 3 para. 2 OECD Model requires a domestic²⁰²¹ or an autonomous²⁰²² interpretation.

Initially, both concepts follow an economic (substance-over-form) approach and, therefore, one should not only consider a legal technical analysis. Moreover, both concepts are focused on the intensity of the relationship between the person claiming the withholding tax/the DTC benefit refund (the subject), and the source-taxed income (the object). Both also apply the principle of the power of disposition. From a temporal point of view, the concept of the “*right to use*” applies at the time of payment of the income whereas the concept of “*beneficial ownership*” applies at the time the income has been received. With regards to the degree of the power of disposition or power of

²⁰¹⁸ The concept of “*beneficial owner*” is known in the Canadian law and can be described according to domestic law. In this vein: *Prévost Car* case, nr. 100.

²⁰¹⁹ DE BROE, thesis, p. 714.

²⁰²⁰ In this vein: DANON, *bénéficiaire effectif*, p. 41.

²⁰²¹ See Chapter 6.5.2.2.1.

²⁰²² See Chapter 6.5.2.2.2.

decision, there are differences. On one hand, the concept of the “*right to use*” requires a free power of decision; on the other hand, in relation to the concept of “*beneficial ownership*”, it is sufficient for a person to only have certain powers of decision. In this respect, the distinction between the two concepts is a matter of the quantity and quality of power. The concept of the “*right to use*” is, therefore, more restrictive than the concept of the “*beneficial owner*”.

6.5.2.3.1 Arguments in Favor of an Autonomous Interpretation

Various arguments can be advanced favoring an autonomous interpretation of the “*beneficial ownership*” concept in the context of Art. 3 para. 2 OECD Model²⁰²³. “*Beneficial ownership*” is an independent and autonomous concept of international tax law and a part of the international tax language²⁰²⁴. Such terms should be interpreted autonomously and not according to domestic law, since no precise definition can be found in the contracting states’ domestic laws, particularly in the laws of civil law states²⁰²⁵. An autonomous interpretation would also avoid divergences between the contracting states which could result in double taxation or double non-taxation²⁰²⁶. An autonomous interpretation would additionally prevent contracting states from giving “*beneficial ownership*” a meaning and role similar to domestic anti-abuse provisions. Some contracting states consider the concept of “*beneficial ownership*” as an anti-abuse provision and therefore, may otherwise use it in a way which undermines the objective of the treaty²⁰²⁷. This view has also been confirmed by the IFA Congress in Eilat and Israel²⁰²⁸.

²⁰²³ BAUMGARTNER, thesis, p. 157 et seq.

²⁰²⁴ Among others: DU TOIT, thesis, p. 173; DANON, thesis, p. 331; DANON, *bénéficiaire effectif*, p. 52; WHEELER, *Attribution of Income*, p. 477; POLIVANOVA ROSENAUER, *Nutzungsberechtigung*, p. 257; OLIVER/LIBIN/VAN WEEGHEL/DU TOIT, *Beneficial Ownership*, p. 310.

²⁰²⁵ Among others: DU TOIT, thesis, p. 173 et seq.; DANON, thesis, p. 329 et seq.; DANON, *bénéficiaire effectif*, p. 40.

²⁰²⁶ DANON, thesis, p. 330; DANON, *bénéficiaire effectif*, p. 40.

²⁰²⁷ DANON, thesis, p. 331.

²⁰²⁸ In this vein also: BAUER-BALMELLI, thesis, p. 567; DANON, *trusts*, p. 329.

6.5.2.3.2 Arguments in Favor of an Interpretation according to Domestic Law (“*lex fori*”)

One argument for the interpretation of the concept of “*beneficial ownership*” according to domestic law lies in the fact that there is no express definition included in the relevant DTCs. When analyzing the concept from a Swiss perspective, therefore, Sybille Cretti argues that the term has to be interpreted according to the domestic concept of “*right to use*” under Art. 21 para. 1 (a) WTL. This approach follows the continuous practice of the Federal Supreme Court²⁰²⁹. Additionally, the Federal Tax Administration, in both the “*Denmark case*” court decision and the “*Germany case*” court decision, interpreted “*beneficial ownership*” according to domestic law. In the “*Denmark case*”, the Federal Tax Administration interpreted the term “*recipient of income*” (under which the “*beneficial ownership*” concept is included) of Art. 3 para. 2 of the DTC between Switzerland and Denmark, in the sense of the “*right to use*” under Art. 21 para. 1 lit. a WTL. It concluded that the renvoi to domestic law must align with the context of the DTC. In the “*Germany case*”, the Federal Tax Administration argued that the concept of “*beneficial ownership*” had to be interpreted in an autonomous way. Despite their statement, however, the Federal Tax Administration conducted the interpretation of the concept under Art. 21 para. 1 (a) WTL, i.e., according to domestic law.

6.5.2.3.3 Conclusion

For the aforementioned reasons, it appears obvious that the “*beneficial ownership*” concept requires an international autonomous interpretation rather than an interpretation that refers to domestic law.

6.5.3 Collective Investment Schemes and Trusts as Beneficial Owners

There is only scarce guidance available as to the specific meaning and the applicability of the term “*beneficial ownership*” to CISs and trust structures. In general, the fulfillment of the “*beneficial ownership*” requirement by a CIS should be assessed based on the specific facts and circumstances at issue

²⁰²⁹ CRETTI, thesis, p. 152. In vein also: BAUER-BALMELLI, thesis, p. 586 et seq.

as well as the relationship between the CIS and its investors²⁰³⁰. The analysis of whether a CIS fulfils the "*beneficial ownership*" requirement is outlined in the CIV Report. For trusts, however, there is no final interpretation of the term "*beneficial owner*" as per today. The case of trusts will therefore be analyzed under the OECD materials and the recent OECD Reports.

In the following chapter, the term "*beneficial owner*" is summarized in order to outline a conclusion in the context of CISs and trusts by discussing (i) the DTCs signed by Switzerland, (ii) relevant selected court decisions, and (iii) the applicable OECD materials.

6.5.3.1 *Interpretation of "Beneficial Ownership" under DTCs Signed by Switzerland*

To the best of the author's knowledge, as per today there is only one DTC signed by Switzerland that contains an explicit clause defining the term "*beneficial owner*" in the context of CISs. The provision in question is Art. 3 (b) of the Protocol of 6 June 1980 to the DTC between Switzerland and New Zealand, stating that "*(...) dividends, interest or royalties in respect of which a trustee is subject to tax in New Zealand shall be treated as being beneficially owned by that trustee*".

The following example illustrates how this definition is applied. When determining whether dividends, interest or royalties are beneficially owned by residents of New Zealand for the purpose of Arts. 10, 11 and 12 DTC Switzerland-New Zealand, such income, on which a trustee is subject-to-tax in New Zealand, will be treated as being beneficially owned by that person²⁰³¹. In other words, a New Zealand resident trustee is considered the beneficial owner of Swiss-source trust income under Arts. 10, 11 and 12 DTC Switzerland-New Zealand, provided that the income is attributed to and taxed at the level of the trustee in New Zealand²⁰³². The trust itself is not subject-to-tax in New Zealand, and therefore, cannot be granted treaty access. This special treaty provision is not applicable to irrevocable fixed interest trusts or irrevocable discretionary trusts as, in these cases, the income is not considered to

²⁰³⁰ In this vein: VIITALA, thesis, p. 92-95.

²⁰³¹ In this vein: JUNG, International Taxation, p. 150.

²⁰³² WHEELER, Taxation of Trusts in Common Law Jurisdictions, p. 49.

be income of the trustee. On this basis, in the situation of an irrevocable fixed interest trust, New Zealand would generally recognize the income as “*beneficially owned*” directly by the beneficiary, and the beneficiary (not the trustee) would be the person entitled to claim treaty benefits²⁰³³.

6.5.3.2 *Interpretation of the Term “Beneficial Ownership” under Relevant Selected Court Decisions*

So far, no court decisions have directly addressed the issue of “*beneficial ownership*” for CISs and trusts. Nevertheless, it is important to analyze how the requirement of “*beneficial ownership*” is interpreted in selected court decisions (in terms of corporate entities) in order to draw conclusions that might help anticipating future court decisions regarding the fulfillment of this requirement by CISs and trusts.

Accordingly, the following selection of cases demonstrates the spectrum of different possible interpretations of the “*beneficial ownership*” term. The cases range between a “*legal analysis and a wide economic or practical construction*”²⁰³⁴. In general terms, however, the decisions seem to have followed a “*case-by-case*” approach, focusing on the particularities of the case, such as location of the company, extent of ownership, risk and discretion²⁰³⁵. The two decisions in the “*Indofood*” line of cases as well as the “*Danish Swap*” case demonstrate how courts can, although faced with the same facts, interpret the meaning of “*beneficial ownership*” differently, while remaining in line with the OECD Model and its Commentary²⁰³⁶. This is exemplified by the “*Danish Swap*” case in particular, where the higher court arrived at a completely different conclusion compared to the lower court, although both decisions were based on identical facts. The “*Prévost*” case adopts a domestic meaning rather than an international meaning of the term “*beneficial*

²⁰³³ PREBBLE, *Accumulation Trusts and Double Tax Conventions*, p. 69 et seq.

²⁰³⁴ In this vein also: DE BROE, thesis, p. 713.

²⁰³⁵ AVI-YONAH/PANAYI, *Treaty Shopping*, p. 20.

²⁰³⁶ High Court, Chancery Division, *Indofood International Finance Ltd. v. JP Morgan Chase Bank N.A.*, 7 October 2005, EWHC 2103 = *International Tax Law Reports* 8 (2005) pp. 235, versus: Court of Appeal, *Indofood International Finance Ltd. v. JP Morgan Chase Bank N.A.*, 2 March 2006, EWCA Civ 158 = *International Tax Law Reports* 8 (2006) pp. 1-32.

ownership”²⁰³⁷. Generally speaking, these decisions illustrate which factors courts consider when they deny DTC access. In the “*Swiss-Luxembourg*” case, for example, the court ruled that it will not grant DTC benefits “*where there is a sham or where taxpayers do not respect the legal consequences of their structures*”²⁰³⁸. Specifically, income should be attributed to the person who has effective control over its ownership. Authors clarify, however, that there should not be confusion between the person who has effective control over the ownership and the ultimate beneficial owner²⁰³⁹.

The “*Swiss-Luxembourg*” and the “*Bank of Scotland*” cases demonstrate that tax courts are willing to take a “*substance-over-form*” approach when determining the beneficial owner of income. Even though there are a number of decisions, the amount is not enough²⁰⁴⁰ to eliminate legal uncertainty and inconsistency²⁰⁴¹.

The UN Committee of Experts has discussed the definition and scope of the term²⁰⁴², and concluded that in principle, a “*substance-over-form*” approach will be followed. This means that when determining the beneficial owner of certain income, the analysis of the facts should not be limited to a purely legal analysis of formal characterizations but should rather be understood in their wider economic context²⁰⁴³. This wide, economic and practical view is

²⁰³⁷ The concept of “*beneficial owner*” is known in Canadian law and can be described according to domestic law. In this vein: *Prévost Car* case, nr. 100.

²⁰³⁸ DE BROE, thesis, p. 714.

²⁰³⁹ In this vein: DANON, *Bénéficiaire effectif*, p. 41.

²⁰⁴⁰ In this vein also: AVERY JONES/VANN/WHEELER, Response to the OECD Discussion Draft, p. 1.

²⁰⁴¹ ARNOLD, *Tax Treaty News*, p. 176.

²⁰⁴² United Nations Committee of Experts on International Cooperation in Tax Matters. Information retrieved from www.un.org/esa/ffd/tax/sixthsession/Report_AUV.pdf on 6 November 2011.

²⁰⁴³ Against: JIMENEZ, *Beneficial Ownership*, Part II, nr. 4. He points out that “*a legal approach to the concept seems to be preferable and will reduce the existing confusion*”.

in line with the definitions suggested by Charl P. Du Toit²⁰⁴⁴, Robert Danon²⁰⁴⁵ Klaus Vogel²⁰⁴⁶ and Beat Baumgartner²⁰⁴⁷.

6.5.3.3 *Interpretation of the Term “Beneficial Ownership” under the OECD Materials*

As demonstrated above, the “*beneficial owner*” concept is controversial and difficult to grasp, in particular in the context of CISs and trusts. This is mainly due to the fact that CISs may, for instance, be seen as conduit companies and cannot therefore be the “*beneficial owners*” of the income they receive. As for trusts, there is no clear legal framework with regard to Articles 10, 11 and 12 of the OECD Commentary. This Chapter discusses the interpretation of the term “*beneficial ownership*” in (i) the OECD Public Discussion Draft and the OECD Revised Draft on the meaning of the term “*beneficial owner*”²⁰⁴⁸ as well as (ii) the Collective Investment Vehicles Report²⁰⁴⁹.

6.5.3.3.1 The OECD Public Discussion Draft and the OECD Revised

²⁰⁴⁴ DU TOIT, thesis, p. 249 who defines the “*beneficial owner*” as the person whose ownership attributes outweigh those of any other person.

²⁰⁴⁵ DANON, thesis, p. 339-340 who defines the “*beneficial owner*” as the person who legally, economically or factually has the power to control the attribution of the income.

²⁰⁴⁶ VOGEL, Double Taxation Conventions, p. 562 who defines the “*beneficial ownership*” as follows: “*The beneficial owner is he who is free to decide whether or not the capital or other assets should be used or made available for use by others or on how the yields therefrom should be used or both*”.

²⁰⁴⁷ BAUMGARTNER, thesis, p. 157, defines the term “*beneficial ownership*” as follows (translated from German): “*Beneficial owner is the person who at the time of payment of the relevant income is not only able to take minor decisions as pertains to the use of said income, but may take at least certain relevant decisions in this regard independently. This decision power criteria is not met where a person is, at the time of payment of the income, under contractual obligation to forward the received income to a third party or under other factual restrictions such as intense control through a legal entity, requiring the income to be forwarded to a third party and specifically where the receipt of said income depends on the receiving person’s obligation to forward said income to a third party*”.

²⁰⁴⁸ See Chapter 6.5.3.3.1.

²⁰⁴⁹ See Chapter 6.5.3.3.2.

Draft on the Meaning of the Term “Beneficial Owner”

As mentioned previously, neither the OECD Model nor the OECD Commentary contain a definition of the term “*beneficial owner*”. Therefore, the OECD Committee on Fiscal Affairs, through its Working Party Nr. 1 on Tax Conventions and Related Questions, has released reports aimed at clarifying the interpretation of the concept in the context of the OECD Model. The OECD released a Public Discussion Draft on April 11, 2011²⁰⁵⁰ as well as a Revised Discussion Draft on October 19, 2012²⁰⁵¹.

The first Discussion Draft defined the beneficial owner as the person who has the “*full right to use and enjoy*” the income²⁰⁵² and introduced a substance-over-form approach to the analysis. If the “*beneficial ownership*” criterion is defined this way, however, a person who is not the full owner of the income, for instance a company with an obligation to pay a certain dividend, is arguably not to be considered the “*beneficial owner*” of such amount. The definition was, therefore, overinclusive.

In the revised version of the Public Discussion Draft and the OECD Commentary, the OECD proposes that “*the recipient of a dividend is the “beneficial owner” of that dividend where he has the right to use and enjoy the dividend unconstrained by a contractual or legal obligation to pass the payment received to another person*”²⁰⁵³. The OECD thus eliminated the “*full right*” test and instead included in the revised draft a “*right to use and enjoy*” test²⁰⁵⁴. In the revised draft, the OECD again provided a negative definition of the “*beneficial owner*” concept.

²⁰⁵⁰ OECD, Clarification of the meaning of “Beneficial Owner” in the OECD Model Tax Convention Discussion Draft, 2011.

²⁰⁵¹ OECD, Clarification of the meaning of “Beneficial Owner” in the OECD Model Tax Convention Revised Discussion Draft, 2012.

²⁰⁵² AVERY JONES/VANN/WHEELER, Response to the OECD Discussion Draft, p.1.

²⁰⁵³ OECD, Clarification of the meaning of “Beneficial Owner” in the OECD Model Tax Convention Revised Discussion Draft, 2012, para. 12.4 and OECD Commentary 2014 ad Art. 10 para. 12.4.

²⁰⁵⁴ OECD, Revised Discussion Draft on Beneficial Owner, para 12.4 and OECD Commentary 2014 ad Art. 10 para 12.4.

Under the definition, intermediaries such as agents or nominees, who are interposed between the beneficiary and the payer, are clearly not considered “*beneficial owners*” in the context of Art. 10, 11 and 12 OECD Model²⁰⁵⁵. This definition raised the question as to whether an intermediary can qualify for a tax limitation in the source state where the person in the other contracting state is a resident²⁰⁵⁶.

The requirement in the first Discussion Draft that the “*beneficial owner*” had to be “*unconstrained by a contractual or legal obligation to pass on the payment received to another person*” raised issues regarding distribution obligations to the investors in CISs that are usually entitled to DTC benefits. Accordingly, the Revised Draft and the OECD Commentary introduced an additional requirement that, to be relevant for the “*beneficial owner*” analysis, this obligation “*to pass on the payment*” had to be “*related*” to the payment received²⁰⁵⁷. This means that, if there is an obligation to pass on the payment but this obligation is “*unrelated*” to the payment received, the recipient shall still be considered the “*beneficial owner*” of the income²⁰⁵⁸. The Draft, however, does not provide a definition of the terms “*related*” or “*unrelated*” payment. Lastly, the Discussion Draft also clarifies that beneficial and ultimate beneficial ownership are not to be equated – an entity to which income is paid may well be regarded as the beneficial owner even if other persons (typically shareholders) exercise “*ultimate effective control*” over the entity²⁰⁵⁹.

As for the treatment to be provided to CISs, the Revised Discussion Draft and the OECD Commentary specifically clarify that distribution obligations of CISs constitute “*unrelated*” obligations for the purposes of the “*beneficial*

²⁰⁵⁵ OECD Commentary 2014, nr. 12.2 ad. Art. 10; nr. 11 ad. Art. 11, nr. 4.2 ad. Art. 12.

²⁰⁵⁶ KUBIK, thesis, p. 154 in connection with OECD Commentary 2014, nr. 12.2 ad. Art. 10; nr. 11 ad. Art. 11, nr. 4.2 ad. Art. 12.

²⁰⁵⁷ OECD, Clarification of the meaning of “Beneficial Owner” in the OECD Model Tax Convention Revised Discussion Draft, 2012, para. 12.4 and OECD Commentary 2014 ad Art. 10 para 12.4.

²⁰⁵⁸ OECD, Clarification of the meaning of “Beneficial Owner” in the OECD Model Tax Convention Revised Discussion Draft, 2012, para. 12.4 and OECD Commentary 2014 ad Art. 10 para 12.4.

²⁰⁵⁹ The Prévost Case comes to the same conclusion. See chapter 6.5.2.2.7.4.

owner” test²⁰⁶⁰. Under this definition, therefore, CISs can be considered the “*beneficial owners*” of the income they receive and distribute to investors.

For the meaning of the term “*beneficial owner*” in the context of trusts, both Discussion Drafts provide little clarification. The Revised Discussion Draft and the OECD Commentary, however, state that, even if the trustee of a discretionary trust would not be considered the “*beneficial owner*” under the relevant domestic trust law, he could qualify as the “*beneficial owner*” under article 10 of the Model. When the trustee has discretionary powers to manage assets on behalf of their beneficiaries, for example, by not distributing dividends in a certain year, the trust could be considered as the “*beneficial owner*”²⁰⁶¹.

On the other hand, trustees of a “*fixed interest trust*” who have an obligation to distribute trust income to certain beneficiaries do not satisfy the “*beneficial ownership*” requirement, as they do not have full discretion and enjoyment of the income²⁰⁶². Thus, if the trust is structured as a “*fixed interest trust*”, neither the “*trustee*” nor the “*trust*” has discretionary power on how to distribute the assets. However, the “*beneficial ownership*” requirement is certainly met by the beneficiary to whom the income is allocated²⁰⁶³.

Thus, the result in trust cases depends on the particular organization that has been chosen for the trust structure at hand. Some authors consider that in order to qualify as the “*beneficial owner*” of a certain income, it should be ir-

²⁰⁶⁰ OECD, Clarification of the meaning of “Beneficial Owner” in the OECD Model Tax Convention Revised Discussion Draft, 2012, para. 12.4 and OECD Commentary 2014 ad Art. 10 para 12.4.

²⁰⁶¹ OECD, Revised Discussion Draft on Beneficial Owner, para. 12.1 and OECD Commentary 2014 ad Art. 10 para 12.1.

²⁰⁶² OECD, Revised Discussion Draft on Beneficial Owner, footnote to para. 12.1 and OECD Commentary 2014 ad Art. 10 para 12.1.

²⁰⁶³ OECD, Revised Discussion Draft on Beneficial Owner, footnote to para. 12.1 and OECD Commentary 2014 ad Art. 10 para 12.1.

relevant whether the trust has an incorporated or unincorporated legal structure; the legal structure could at most be a useful indicator as to whether the body qualifies as the “*beneficial owner*” of the income²⁰⁶⁴.

From a purely Swiss tax perspective, under the rules of Circular Letters 20/30, a Swiss resident trustee is never entitled to benefit from DTCs. In this sense, even if the trustee has discretionary powers²⁰⁶⁵, he can never obtain relief from foreign or Swiss withholding taxes, as under the Swiss “*lex fori*” attribution rules the trust income is not attributed to the trustee²⁰⁶⁶. On the other hand, in common law jurisdictions, trustees may generally qualify as “*beneficial owners*”, and, consequently, have access to DTCs if the other requirements are met²⁰⁶⁷.

It is worth mentioning that the Commentary of Article 26 OECD Model states that the term “*agency*” is “*(...) very broad and includes all forms of corporate service providers (e.g. company formation agents, trust companies, registered agents, lawyers)*”²⁰⁶⁸. In the author’s view, a trustee can be considered a more appropriate agent based on the trust deed. As mentioned above, the OECD considers all intermediaries, such as agents or nominees, who are interposed between the beneficiary and the payer, not to be beneficial owners, as they merely act in the capacity of fiduciaries or asset managers²⁰⁶⁹. Some authors have suggested that corporate trustees should be considered as agents and, therefore, may not fulfill the requirements of “*beneficial owners*” of the income at hand²⁰⁷⁰. This finding is supported by the OECD Report, which geared towards determining the person who has effec-

²⁰⁶⁴ In this vein: BONGAARTS/ED, General report on the taxation of investment funds, p. 45-46; GRILLI, Treaty entitlement of investment funds, p. 925.

²⁰⁶⁵ JUNG, International Taxation, p. 152.

²⁰⁶⁶ Para. 4.2 Circular 30/20.

²⁰⁶⁷ KOELE, Trusts and the Application of the OECD Model Convention, p. 88-89. In this vein also: JUNG, International Taxation, p. 152.

²⁰⁶⁸ OECD Commentary 2014, nr. 19.12 ad. Art. 26.

²⁰⁶⁹ OECD Commentary 2014, nr. 12.1 ad. Art. 26.

²⁰⁷⁰ KUBIK, thesis, p. 155.

tive control over the assets. As may be deduced from the definitions suggested by Charl P. Du Toit²⁰⁷¹, Robert Danon²⁰⁷² and Klaus Vogel²⁰⁷³, the “*beneficial owner*” must have discretionary power over the income or certain rights derived from said income.

6.5.3.3.2 The Collective Investment Vehicles Report

From a tax policy perspective regarding CISs, it can be stated that the purpose is to give source states treaty benefits at the level of the interposed CIS. The CIV Report clearly follows this idea. Under this Report, a vehicle that meets the definition of a CIS as stated in paragraph 4 of the Report is to be considered the “*beneficial owner*” of the income it receives, as long as the managers of the CIS have discretionary powers to manage the assets on behalf of the investors and the CIS meets the requirements to be considered a “*person*” and a “*resident*” of the state in which the CIS is established²⁰⁷⁴.

It should be noted that the CIV Report, unlike the Partnership Report, does not consider the person to whom the income is attributed according to domestic law to be the “*beneficial owner*”. The CIV Report is silent on the term “*attribution of income*”²⁰⁷⁵ and the definition of a CIS provided in paragraph 4 of the CIV Report may be assimilated to the “*beneficial owner*” term. This serves the purpose of reducing complexity with regard to CISs.

The OECD Commentary mirrors this view by stating that a “*widely-held*” CIS that holds a “*diversified portfolio of securities*”, is subject to “*investor-protection regulation*”²⁰⁷⁶ and fulfills the “*person*” and “*resident*” requirements, should be considered the “*beneficial owner*” of the received income,

²⁰⁷¹ DU TOIT, thesis, p. 249 who defines the beneficial owner as the person whose ownership attributes outweighs that of any other person.

²⁰⁷² DANON, thesis, p. 339-340 who defines the beneficial owner as the person who legally, economically or factually has the power to control the attribution of the income.

²⁰⁷³ VOGEL, Double Taxation Conventions, p. 562 who defines the “*beneficial ownership*” as follows: “[T]he beneficial owner is he who is free to decide whether or not the capital or other assets should be used or made available for use by others or on how the yields therefrom should be used or both”.

²⁰⁷⁴ CFA Report, para. 33 and OECD Commentary 2014, nr. 6.14 ad. Art. 1.

²⁰⁷⁵ See Chapter 6.1.2.3.5.4.

²⁰⁷⁶ OECD Commentary 2014, nr. 6.8 and 6.14 ad. Art. 1.

as long as the managers have discretionary powers to manage the assets on behalf of the investors²⁰⁷⁷ that go beyond those performed by a nominee, agent or conduit²⁰⁷⁸.

6.6 Hypothetical Approaches for Double Tax Convention Access

In Switzerland, as in most other contracting states, whether CISs and trusts can access DTCs is a controversial issue²⁰⁷⁹. In order to achieve legal certainty and an unequivocal approach, clear provisions should be included in DTCs, such as those discussed in the CFA Report and inserted in the OECD Commentary 2014 for CISs²⁰⁸⁰. In the following paragraphs, the different approaches will be analyzed in detail, e.g., the “No Look Approach”, the “Look Through Approach”, the “Partial Look Through Approach” and “Partial Look Through Approach Plus”, will attempt to determine which of these approaches will better serve the interests at the level of the CIS/trust, at the level of the investor, settlor, beneficiary or trustee and at the level of the financial center. Even though CISs and trusts may otherwise be entitled to benefit from DTCs, their respective treatment should be dealt with by way of explicit provision in DTCs, within an additional Protocol to them or in the OECD Commentary. Contracting parties have the option to adopt express rules regarding the personal entitlement of CISs and trusts, since it lies within their discretion to designate the persons entitled to a DTC. With regard to CISs’ entitlement to the benefit, the CFA²⁰⁸¹ distinguished three theoretical approaches: (i) the “*No-Look Through Approach*”²⁰⁸², (ii) the *Partial Look-Through Approach*²⁰⁸³ and the *Partial Look-Through Approach Plus*²⁰⁸⁴ and the (iii) *Look-Through Approach*”²⁰⁸⁵. Hypothetically, these methods could analogically apply to other hybrid entities, such as trusts, as the central

²⁰⁷⁷ OECD Commentary 2014, nr. 6.14 ad. Art. 1

²⁰⁷⁸ CFA Report, para. 35.

²⁰⁷⁹ See Chapter 6.1.

²⁰⁸⁰ OECD Commentary 2014, nr. 6.8-6.34 ad Art. 1.

²⁰⁸¹ OECD Commentary 2014, nr. 6.17, 6.21, 6.26 and 6.28 ad Art. 1.

²⁰⁸² See Chapter 6.6.1.

²⁰⁸³ See Chapter 6.6.2.1.

²⁰⁸⁴ See Chapter 6.6.2.2.

²⁰⁸⁵ See Chapter 6.6.3.

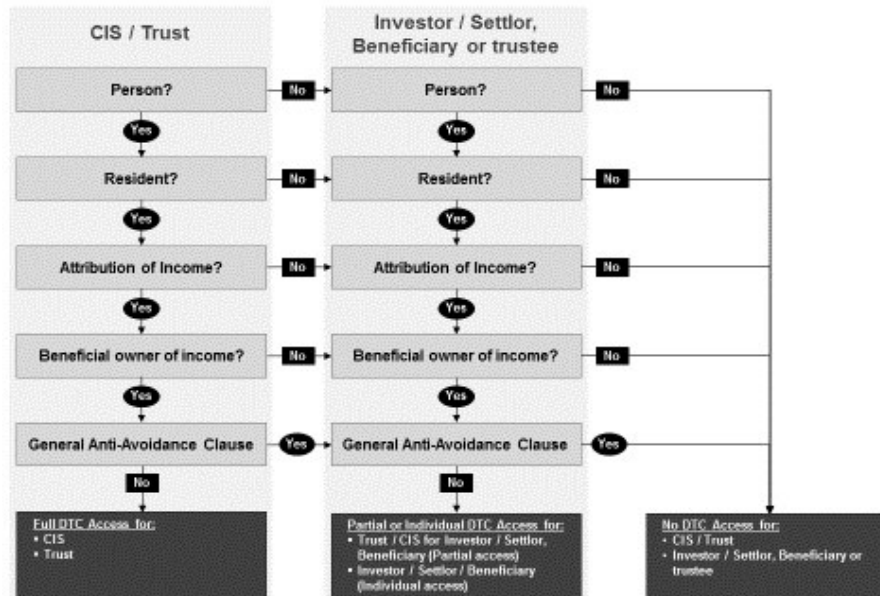
questions are of a similar nature. It is crucial that financial centers such as Switzerland fully grasp the advantages and drawbacks of each approach. It should be taken into consideration when reading the next chapter that although the OECD when drafting the CFA Report only intended to provide propositions to CISs, it is the author's opinion that these propositions provided for CISs may be thoughtfully applicable to trusts.

The main question is which of these methods best protects the interests of the financial center as well as its investors: whether it is best that a CIS/trust is entitled to claim benefits in its own right or in the right of its investors/beneficiaries, or whether the investor/beneficiary should be individually entitled to DTC benefits. Depending on the selected approach, the claim may thus be made either (i) by the individual, i.e. by the CIS or trust or by its investors/beneficiaries (Individual DTC Access)²⁰⁸⁶; (ii) by the CIS or trust on behalf of its investors/beneficiaries (Partial Access)²⁰⁸⁷; or (iii) by no-one (No Access).

²⁰⁸⁶ See Chapter 6.6.1 and 6.6.4.

²⁰⁸⁷ See Chapter 6.6.2.

Figure 6.15: Access to Double Tax Conventions



Source: Own figure

6.6.1 The “No-Look Through” Approach - Collective Investment Schemes and Trusts Have Full Access to DTCs

In what is called the “*no-look through approach*”²⁰⁸⁸, the CIS or trust is entitled to benefit from DTCs in its own right and with respect to all the income it receives, irrespective of the residence of its investors or the parties involved in the trust structure²⁰⁸⁹, so long as all of the conditions for DTC eligibility are met. This approach is the simplest and most efficient, and is largely favored by financial centers such as Switzerland due to the large

²⁰⁸⁸ Many authors refer to the term “*in its own right-approach*”. Among others: VERMEULEN, Treaty Benefits Approaches, p. 87.

²⁰⁸⁹ In this vein: BONGAARTS/ED, General report on the taxation of investment funds, p. 52-53.

amount of DTCs concluded by them²⁰⁹⁰. In this matter, the CFA, whose opinion is principally based on the ICG's recommendations, suggests adding an explicit provision to the OECD Model, stating that a CIS should be treated as an individual resident of the contracting state in which it is established²⁰⁹¹: *"Notwithstanding the other provisions of this Convention, a collective investment vehicle which is established in a Contracting State and which receives income arising in the other Contracting State shall be treated for purposes of applying the Convention to such income as an individual that is a resident of the Contracting State in which it is established and as the beneficial owner of the income it receives (provided that, if an individual who is a resident of the first-mentioned State had received the income in the same circumstances, such individual would have been considered to be the beneficial owner thereof), but only to the extent that the beneficial interests in the collective investment vehicle are owned by equivalent beneficiaries"*²⁰⁹².

However, this approach does not entirely conform to the current practice in the application of DTCs, since most countries, including Switzerland, do not consider CISs or trusts as residents for DTC purposes²⁰⁹³. However, by way of comparison, the Netherlands allows certain Dutch CISs to be entitled to DTCs on behalf of their investors, even if they reside outside the Netherlands²⁰⁹⁴. CISs and trusts are often not subject to taxation in their state of residence, and therefore one of the key conditions regarding the personal scope of application of DTCs under Art. 4 OECD Model is missing. However, if a CIS or trust is considered as a resident, this approach could lead to the establishment of CISs and trusts solely for *"treaty shopping"* purposes. This problem may be illustrated by the following example: the individual investors of a CIS are residents of another contracting state, different from the CIS's state of establishment. If the DTC between the source state and the residence state of the CIS provides for a higher withholding tax deduction than the deduction that would have been granted between the source state and the residence state of the investors, this could provide an incentive for

²⁰⁹⁰ Assuming that the CIS jurisdiction (like for example Switzerland) disposes of a considerable DTC network. For instance, this approach would be uninteresting for Liechtenstein, as it still does not dispose over a wide DTC network as per today.

²⁰⁹¹ OECD Commentary 2014, nr. 6.21 ad Art. 1.

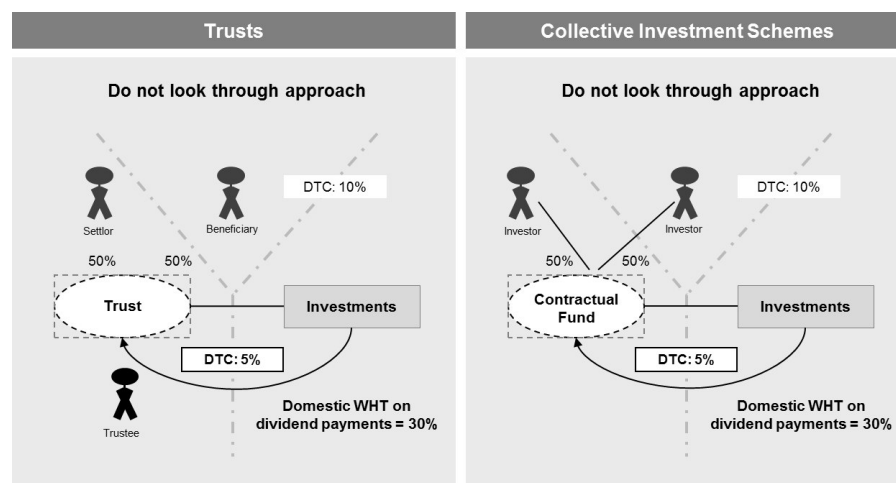
²⁰⁹² OECD Commentary 2014, nr. 6.21 ad Art. 1.

²⁰⁹³ See in detail: Chapter 6.3.6.

²⁰⁹⁴ DE BRUIN, Dutch closed mutual fund, p. 10-11.

other CISs and trusts to become established in the state of residence of the CIS, but merely for “*treaty shopping*” purposes. In such a situation, investment through a CIS becomes more attractive from a tax perspective than direct investments by the investors. Such practices could be avoided by restricting DTC benefits through general anti-abuse or anti-tax-treaty shopping rules, or by other specific provisions. In line with the reasoning of the CFA Report, however, a publicly traded CIS could never be effectively used for “*treaty shopping*”²⁰⁹⁵ since its shareholders or unit holders can never control the CIS in their own right, having only limited voting power. Thus, the approaches discussed below, which, by way of analogy, may also apply to trust relationships, are better suited to fulfil the ratio legis of avoiding abuse and tax treaty shopping.

Figure 6.16: Access to Double Tax Conventions of Collective Investment Schemes and Trusts



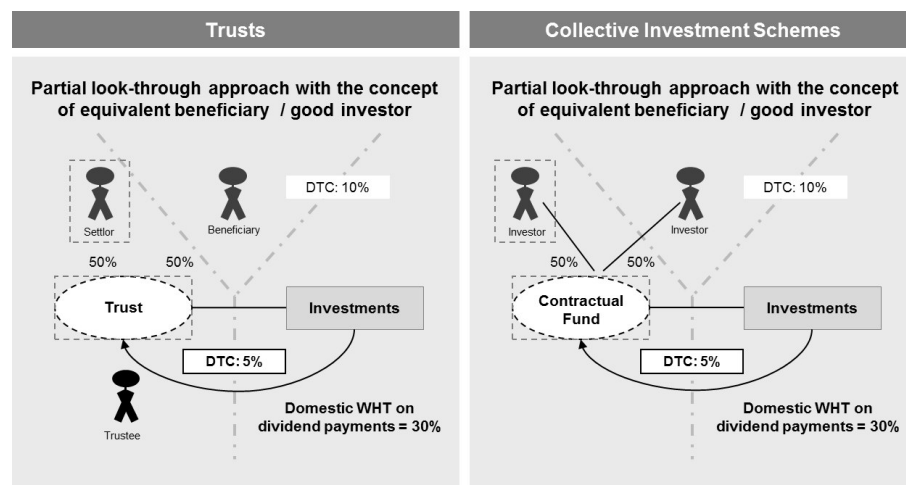
Source: Own figure

²⁰⁹⁵ In this vein also: GLÄSER, thesis, p. 254.

6.6.2 The “Partial Look-Through Approach” - Collective Investment Schemes and Trusts Have Partial Access to DTCs

The “*partial look-through*” approach deviates from the “*no-look through approach*” in that it provides for the avoidance of “*treaty shopping*”²⁰⁹⁶. The “*partial look-through approach*” ensures that the CIS’s investors (or the trust’s beneficiaries, settlors or trustees), who would have been entitled to benefits with respect to source state income if they had received it directly, are not put in a worse position by investing through a hybrid entity located in a third contracting state²⁰⁹⁷. In line with the CFA Report and to simplify the analysis, the following two approaches are only analyzed in relation to CISs. In theory, these approaches could be structured in other different ways²⁰⁹⁸.

Figure 6.17: Partial Access to Double Tax Conventions of Collective Investment Schemes and Trusts



Source: Own figure

²⁰⁹⁶ CFA Report, para. 52-57 and OECD Commentary 2014, nr. 6.19-6.20 ad Art. 1.

²⁰⁹⁷ OECD Commentary 2014, nr. 6.23 ad Art. 1.

²⁰⁹⁸ FIBBE, Changes to the OECD Commentary on Collective Investment Vehicles, p. 8.

6.6.2.1 The “Partial Look-Through” Approach

The “*partial look-through*” approach refers to a situation in which DTC access is available only to the extent that the investors of the CIS fulfill the conditions to be characterized as “*equivalent beneficiaries*”²⁰⁹⁹. The term “*equivalent beneficiary*” is defined by the CFA as: “*a resident of the Contracting State in which the CIV is established, and a resident of any other State with which the Contracting State in which the income arises has an income tax convention that provides for effective and comprehensive information exchange who would, if he received the particular item of income for which benefits are being claimed under this Convention, be entitled under that convention, or under the domestic law of the Contracting State in which the income arises, to a rate of tax with respect to that item of income that is at least as low as the rate claimed under this Convention by the CIV with respect to that item of income*”²¹⁰⁰. The individual residents must not necessarily be residents of the same contracting state as the CIS²¹⁰¹. More precisely, an investor resident in another contracting state than that of the CIS may only qualify as an “*equivalent beneficiary*” if the DTC rate is not less favorable than it would be through a direct investment. If the investors have less favorable DTC rates, they consequently will not be considered “*equivalent beneficiaries*”. In the case that the investors are not considered “*equivalent beneficiaries*”, the source state would not be required to provide a reduced DTC rate in respect of the portion of income attributable to these non-equivalent investors.

6.6.2.2 The “Partial Look-Through Approach Plus”

The “*partial look-through approach plus*” refers to a situation in which DTC entitlement is available only to the extent that investors are considered to be “*good investors*”. The term “*good investor*” is defined by the CFA as the “*individual who is a resident of the Contracting State in which it [the collective investment vehicle, comment by the author] is established and is the beneficial owner of the income it receives (provided that, if an individual*

²⁰⁹⁹ OECD Commentary 2014, nr. 6.21 ad Art. 1.

²¹⁰⁰ OECD Commentary 2014, nr. 6.21 b (ii) ad Art. 1.

²¹⁰¹ In this vein: BONGAARTS/ED, General report on the taxation of investment funds, p. 56.

*who is a resident of the first-mentioned State had received the income in the same circumstances, such individual would not have been considered to be the beneficial owner thereof), but only to the extent that the beneficial interests in the collective investment vehicle are owned by equivalent beneficiaries*²¹⁰². Under this approach, individual residents must necessarily be residents of the same contracting state as the CIS. However, the CFA goes a step further by suggesting that, when a certain threshold or percentage of the investors are either “good investors” or are residents of the contracting state in which the CIS is established, the CIS should be treated as resident in the contracting state in which it is established and as the beneficial owner of all of the income it receives²¹⁰³. This solution would also considerably mitigate some of the procedural obstacles of the investors that otherwise might arise in relation to (and might be disproportionate to the size of) the tax refund²¹⁰⁴.

This regulation is comparable to the Special Regulation on the Treaty Entitlement of Partnerships pursuant to the Negotiation Protocol of 18 June 1971 in connection with the Negotiation Protocols of 22/26 November 1971 and of 24/26 January 1972. In this regard, partnerships are considered to be directly entitled to withholding tax relief under the dividend, interest and royalty articles of the DTC between Switzerland and Germany when at least three-quarters of their profits can be attributed to individuals who are resident in the state in which the partnership is located²¹⁰⁵. This regulation clearly benefits third country partners because it does not solely rely on residence. A restriction applies, however, where the persons to whom the three-quarters are attributed could not claim the withholding tax relief by direct attribution as well²¹⁰⁶.

More precisely, an investor who is a resident of another contracting state to that of the CIS will not be considered a “good investor” until a certain threshold or percentage of “good investors” is reached. In general, the source state would be required to provide a reduced DTC rate (between the

²¹⁰² OECD Commentary 2014, nr. 6.26 ad Art. 1.

²¹⁰³ OECD Commentary 2014, nr. 6.27 ad Art. 1.

²¹⁰⁴ OECD Commentary 2014, nr. 6.27 ad Art. 1.

²¹⁰⁵ LANG/REICH/SCHMIDT, Personengesellschaften, p. 766-767. Michael Lang considers the partnership as entitled to treaty benefits. In contrast, Markus Reich and Christian Schmidt hold the opinion that it should be considered as a special regulation as according to Swiss law principles, the partnership is clearly not considered a tax resident.

²¹⁰⁶ Art. 4 para. 3 and 4 DTC Switzerland-Germany.

state of residence of the CIS and the state of residence of the individual residents) in respect of the portion of income attributable to the “good investors”. However, if the threshold is met, the source state could provide an even more attractive DTC rate or a greater foreign tax credit to individual residents than that applicable to CIS without DTC entitlement.

6.6.3 The “Look-Through Approach”

In the “look-through approach”, the CIS or trust is entitled to DTC benefits in its own right on behalf of its investors or beneficiaries, at the rates applicable between the source state and the state where the investors/beneficiaries reside, as if the DTC applied directly. In this scenario, unlike a direct claim, the CIS or trust is entitled to DTC access on behalf of certain of its investors or beneficiaries²¹⁰⁷. This approach ensures that the investors or beneficiaries profit from the preferential rates they would have been subjected to if they had invested directly²¹⁰⁸. This method is therefore comparable to the DTC entitlement of partnerships²¹⁰⁹. In order to ensure the preferential treaty position of investors investing directly, the CFA suggests adding the following paragraph: “*a collective investment vehicle described in subparagraph c) which is established in a Contracting State and which receives income arising in the other Contracting State shall not be treated as a resident of the Contracting State in which it is established, but may claim, on behalf of the owners of the beneficial interests in the collective investment vehicle, the tax reductions, exemptions or other benefits that would have been available under this Convention to such owners had they received such income directly*”²¹¹⁰. This special provision, however, is not clear. If such a special regulation were to apply to investors resident outside the contracting states, the term “*this Convention*” at the end of paragraph a) should be replaced by the terms “*any Convention to which the other Contracting State is a party*”.

²¹⁰⁷ The OECD has analysed this mechanism by introducing, on 23 January 2013, the Treaty Relief and Compliance Enhancement (TRACE) – Implementation Package for authorised intermediaries such as CISs. See the Report of the OECD’s Committee on Fiscal Affairs (“CFA”), The Treaty Relief and Compliance Enhancement (TRACE) - Implementation Package for Authorised Intermediaries System, in: OECD Report, 23 January 2013.

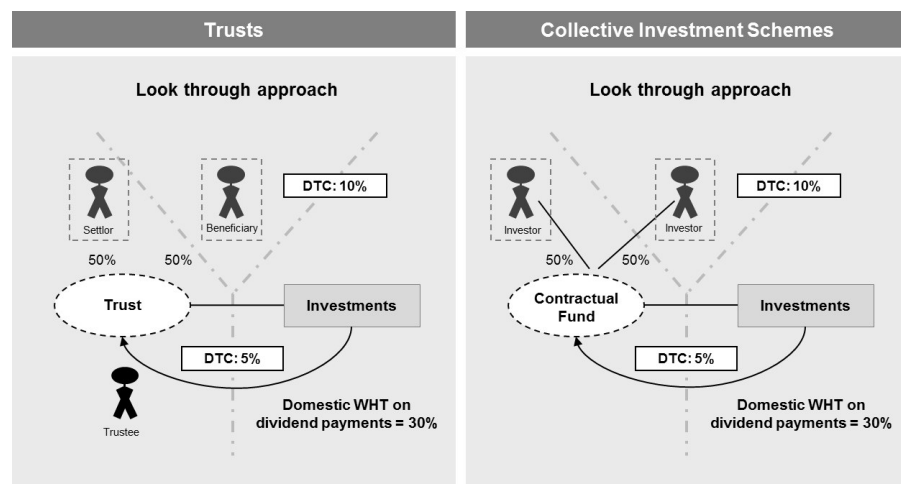
²¹⁰⁸ OECD Commentary 2014, nr. 6.28 ad Art. 1.

²¹⁰⁹ OECD Commentary 2014, nr. 6.5. ad Art. 1.

²¹¹⁰ OECD Commentary 2014, nr. 6.28 ad Art. 1.

If it is understood that any other Convention applies, this approach may extensively increase the administrative burden as the CIS or trust may have to determine the treaty position of each of its investors or beneficiaries.

Figure 6.18: Access to Double Tax Conventions by Collective Investment Schemes and Trusts on behalf of the Investors and Beneficiaries



Source: Own figure

6.6.4 Excursus: Access to Double Tax Conventions by Investors or Beneficiaries, Settlers and Trustees

If the CIS or trust is not considered to be a “resident person” within the meaning of Art. 4 para. 1 OECD Model, and is therefore not entitled, in its own right, to obtain benefits under the DTC, or rather to obtain a refund of the withholding tax on dividends or interest, it must be considered whether the investors of the CIS or the beneficiaries, settlors or trustees of the trust may generally fulfill the relevant conditions for DTC entitlements. If an investor resides in a state with which the source state has concluded a DTC but is not entitled to DTC benefits, the DTC’s purpose of eliminating double taxation cannot be fulfilled²¹¹¹. Moreover, the investor’s administrative burden

²¹¹¹ CFA Report, para. 36 and OECD Commentary 2014, nr. 6.26 ad Art. 1.

to obtain a refund may be too high in comparison to the amount of the tax refund at stake²¹¹². On the other hand, if tax administrations allow CISs or trusts to claim the refund on behalf of their investors and beneficiaries, this would align the interests of both businesses and governments since it would reduce the overall administrative compliance burden²¹¹³. Moreover, it would be practically impossible for investors to prove that Swiss or foreign source dividends and interest income were received through a fund²¹¹⁴. However, tax authorities would certainly be violating the DTC if they denied the request on the basis that the relevant investor, beneficiary, settlor or trustee does not earn income from Swiss or foreign dividends or interest, but rather from their participation in the CIS or trust. Such a formal interpretation would not be in line with the purposes of the DTC.

In countries with which Switzerland has concluded a special protocol or exchange of letters regarding the treatment of CISs, the claim for refund of the withholding tax may be made by the CIS as representative of the investors²¹¹⁵. Sometimes this practice is combined with an individual tax refund claim. For example, if an investor resident in Germany indirectly holds a qualifying participation in a Swiss company through a foreign CIS, he should be entitled to obtain a full refund of the withholding tax. In a first step, the refund of 20% of the 35% Swiss withholding tax can be obtained by the CIS²¹¹⁶, and in a second step, the remaining 15% can be obtained by the investor in his own name²¹¹⁷.

²¹¹² SORGENFREI, *Steuerlicher Transparenzgrundsatz*, p. 471.

²¹¹³ CFA Report, para. 38 and OECD Commentary 2014, nr. 6.28-31 ad Art. 1.

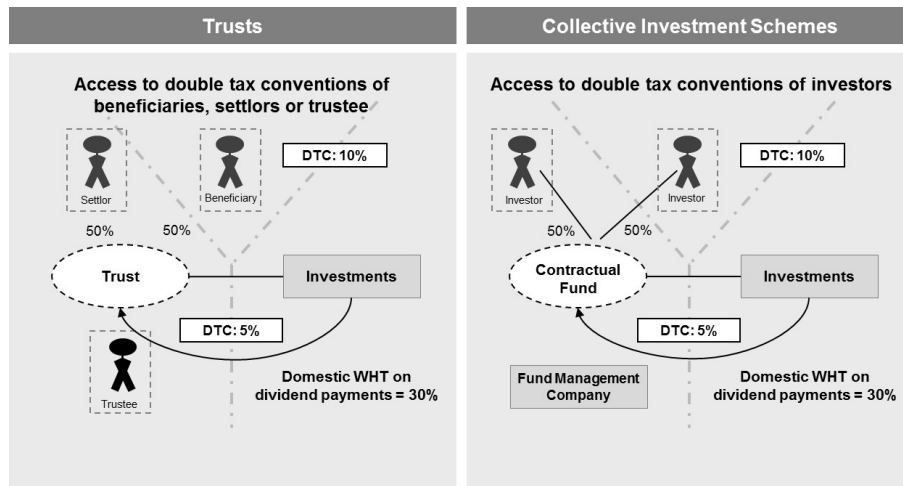
²¹¹⁴ CFA Report, para. 37 and OECD Commentary 2014, nr. 6.28-31 ad Art. 1.

²¹¹⁵ See Chapter 2.3.6.5.

²¹¹⁶ Art. 10 para. 2 (c) DTC Switzerland-Germany. HEUBERGER/OESTERHELT, *Collective Investment Vehicles*, p. 36, Footnote 22.

²¹¹⁷ Art. 10 para. 3 DTC Switzerland-Germany.

Figure 6.19: Access to Double Tax Conventions by Investors or Beneficiaries, Settlers or Trustee



Source: Own figure

7 The Application of DTCs to CISs and Trusts from a Swiss Perspective

*Denn es ist nicht genug, einen
guten Kopf zu haben; die Hauptsache
ist, ihn richtig anzuwenden
(René Descartes, 1596-1650)*

7.1 General Introduction

This chapter will treat different case scenarios in order to illustrate the application of DTCs to CISs and trusts from a Swiss perspective. The analysis will consider the scenario of Switzerland both as the source country²¹¹⁸ and the residence country²¹¹⁹. In a first step, cases without a qualification conflict, in which the hybrid entity is consistently treated as either fiscally-opaque (intransparent) or fiscally-transparent (*“flow-through”*) by both the source and residence countries, are discussed. In a second stage, the author will address the opposite case where qualification conflicts can arise in the treatment of the hybrid entity as either fiscally-opaque (intransparent) or fiscally-transparent (*“flow-through”*) due to the differences in the domestic tax laws of the residence and source states, resulting in DTCs being applied in a different way under the respective states’ laws.

If Switzerland is the source country, a number of possible scenarios may be distinguished. For instance, Switzerland can consider the foreign CIS/trust as *“resident”* for DTC purposes and may attribute the income to the CIS/trust (intransparent view). In this scenario, one must examine whether the CIS/trust is entitled to DTC benefits provided for in the DTC between the source country (Switzerland) and the residence country where the CIS/trust is located.

In other situations, Switzerland does not consider the CIS/trust as *“resident”* under the DTC, and the income might be attributed to the parties involved, such as the investor of a CIS or the beneficiary of a trust (transparent view). In these scenarios, the DTC benefits must be examined at the investor’s or

²¹¹⁸ See Chapter 7.1.1.

²¹¹⁹ See Chapter 7.1.2.

beneficiary's level. Insofar as the "*attribution of income*" proves to be unproblematic, the individual articles on distribution, namely Art. 10, 11, 12, 13 para. 5 and 21 OECD Model, must be examined regarding their applicability to the specific source incomes. The analysis of the term "*beneficial ownership*" contained in Art. 10, 11 and 12 OECD Model is of particular importance to this purpose.

Switzerland may also, in certain scenarios, be the residence country of either the CIS/trust or the investor/beneficiary. The first of these scenarios is the situation in which the CIS/trust has an unlimited tax liability in Switzerland. In principle, this situation is unlikely to occur. Indeed, CIS are generally not considered tax-subjects in Switzerland, but rather fiscally-transparent entities ("*flow-through*")²¹²⁰. As far as trusts are concerned, they are not tax subjects in Switzerland, either. This results explicitly from Circular Letter 20/30²¹²¹. Therefore, and under the current treaty framework, it is more likely that an investor within a CIS or a beneficiary of a trust - and not the CIS/trust entity itself - is "*liable to tax*" under the Swiss DTCs and fulfills the criteria for DTC benefits. In other words, one needs to assess whether the CIS/trust entity itself or its investors/beneficiaries may benefit from the access to DTCs.

As for the "*residency*" criteria, the analysis should be made in the light of Art. 4 para. 1 OECD Model. If the CIS/trust is considered, for instance, as fiscally-opaque (intransparent) by the state of establishment (and therefore fulfills the "*liable to tax*" criteria according to Art. 4 para. 1 OECD Model), the requirements for access to the DTC between the residence state where the CIS/trust is established and the source state at the investment level would be fulfilled. As a result, the income generated in the source state at the investment level would generally fall within the scope of the relevant DTC. Any withholding tax perceived on that income would need to be reduced based on the relevant DTC article.

On the other hand, if the CIS/trust is not considered as fiscally-opaque (intransparent) by the state of establishment, (and thus not "*liable to tax*" under Art. 4 para. 1 OECD Model), the requirements for access to the DTC between the residence and the source state would generally not be fulfilled. Nevertheless, the investor/beneficiary of the CIS/trust under analysis could

²¹²⁰ See Chapter 2.3.3.

²¹²¹ See Chapter 3.3.3.

be entitled to DTC access, if the relevant requirements for DTC access are met.

If the persons involved are considered Swiss residents for DTC purposes, the distribution from either the CIS or the trust must be assessed (if the assets were not already attributed for tax purposes, as in the scenario of a revocable trust). Insofar as the “*attribution of income*” proves to be unproblematic, the individual articles on distribution, namely Art. 10, 11, 12, 13 para. 5 and 21 OECD Model must be examined depending on specific types of income because the applicability of these articles of distribution is different for each scenario. Either Switzerland considers the CIS/trust as “*resident*” for DTCs purposes and attributes the income to the CIS/trust (intransparent view) or the CIS/trust is not considered as “*resident*” under the DTC and the income may directly be attributed to the parties involved, i.e. the investor of a CIS or the beneficiary of a trust (transparent view).

Whether Switzerland is the source country or even if it is the residence country, bilateral attribution conflicts as well as attribution conflicts in triangular scenarios need to be examined. Despite the multitude of conceivable attribution conflicts, the following chapters will only analyze certain selected cases. In order to avoid repetition, references will be made to issues discussed in previous chapters²¹²².

Although the following analysis explicitly deals with the beneficiary of a trust, the DTC analysis can generally be applied by analogy to the settlor. It should be noted that a trust cannot be established under Swiss law, and is therefore always of foreign legal nature. As a reminder, the concept of “*beneficial ownership*” and the “*attribution of income*” criteria are, amongst other conditions, crucial for determining the personal scope of application of a DTC. As already explored, the “*beneficial ownership*” and “*attribution of income*” (if applicable) requirements cannot be considered as stand-alone conditions in the case of hybrid entities such as CISs, trusts and partnerships²¹²³.

²¹²² See Chapter 6.4.4.

²¹²³ See Chapter 6.

In this sense, the Partnership Report does not focus on the requirement of “*beneficial ownership*”. The Report rather deals with conflicts of attribution²¹²⁴ and links the requirement of “*attribution of income*” to the “*beneficial ownership*” concept²¹²⁵. In fact, in the Partnership Report, the “*beneficial ownership*” criteria is closely linked to the fulfilment of the “*attribution of income*” criteria. This goes against the original purpose of the “*beneficial ownership*” concept²¹²⁶. According to the Partnership Report, a partnership is deemed to be the “*beneficial owner*” of the income it receives if the partnership is treated as fiscally-opaque (intransparent)²¹²⁷. However, if the partnership is fiscally-transparent (“*flow-through*”), the partners will be considered the “*beneficial owners*” (depending on their respective residence country for treaty purposes)²¹²⁸.

Under the CIV Report, a vehicle that meets the definition of a CIS as explained in paragraph 4 of such Report is to be considered the “*beneficial owner*” of the income it receives, as long as the managers of the CIS have

²¹²⁴ OECD, Partnership Report, para. 54: “*Another approach would involve consideration of the terms of the distributive rules in the relevant Articles of the Convention. Under that analysis, in the case of dividends, interest and royalties, the inquiry would be whether or not the recipient of the item of income was the beneficial owner of the income under the laws of the State of residence of the taxpayer claiming treaty benefits and thus the taxpayer in relation to the income. In the case of a partnership treated as transparent under the laws of the source State but as a taxable entity under the laws of the residence State, the entity itself and not the partners would be treated as the beneficial owner (emphasis added by the author). Because of the treatment of the income in the State of residence, the partners would not be the beneficial owners of the income for purposes of the treaty. Thus the partners would not be entitled to treaty benefits in those circumstances and whether the entity was so entitled would depend on whether it independently qualified as a resident*”.

²¹²⁵ See Chapter 6.1.4. In this vein also: LANG, General report on double non-taxation, p. 44.

²¹²⁶ VANN, Beneficial Ownership: Recent Trends, p. 301.

²¹²⁷ OECD, Partnership Report, para. 33 and OECD Commentary 2014, nr. 5 ad. Art. 1.

²¹²⁸ OECD, Partnership Report, para. 54 and OECD Commentary 2014, nr. 8.8 ad. Art. 4.

Interestingly, some countries such as Austria extend the Partnership Report solution to other type of entities, such as trusts. In this sense, they solve the problem of who the “*beneficial ownership*” is by applying the “*attribution of income*” criteria. Katharina Kubik cites Austrian case law that shows how a trust in Austria is always the “*beneficial owner*” of income that Austria attributes to the trust, pursuant to its interpretation of the “*attribution of income*” requirement. See KUBIK, thesis, p. 157.

discretionary powers to manage the assets on behalf of the investors, and the CIS meets the requirements to be considered a “*person*” and a “*resident*” of the State in which the CIS is established²¹²⁹. Interestingly, the CIV Report, unlike the Partnership Report, is silent in regard to the “*attribution of income*” criteria²¹³⁰. Lastly, even though under the BEPS Action No. 2 (Treaty Issues) the fulfilment of these criteria is a mandatory requirement for trusts, it is the author’s view such requirement is not necessary for CISs that want to benefit from DTC access. In this sense, the Partnership Report and BEPS Action No. 2 (Treaty Issues) cannot simply be applied (by analogy) to CISs²¹³¹.

7.1.1 Switzerland as the Source Country

This chapter examines the scenario in which Switzerland is the source country of the income and analyses the tax consequences for DTC purposes from the Swiss perspective for CISs and their investors as well as trusts and their beneficiaries.

7.1.1.1 *Equal Treatment of CISs and Trusts: Fiscally-Opaque in the Residence Country of the CIS/Trust and Fiscally-Opaque at the Investment Level in the Source Country*

In the situation described in the title, the author assume that Switzerland is the source country of a certain income. The foreign CIS/trust directly invests in Swiss assets and obtains Swiss source income that is subject to Swiss withholding tax at a rate of 35%. Neither the CIS/trust nor any investors of the CIS or any party involved in the trust structure is a tax resident in Switzerland. Furthermore, the author assumes that both the residence country of the CIS/trust and Switzerland as the source country consider the CIS/trust to be fiscally-opaque (intransparent).

In this scenario, the question arises as to whether the CIS/trust is entitled to relief from Swiss withholding tax, that is, whether the DTC requirements are fulfilled and, if so, by whom (the CIS/trust or the investor/beneficiary). Due

²¹²⁹ CFA Report, para. 33 and OECD Commentary 2014, nr. 6.14 ad. Art. 1.

²¹³⁰ See Chapter 6.1.2.3.5.

²¹³¹ See Chapter 6.1.3.

to the fact that the hybrid entity is fiscally-opaque (intransparent) in its residence country, the CIS/trust is considered as “*person*”²¹³² and “*resident*”²¹³³ under the DTC entered into by the source and residence countries. In a trust relationship, unlike for CISs, both the criteria of “*beneficial owner*” and the “*attribution of income*” must be fulfilled²¹³⁴.

If the CIS/trust is considered as a “*resident*” by the state of establishment in the sense of the DTC, it is also considered “*resident*” in the other contracting state. As a consequence, the DTC between Switzerland and the residence country is applicable. A CIS/trust may claim treaty benefits in its own name, irrespective of where the relevant investors/beneficiaries are residents. The following subsections examine a few of the problematic issues relating to CISs/trusts from a Swiss perspective.

7.1.1.1.1 Treaty Eligibility of Foreign CISs organized in Corporate Form

CISs organized in corporate form (such as the foreign SICAV) are included in the personal scope of Art. 3 para. 1 (a) OECD Model as, from a Swiss perspective, they are comparable to a legal entity. According to the wording of Art. 3 para. 1 (b) OECD Model, a SICAV is a “*company*” and, therefore, considered a “*person*” in the DTC context.

The OECD Model addresses the concept of “*residency*” in Art. 4 para. 1 and determines that it is defined by the tax treatment in the two contracting states. The determination of whether a CIS is a “*resident*” of a contracting state depends on the tax treatment of the CIS (whatever its legal form) in the state of establishment, which may vary considerably from one country to another. The CIVs Report, conversely, specifically defines the residency criteria. It distinguishes between fiscally-transparent (“*flow-through*”) and fiscally-opaque (intransparent) entities. Amongst opaque entities, the CIVs Report differentiates four types of tax treatments: (i) CISs that are tax-exempt under the condition that they fulfil certain criteria; (ii) CISs that are subject to tax but whose base is reduced in proportion to distributions paid to investors; (iii) CISs subject to a low or zero tax rate; and (iv) CISs that are fully

²¹³² See Chapter 6.2.

²¹³³ See Chapter 6.3.

²¹³⁴ See Chapter 6.1.3.

taxed but use mechanisms to grant credit for the investor payment to avoid double taxation. The CIVs Report only excludes from the definition of “*resident*” those CISs that are fiscally-transparent (“*flow-through*”) and totally and unconditionally exempt²¹³⁵. A CIS will be considered a “*resident*” if the contracting state treats the CIS as fiscally-opaque (intransparent), even when that state does not in fact impose any tax on the CIS. Thus, the residence test used by the CIVs Report is consistent with the definition of “*liable to tax*” contained in Paragraph 8.5 of the Commentary on Art. 4 of the OECD Model Convention. The CIVs Report, however, recognizes that not all countries agree with the principles of Paragraph 8.5. Therefore, the CIVs Report suggests that the issue of residency should be negotiated between contracting countries²¹³⁶.

From a Swiss perspective, the “*resident*” criteria is fulfilled if there is in at least one contracting state simple recognition as a taxpayer with a locality-related or territorial attachment to the jurisdiction, irrespective of whether any income taxes are effectively paid. Therefore, it may be assumed that CISs in corporate form fulfills the requirement of residency. The Federal Administrative Court has recently confirmed this solution in a case of a corporate entity in the “*Madeira*” case of September 7, 2011, which in turn has a direct impact on the corporate form of CISs, such as SICAVs²¹³⁷. However, the requirement of residency is not fulfilled in the context of a Swiss SICAV under the OECD materials²¹³⁸ since the CIV Report clearly excludes from the definition of “*resident*” those CISs that are fiscally-transparent and totally and unconditionally exempt²¹³⁹.

As far as the “*attribution of income*” criteria is concerned, the CIV Report is silent in this regard. Thus, this criteria will not be discussed under this chapter, which is only addressing CISs.

Finally, the “*beneficial ownership*” requirement needs to be fulfilled. As said, this requirement derives from the distributive rules, in particular Art. 10

²¹³⁵ CFA Report, para. 29 and OECD Commentary 2014, nr. 6.12 ad. Art. 1.

²¹³⁶ CFA Report, para. 30 and OECD Commentary 2014, nr. 6.11 ad. Art. 1.

²¹³⁷ See Chapter 6.3.6.3.

²¹³⁸ See Chapter 6.3.6.3.

²¹³⁹ CFA Report, para. 29 and OECD Commentary 2014, nr. 6.11 and 6.12 ad. Art. 1.

para.1 OECD Model on dividends, and Art.11 para. 1 OECD Model on interest. Under these rules, in order to obtain a reduction of the withholding tax, the CIS must be the “*beneficial owner*” of the relevant income. There is disagreement amongst scholars on how to interpret the term “*beneficial ownership*”²¹⁴⁰. According to the OECD Commentary, a CIS organized in a corporate form, which meets the definition of a CIS in light of the CIV Report²¹⁴¹ should be considered as the “*beneficial owner*” of the income it receives as long as the managers have discretionary powers to manage the assets on behalf of the interest holders of the CIS²¹⁴².

7.1.1.1.2 Treaty Eligibility of Foreign Contractual CISs/Trusts

In principle, contractual CISs and trusts are not included in the personal scope of Art. 3 para. 1 (a) OECD Model, unless they are effectively taxed at the level of the CIS/trusts. Switzerland, however, has concluded DTCs with some common law jurisdictions such as, for instance, the United States and Canada. These DTCs specifically include trusts in their definition of “*person*”. Under these treaties (and only when specifically so provided for), trusts are included in the definition of “*person*”. As far as foreign contractual CISs are concerned, it should be mentioned that a few Swiss DTCs include specific provisions allowing bundled refund claims of the investors. The application of these provisions to CISs mainly occurred by way of amendments to DTCs concluded with some contracting states such as Australia, Denmark, Germany, France, the United Kingdom, Japan, Canada, the Netherlands, Norway, Austria, Sweden and Spain. For such bundled refund claims, the treaty entitlement of the individual investors is decisive. Under these agreements, DTC benefits may be claimed fully or partially by CISs on behalf of, and by reference to, qualifying Swiss resident investors in Switzerland²¹⁴³.

²¹⁴⁰ See Chapter 6.5.2.

²¹⁴¹ The criteria being that it is “*widely-held*” with a “*diversified portfolio of securities*” and subject to “*investor-protection regulation*”.

²¹⁴² OECD Commentary 2014, nr. 6.8, 6.14 ad. Art. 1.

²¹⁴³ Chapter 2.3.6.5.

Considering the “*residence*” criteria, the determination of whether a foreign contractual CIS is a “*resident*” of a contracting state depends on the tax treatment of the CIS in the state of establishment²¹⁴⁴ which, as already mentioned, may vary considerably from one country to another. This fact is acknowledged by the CIV Report, where at least four types of different tax treatment for opaque entities are distinguished²¹⁴⁵, and only those CISs that are fiscally-transparent and totally and unconditionally exempt are excluded from the definition of “*resident*”²¹⁴⁶.

Nevertheless, it should be noted that from a Swiss perspective, contractual CISs and trusts are only considered as “*resident persons*” within the meaning of Article 4 para. 1 OECD Model if they are subject to corporate income tax and considered fiscally-opaque (intransparent) in the residence country. The author assumes that fiscally-transparent (“*flow-through*”) contractual CISs and trusts are clearly not classified as “*resident persons*” and thus, do not fulfill the requirement of residency under the current Swiss DTCs. Consequently, they are not entitled to treaty benefits. In the author’s view, the “*Madeira*” case has no impact in the case of contractual CISs or trusts as its scope is limited only to CISs in corporate form (such as SICAVs) and under no circumstances could be extended to contractual CISs or trusts. There is no indication that the “*Madeira*” decision should also be applicable to contractual CISs/trusts.

When assessing the “*attribution of income*” criteria, it should be kept in mind that under the BEPS Action 2 Report that requirement is only applicable to trusts, but not to CISs. As mentioned above, the CIV Report is silent in regards to the “*attribution of income*” criteria. Therefore, the author suggests that this criteria should not apply for CISs.

Finally, as far as the “*beneficial ownership*” criteria is concerned, please refer to the discussion above or in previous chapters²¹⁴⁷ for a more detailed discussion on the specific requirements.

²¹⁴⁴ CFA Report, para. 28 and OECD Commentary 2014, nr. 6.11 ad. Art. 1.

²¹⁴⁵ CFA Report, para. 28 and OECD Commentary 2014, nr. 6.11 ad. Art. 1.

²¹⁴⁶ Chapter 6.3.6.3.

²¹⁴⁷ See Chapter 6.5.

7.1.1.1.3 Treaty Eligibility of CISs Taking the Form of Partnerships

The treaty eligibility of CISs taking the form of partnerships requires a preliminary comment. For CISs in the form of partnerships, both the Partnership Report as well as the CIV Report may be applicable since partnerships are CISs in a special form. It is thus submitted that the CIV Report is applicable to partnerships as a "*lex specialis*". Whether tax authorities would follow this submission in a particular case is however, unclear. In the present chapter, only an assessment under the Partnership Report will be performed. For the analysis of the treaty eligibility of partnerships under the CIV Report, please refer to the previous chapter.

CISs in the form of partnerships are included in the personal scope of Art. 3 para. 1 (a) OECD Model. However, a CIS in the form of a partnership only fulfills the requirement of a "*resident person*" in the sense of Article 4 para. 1 OECD Model if it is subject to corporate income tax and considered fiscally-opaque (intransparent) in its residence state²¹⁴⁸. The author assumes that fiscally-transparent partnerships are not considered "*resident persons*" and therefore do not fulfill the requirement of residency, making them ineligible for treaty benefits.

As far as the "*beneficial ownership*" requirement is concerned, the Partnership Report links the latter to the "*attribution of income*" requirement²¹⁴⁹. In other words, there is a presumption that a partnership fulfils the "*beneficial ownership*" condition if a certain income can be attributed to it²¹⁵⁰. This goes against the original purpose of the "*beneficial ownership*" concept²¹⁵¹. According to the Partnership Report, a partnership is deemed to be the "*beneficial owner*" of the income it receives if the partnership is treated as fiscally-opaque (intransparent)²¹⁵². However, if the partnership is fiscally-transparent

²¹⁴⁸ OECD, Partnership Report, para. 33 and OECD Commentary 2014, nr. 5 ad. Art. 1..

²¹⁴⁹ See Chapter 6.1.2.3.4.2. In this vein also: LANG, General report on double non-taxation, p. 44.

²¹⁵⁰ OECD, Partnership Report, para. 35 and OECD Commentary 2014, nr. 6.4 ad. Art. 1.

²¹⁵¹ VANN, Beneficial Ownership: Recent Trends, p. 301.

²¹⁵² OECD, Partnership Report, para. 35 and OECD Commentary 2014, nr. 5 ad. Art. 1.

(“*flow-through*”), the partners will be considered to be the “*beneficial owners*” (depending on their respective residence country for treaty purposes)²¹⁵³.

For a more detailed discussion on the specific requirements of the terms “*attribution of income*” as well as “*beneficial ownership*”, see above or the previous chapters²¹⁵⁴.

7.1.1.2 *Equal Treatment of CISs and Trusts: Fiscally-Transparent in the Residence Country of the CIS/Trust and Fiscally-Transparent at the Investment Level in the Source Country*

In this scenario, the author assumes that Switzerland as the source country considers the CIS/trust to be fiscally-transparent (“*flow-through*”). Thus, the Swiss source income from investments, subject to the Swiss withholding tax at a rate of 35%, may preserve its original character, and be attributed to and taxed at the level of the investor of a CIS or the beneficiary of a trust. Furthermore, the author assumes that the residence country of the CIS/trust also considers the CIS/trust to be fiscally-transparent (“*flow-through*”). The income may be attributed to and taxed at the level of the investor of the CIS or at the level of the beneficiary of the trust, both not being residents in Switzerland.

If Switzerland considers the CIS/trust to be fiscally-transparent (“*flow-through*”), resulting in the income being taxed at the level of the investor/beneficiary, then the question as to whether the CIS/trust is entitled to treaty benefits becomes redundant. Rather, the relevant question is now whether the investor/beneficiary can be considered “*resident*” and may, as a consequence, benefit from the DTC between his residence country and the source country.

²¹⁵³ OECD, Partnership Report, para. 54 and OECD Commentary 2014, nr. 5 ad. Art. 1 and nr. 8.8 ad. Art. 4. Interestingly, some countries such as Austria solve the problem of “*beneficial ownership*” by applying this term in relation to the “*attribution of income*” criteria. Katharina Kubik demonstrates with Austrian case law how a trust in Austria is always the beneficial owner of income that Austria attributes to the trust, pursuant to the Austrian interpretation of the “*attribution of income*” requirement. See KUBIK, thesis, p. 157.

²¹⁵⁴ See Chapter 6.4 and Chapter 6.5.

Assuming that the other contracting state attributes the income to the same tax subject (i.e. also the investor/beneficiary), the DTC should be applicable in order to get relief from Swiss withholding tax, provided that the “*beneficial owner*” of the income is a resident of the other state. In that case, the income preserves its original character. As a result, it is necessary to determine the relevant distribution article for every type of income. An indicator to determine who has the “*beneficial ownership*” over a certain income is to assess the power to dispose of said income. If the taxable entity has the power to take decisions in regard to income distribution, and the formal income recipient does not have a say in the distribution of the income, there is no doubt that the taxable entity, and not the investor/beneficiary is the “*beneficial owner*” of this income²¹⁵⁵.

The parameters of this scenario essentially correspond to and can be compared with those laid out in example 1 of the Partnership Report²¹⁵⁶, in which the OECD tax committee arrives at the same conclusion. For the following discussion regarding conflicts of attribution, the reasoning behind this conclusion seems to be of great significance. In example 1 of the Partnership Report, the relevant article of distribution (i.e. Art. 11 para. 1 OECD Model) is applicable to interest distributed to “*a person resident in the other Contracting State*”. Therefore, under the given circumstances, it seems appropriate to consider the income as “*paid to*”²¹⁵⁷ the shareholders (investors), as the income is attributed to the shareholders (investors) and not to the company (CIS) for the purpose of determining tax liability in the residence country²¹⁵⁸.

²¹⁵⁵ See Chapter 6.5.

²¹⁵⁶ Partnership Report, Example 1: “*P is a partnership established in State P. A and B are P’s partners who reside in State P. Both States P and S treat P as a transparent entity. P derives interest income from State S that is not attributable to a permanent establishment in State S*”.

²¹⁵⁷ It is suggested that the meaning of the term “*paid to*” should be interpreted by analogy to the meaning developed in the Partnership Report, stating that an item of income is considered “*paid to*” a resident of a Contracting State if the latter exercises its taxing power over the income.

²¹⁵⁸ OECD, Partnership Report, para. 48. “[...] Under paragraph 1 of Article 11, the Article applies to interest that is “*paid to a resident of another state*”. In these circumstances, the income is appropriately viewed as “*paid*” to A and B since it is to them and not to the partnership that the income is allocated for purposes of determining their tax liability in State P (...)”.

In the case of CISs, the CIV Report is silent regarding the interpretation of the term "*paid to*". This leads to conceive its interpretation differently. A first possibility is to assume that an appropriate meaning of the term "*paid to*" could be the one developed in the Partnership Report, as described above. However, the Partnership Report is only applicable to CISs in the form of partnerships. For CISs in general, the analysis of the "*paid to*" requirement will thus need to be conducted under the CIV Report. A second option is to assume that the "*paid to*" definition could be the one developed in the BEPS Action Nr. 2 (Treaty Issues). A third option is to assume that the "*paid to*" requirement has no relevance for CISs. In the author's view, the third option, in line with the CIV Report, is the correct one²¹⁵⁹. Indeed, the analysis outlined above shows that the "*attribution of income*" criteria developed under the Partnership Report does not apply to CISs²¹⁶⁰. Moreover, the BEPS Action Nr. 2 (Treaty Issues) is not applicable to CISs, either²¹⁶¹.

It is worth noting again that a few Swiss DTCs include specific provisions allowing bundled refund claims of the investors²¹⁶², included mainly by way of amendments to DTCs. Examples of such treaties are those concluded with Australia, Denmark, Germany, France, the United Kingdom²¹⁶³, Japan, Canada, the Netherlands, Norway, Austria, Sweden and Spain²¹⁶⁴. In order to be entitled to claim the bundled refund, it is vital that the individual investor is entitled to treaty benefits. These agreements provide that CISs on behalf of,

²¹⁵⁹ See Chapters 6.1.2.3.5.3 and 6.1.2.3.5.5.

²¹⁶⁰ See Chapter 6.1.3.2.

²¹⁶¹ See Chapter 6.1.3.3.

²¹⁶² See GLÄSER, thesis, p. 111.

²¹⁶³ Until 31 December 2008, the DTC between Switzerland and the UK provided for the treaty entitlement of investment funds in Art. 27 para. 9 (for the origin of the provision, see MÉNÉTREY, *Modification de la convention*, p. 545 et seq.). However, this provision was revoked with the revision protocol of 27 June 2007 and of 31 December 2008. It was replaced with the above mentioned regulation. Ever since, CISs must rely on the revision protocol in order for treaty benefits to be applicable to shareholders residing in Switzerland.

²¹⁶⁴ Annex III of Circular 24.

and by reference to, qualifying Swiss resident investors in Switzerland²¹⁶⁵ may fully²¹⁶⁶ or partially²¹⁶⁷ claim DTC benefits.

7.1.2 Switzerland as the Residence Country

In this chapter, the analysis will focus on case scenarios where Switzerland is the residence country. With regard to CISs, in principle only its investors may be subject to unlimited tax liability in Switzerland since it considers the CISs themselves as, in general, fiscally-transparent (*“flow-through”*) and they therefore do not fulfill the *“liable to tax”* criteria. With regard to trusts, only the beneficiary, but not the trust or the trustee, may be subject to unlimited tax liability in Switzerland.

This analysis is comprised of two sub-chapters. The first sub-chapter is based on the assumption that the CISs/trusts are considered as fiscally-opaque (intransparent), and therefore, an independent tax-subject, in both contracting states. In a first step, an analysis on the avoidance of double taxation at the level of the Swiss CIS (such as a Swiss SICAV) will be conducted. In a second step, the avoidance of double taxation at the level of the investors/beneficiaries will be discussed.

²¹⁶⁵ Annex III of Circular 24.

²¹⁶⁶ A full refund of the withholding tax perceived on interests can be claimed under the DTC with Denmark (Art. 11 para. 1 DTC CH – DK), Germany (Art. 11 para. 1 DTC CH – D), France (Art. 12 para. 1 DTC CH – F), Norway (Art. 11 para. 1 DTC CH – N) and Austria (Art. 11 para. 1 DTC CH – A). A full refund of the withholding tax perceived on dividends can only be claimed under the DTC with Denmark (Art. 10 para. 1 DTC CH – DK).

²¹⁶⁷ The withholding tax perceived on dividends can be reduced by 15% under the DTCs with Australia (Art. 10 para. 2 DTC CH-AUS), Germany (Art. 10 para. 2 (c) DTC CH – D), France (Art. 11 para. 2 (a) DTC CH – F), Japan (Art. 10 para. 2 (b) DTC CH – J), Canada (Art. 10 para. 2 (c) DTC CH – CAN), Norway (Art. 10 para. 2 DTC CH – N), Austria (Art. 10 para. 2 DTC CH – A), Sweden (Art. 10 para. 2 phrase 1 DTC CH – S) and Spain (Art. 10 para. 2 (b) DTC CH – E).

In a second sub-chapter, the analysis is based on the opposite assumption that the CIS/trust is considered as fiscally-transparent (“*flow-through*”) in both contracting states and that, as a consequence, the assets and income are attributed to the relevant investor/beneficiary.

This analysis will, however, not discuss the situation of trusts/trustees as they are not considered a tax-subject in Switzerland, and thus they are not considered “*residents*” for DTC purposes. In fact, according to the Swiss Circular Letters 20/30, trusts are considered as fiscally-transparent (“*flow-through*”) in Switzerland. At most, a trust beneficiary (but not the trust itself) may be considered a “*resident*” (as he is subject to unlimited taxation) in Switzerland.

7.1.2.1 *Equal Treatment of CISs and Trusts: Fiscally-Opaque in the Residence Country of the CIS/Trust or its Investor/Beneficiary, and Fiscally-Opaque at the Investment Level in the Source Country*

The following section deals with residency for DTC purposes of CISs and their investors as well as trusts and their beneficiaries from the perspective of Switzerland as the residence country.

7.1.2.1.1 Application of DTCs to CISs Considered as Fiscally-Opaque in Both Switzerland as the Residence Country of the CISs and the Source Country of the Income

In this scenario, the author considers the CIS to be fiscally-opaque (intransparent) in both the source country of its income from fund investments as well as in its residence country. Trusts will not be discussed in this chapter since, as already mentioned, according to the Swiss Circular Letters 20/30, a trust may never be considered as fiscally-opaque (intransparent) in Switzerland.

If under the domestic tax law of their residence country, Swiss corporate CISs are “*liable to tax*”, they are considered “*residents*” according to the DTC between the source country of investments and the residence country.

Therefore, CISs fulfill the criteria of the method articles²¹⁶⁸. As a result, the credit method of Art. 23A OECD Model or the exemption method of Art. 23B OECD Model become applicable, and determine whether withholding tax on dividends²¹⁶⁹ or interest²¹⁷⁰ must be paid in the source country²¹⁷¹. The question as to whether the income of the CIS is subject to withholding tax or can be exempted from it depends on whether (i) the person receiving the dividends/interests is a “*resident*” person, (ii) the income may be “*attributed to*” the resident person²¹⁷² and (iii) the “*beneficial owner*” of the dividends/interest is a “*resident*” of the other contracting state²¹⁷³.

The increased clarity provided by the CIV Report in regards to the application of DTCs to CISs has been welcomed by practitioners. It should be noted that, according to the OECD materials, the requirement of residency would not be fulfilled in the context of a Swiss SICAV²¹⁷⁴. The view adopted by the Swiss Federal Supreme Court in its recent “*Madeira*” decision, conversely, suggests that the residency requirement would be fulfilled in the case of a SICAV organized in corporate form²¹⁷⁵.

Due to the lack of effective tax burden, adding a charge on a CIS whose income is fiscally-transparent (“*flow-through*”) in Switzerland will usually be without impact. Similarly, perceiving the withholding tax at the level of the

²¹⁶⁸ Art. 23 A and B OECD Model.

²¹⁶⁹ Art. 10 OECD Model.

²¹⁷⁰ Art. 11 OECD Model.

²¹⁷¹ For further details: AIGNER, thesis, p. 114.

²¹⁷² Due to the silence of the CIV Report regarding the interpretation of the term “*paid to*”, it may be assumed that an appropriate meaning could be the one developed in the Partnership Report. In the Partnership Report it is stated that an item of income is considered “*paid to*” a resident of a contracting state if the latter exercises its taxing power over the income. A second option is to assume that the “*paid to*” requirement has no relevancy for CISs. In the author’s view, the second option is preferable as the Partnership Report cannot be applied to CISs.

²¹⁷³ As a result, a vehicle that meets the definition of a CIS as explained in paragraph 4 of the CIV Report is to be considered the “*beneficial owner*” of the income it receives as long as the managers of the CIS have discretionary powers to manage the assets on behalf of the investors and the CIS meets the requirements to be considered a “*person*” and a “*resident*” of the State in which it is established.

²¹⁷⁴ See Chapter 6.3.6.3.

²¹⁷⁵ See Chapters 6.3.4.1 and 6.3.5.

investors of a CIS is not possible either, since investors of a fiscally-opaque (intransparent) CIS are not liable to tax for the income of the fund investments. This results in economic double taxation as the income is taxed at the investment and investor level.

7.1.2.1.2 Application of DTCs to Investors/Beneficiaries Based on the Assumption that the CISs/Trusts are Considered as Fiscally-Opaque in Both the Residence Country of the Investors/Beneficiaries and the Source Country of the Income

Under this scenario, the author assumes that both Switzerland as the residence country and the source country of the income treat the CISs/trust as fiscally-opaque (intransparent), and the author analyzes whether the investor/beneficiaries can claim DTC benefits.

It should be noted that the analysis of this chapter does not apply to the situation where the CIS itself is located in Switzerland. As has been previously demonstrated, in such scenario, the Federal Tax Administration applies the “*predominant income test*” in order to qualify certain income as solely dividend or interest payments²¹⁷⁶.

In this sense, Art. 10 OECD Model is applicable to the distributions of the CIS/trust (independently of whether the distributions consist of ongoing income or earnings from sale), the Swiss tax authorities would have to respect the withholding tax restrictions resulting from this distribution article. Distributions could only be taxed at the withholding tax rate provided for by the DTC for dividends. The following subsection analyses the DTC treatment of distributions from the perspective of Switzerland as the residence country of the investor/beneficiary.

Insofar as the foreign CIS/trust is fiscally-opaque (intransparent) from a Swiss perspective, the income perceived by the investor/beneficiary does not retain the original character of the income perceived by the CIS/trust. Instead, it constitutes a separate category of income. In a purely domestic scenario, this qualification is performed according to domestic law. However, in a cross-border scenario, the qualification must take into account the distributive rules contained in the applicable DTC. A domestic qualification of the

²¹⁷⁶ See Chapter 2.3.6.5.3.

type of income is not binding in a cross-border scenario and, therefore, not automatically applicable in a DTC context.

In a DTC context, the qualification of the beneficiaries'/investors' income is generally performed according to the four relevant articles covering the different types of income. In particular, there is Art. 7 OECD Model for business income, Art. 10 para. 3 OECD Model for dividends, Art. 11 para. 3 OECD Model for interest income, and Art. 21 OECD Model for other types of income. Any other distribution articles are generally not relevant for the qualification of distributions from CISs/trusts to Swiss-resident investors/beneficiaries. There is a tension between these different distributive rules, mainly with regard to whether an income should be qualified according to Art. 7 OECD Model as "*business profits*".

7.1.2.1.2.1 Art. 7 OECD Model (Business Profits)

As a preliminary comment, it is necessary to highlight the importance of the qualification of a certain income as business income in the context of a DTC. Indeed, by using a very broad business income qualification, certain countries are attempting to preserve for tax purposes certain income in their respective countries. This is due to the fact that depending on how a certain income is qualified by each country, more or less of that income may be taxed by the qualifying country.

Art. 7 OECD Model determines how profits of an enterprise of a contracting state should be taxed. In connection with the taxation of CISs/trusts, the question arises as to whether the management of the fund's/trust's assets constitutes an enterprise under Art. 7 OECD Model.

Following the distributive rules, the first step is to evaluate the specific categories of income such as those provided for by Arts. 10 and 11 OECD Model since they would have priority over Art. 7 OECD Model²¹⁷⁷. Accordingly, for the qualification of a CIS's/trust's distributions according to the distributive rules, Art. 7 OECD Model may only be applicable when income does not fall under the scope of either Art. 10 or Art. 11 OECD Model²¹⁷⁸. Should none of

²¹⁷⁷ OECD Commentary 2014, nr. 74 ad. Art. 7.

²¹⁷⁸ AIGNER, thesis, p. 119.

the three aforementioned distributive rules be applicable, the “*catch-up clause*” of Art. 21 OECD Model for “*other income*” would be applicable.

As said, Art. 7 OECD Model regulates the attribution of taxing powers on profits of an “*enterprise*” run by a tax-resident person of a contracting state. The tax law applicable to enterprise profits is generally the tax law of the country in which the person administering such enterprise is a “*resident*”, provided that the profits are not attributable to a facility through which that person operates in a different contracting state.

Pursuant to Art. 3 para. 1 (c) OECD Model, the term “*enterprise*” refers to the operation of a business activity. The term “*enterprise*” is not further specified in the OECD materials. Art. 3 para. 1 (h) OECD Model merely contains a statement referring to the term “*business*”, which includes the performance of professional services and other activities of an independent character.

Due to the lack of clear definition, and based on Art. 3 para. 2 OECD Model, the term “*enterprise*” must be interpreted according to domestic law. This has been confirmed by the OECD Commentary²¹⁷⁹. In this sense, Switzerland, considers the business activity of a CIS or a trust to be asset management in nature²¹⁸⁰. Therefore, the business activity of CISs does not constitute an “*enterprise*” under the definition outlined above.

²¹⁷⁹ OECD Commentary 2014, nr. 4 ad. Art. 3.

²¹⁸⁰ Art. 7 CISA in connection with Art. 2 para. 2 (d) CISA states that operating companies engaged in business activities are not subject to regulation under the CISA. The criteria of differentiation are not completely clear from the wording of the legal text. The Swiss Federal Supreme Court Judgment of 5 November 2010, cons. 3.4 (2C_571/2009) holds that an operating company is different from a collective investment scheme because earnings and profits are not realized through the mere investment of capital. Instead, earnings and profits are generated by business activities such as production, trade or service activities. The risk of the investment is not to be found in the mere investment of assets and the management thereof, but in the operating activity of the business. In the area of open-ended CISs, however, the situation is clear. Only CISs can be structured in an open-ended way. Moreover, CISs exclusively manage assets and may not be involved in any business activity. This principle is laid out in more detail in Art. 84 CISO.

7.1.2.1.2.2 Art. 10 OECD Model (Dividends)

Art. 10 OECD Model regulates the attribution of taxing powers on dividends paid by a company resident in a contracting state to a person resident in another contracting state. According to Art. 10 para. 3 OECD Model, dividends are *“income from shares, jouissance shares or jouissance rights, mining shares, founders' shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident”*. Accordingly, the treatment of the company making a distribution under the laws of the country in which it is a resident is decisive for the qualification of the distribution as a *“dividend”*. Income can only be qualified as a dividend payment if it stems from company shares and is issued by a company²¹⁸¹. In the following subsection, the terms *“company”* and *“company shares”* are analyzed in regards to CISs and trusts.

Firstly, one needs to address the issue of whether the CIS/trust can be qualified as a *“company”* according to Art. 3 para. 1 (b) OECD Model. From a Swiss perspective, in the scenario where the CIS/trust is considered as fiscally-opaque (intransparent), it may be treated as a corporate entity for tax purposes. Therefore, the CIS/trust may be qualified as *“company”*. However, the situation is less straightforward when the CIS/trust is not considered as fiscally-opaque (intransparent). In such case, only CISs/trusts organized in a corporate form (such as SICAVs) may fall under the term *“company”*. In the DTCs concluded with Canada or the United States for example, trusts are expressly included in the definition of a *“person”*. This suggests, *a contrario*, that they may not be qualified as a *“company”* and Art. 10 OECD Model would not be applicable²¹⁸².

In the event that a CIS/trust is considered a *“company”* according to treaty terms, the beneficiaries must receive income through *“company shares”*. The term *“company shares”* must be differentiated in two ways. First of all, *“company shares”* should be distinguished from *“interest holders”* according to Art. 11 OECD Model. *“Interest holders”* are explicitly excluded from the

²¹⁸¹ LANG, thesis, p. 132.

²¹⁸² KUBIK, thesis, p. 180.

term "*dividend*" in Art. 10 para. 3 OECD Model. Secondly, one must distinguish the term "*company*" from the term "*permanent establishment*" as applicable according to Art. 7 OECD Model. Indeed, one may have to assume business profits. The term "*company shares*" should be given a broad meaning²¹⁸³.

The fact that "*company shares*" are different from "*interest holders*" shows that any owner of "*company shares*" (shareholder), unlike an "*interest holder*", assumes a business risk that corresponds to the risk of a full shareholder²¹⁸⁴. This is because the earnings generated from capital are based on the business results and may also lead to losses of the invested capital. Simultaneously, however, there are chances for the assets to increase in value. In particular, there is no requirement that an "*interest holder*" has the same rights as a regular shareholder²¹⁸⁵. Even a complete lack of voting rights, such the case of preference shares, does not speak against the qualification as "*company shares*"²¹⁸⁶.

As far as CISs and trusts are concerned, a refined approach seems appropriate. In regard to the criteria of a "*company share*", it becomes apparent that beneficiaries of a trust do not receive income from "*company shares*". Firstly, the beneficiary has not invested any capital for use by the trust and, secondly, the latter does not assume any risks in relation to the sums invested²¹⁸⁷. Indeed, the capital of a trust is either defined in advance or allocated by the trustee. It does not immediately depend on the business result of the trust's operations²¹⁸⁸. Therefore, the trust's assets cannot be categorized under the dividend article, as they cannot be considered as income from "*company shares*"²¹⁸⁹.

²¹⁸³ AIGNER, thesis, p. 123.

²¹⁸⁴ OECD Commentary 2014, nr. 25 ad. Art. 10. For further details see: GLÄSER, thesis, p. 94 et seq.

²¹⁸⁵ Amongst others: GLÄSER, thesis, p. 88; AIGNER, thesis, p. 123.

²¹⁸⁶ AIGNER, thesis, p. 123.

²¹⁸⁷ In this vein also Katharina Kubik from an Austrian perspective: KUBIK, p. 181.

²¹⁸⁸ In this vein also Katharina Kubik from an Austrian perspective: KUBIK, p. 181.

²¹⁸⁹ In this vein also Katharina Kubik from an Austrian perspective: KUBIK, p. 181.

In the case of investments in CISs, conversely, the requirements of a “*company*” and “*company shares*” may be fulfilled. If, however, distributions made by the CIS reduce its taxable base, such distributions only qualify as dividends according to Art. 10 OECD Model if they are also tax deductible at the level of the corporation limited by shares. If this is not the case, they must be qualified according to Art. 21 OECD Model²¹⁹⁰. In the scenario where the investor itself has granted capital to the CIS and he still holds a risk in relation to his investment, the results of the investor's business activity is typically reflected in the value of the certificates²¹⁹¹. Fiscally-opaque (intransparent) CIS distributions can generally be subsumed under the dividend article as they are to be considered as income from “*company shares*”.

7.1.2.1.2.3 Art. 11 OECD Model (Interest)

Art. 11 OECD Model regulates the attribution of taxing powers for interest generated in one contracting state and being paid to a resident person of another contracting state. According to Art. 11 para. 3 OECD Model, interest means: “*income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures*”. The OECD Commentary includes illustrative examples explaining the term “*interest*”²¹⁹².

Under this article, the term “*interest*” needs to be distinguished from the term “*dividend*” of Art. 10 para. 3 OECD Model. The relevant criteria on which the differentiation between these two terms is based is the business risk encountered²¹⁹³. According to Michael Lang, all income from capital granted should be qualified as income from interest according to Art. 11 OECD Model, provided that there is a claim for repayment of the invested capital²¹⁹⁴. Such article also requires the interest to be generated in the other contracting state. If this is the case, the requirement should be regarded as

²¹⁹⁰ LANG, thesis, p. 108.

²¹⁹¹ In this vein also GLÄSER, thesis, p. 94.

²¹⁹² OECD Commentary 2014, nr. 18 et seq. ad. Art. 11.

²¹⁹³ OECD Commentary 2014, nr. 19 ad. Art. 11.

²¹⁹⁴ LANG, thesis, p. 95 et seq.

fulfilled, as long as the debtor of the interest is a resident person of the other contracting state²¹⁹⁵.

As far as CISs and trusts are concerned, a more refined approach seems appropriate and necessary. Assuming that the CIS/trust is a resident person of the other contracting state, one must evaluate whether the CIS's/trust's distributions fulfill the criteria of "*interest*" income under Art. 11 para. 3 OECD Model. If one allocates the interest income according to Art. 11 OECD Model to the interest creditor (who is not running any business risk), these distributions cannot be considered as "*interest*" in the sense of the treaty definition. Indeed, the investors/beneficiaries do not generally invest capital into a CIS/trust. Therefore, they do not have any claims against the CIS/trust that could result from the grant of capital that would generate "*interest*" according to treaty terms²¹⁹⁶. Therefore, CIS/trust grants can generally not be subsumed under the interest article, as they do not represent income from payments resulting from a grant.

7.1.2.1.2.4 Art. 21 OECD Model (Other Income)

Art. 21 OECD Model regulates the attribution of taxing powers for income that is not caught by any of the other distributive rules contained in Arts. 6 to 20 OECD Model. Art. 21 OECD Model, thus, represents a "*catch-up clause*" which ensures that all income falls within the scope of a distributive rule²¹⁹⁷. Therefore, it is conceivably broad in its scope and can find subsidiary application alongside with another distributive rule.

Art. 21 OECD Model is particularly relevant in two scenarios. First, this article may find application for income that does not fall within the scope of any of the distributive rules provided for by Arts. 6 to 20 OECD Model. Second, Art. 21 OECD Model may be applicable for income that is expressly covered by Arts. 6 to 20 OECD Model, yet does not completely fulfill all the criteria laid out in these provisions²¹⁹⁸. According to Art. 21 OECD Model, only the

²¹⁹⁵ Art. 11 para. 5 OECD Model.

²¹⁹⁶ In this vein also Katharina Kubik from an Austrian perspective with regard to the trust relationship: KUBIK, p. 182.

²¹⁹⁷ OECD Commentary 2014, nr. 1 ad. Art. 21.

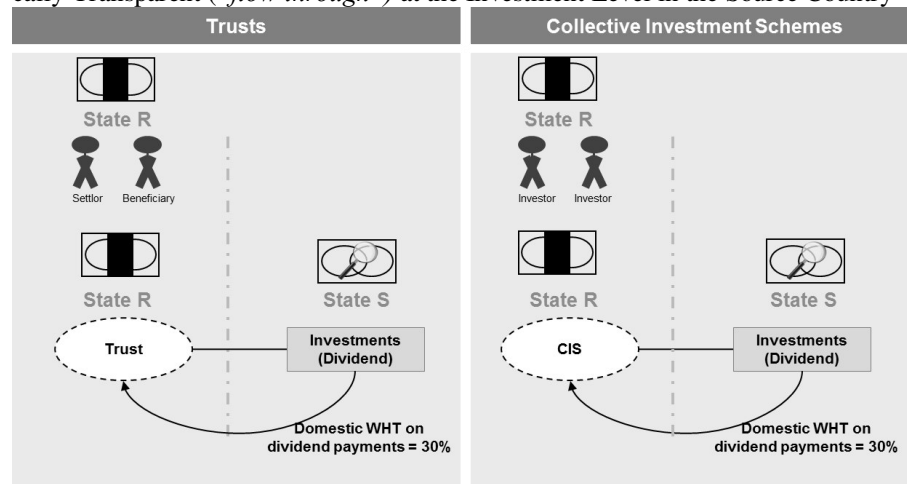
²¹⁹⁸ OECD Commentary 2014, nr. 1 ad. Art. 21. In this vein also: GLÄSER, thesis, p. 91.

residence country has taxing powers. The source country of the CIS/trust distributions may not levy taxes.

7.1.2.2 Differential Treatment of CISs and Trusts: Fiscally-Opaque in the Residence Country of the CIS/Trust or its Investor/Beneficiary, but Fiscally-Transparent at the Investment Level in the Source Country

This paragraph assumes that the CIS/trust has differential treatment in the residence country of either the CIS/trust or its investors/beneficiaries, and in the source country. Thus, the CIS is treated as fiscally-opaque (intransparent) by the residence country (and therefore, income from investments is attributed to the CIS/trust), and as fiscally-transparent (“flow-through”) by the source country (and income from investments is therefore attributed directly to the investor/beneficiary).

Figure 7.1: Differential Treatment of CISs and Trusts: Fiscally-Opaque (intransparent) in the Residence Country of the CIS/trust or its Investor/Beneficiary, but Fiscally-Transparent (“flow-through”) at the Investment Level in the Source Country



Source: Own figure

In this scenario, under the domestic law of the residence country (country R), the CIS (according to the criteria of the CIV Report) and the trust²¹⁹⁹ are “*liable to tax*”, and therefore, they are considered as “*resident persons*” within the meaning of the DTC. From the perspective of the source country (country S), however, the CIS/trust is considered as fiscally-transparent (“*flow-through*”), and consequently, not a “*resident person*”.

The critical question here is whether the DTC signed between the source country S, and the residence country R is applicable to the CIS/trust and, therefore, the CIS/trust itself meets the application criteria of the method article. Should this not be the case, the question arises as to whether the DTC signed between the source country S and the residence country R may be applicable to the investor/beneficiary²²⁰⁰.

According to the domestic law of the source country S, who considers the CIS/trust as fiscally-transparent (“*flow-through*”), the income components are not attributed to the CIS/trust itself, but to the respective investors/beneficiaries. Since the BEPS Report was released, the “*attribution of income*” criteria has become a key element when determining the conditions under which the “*resident person*” can benefit from DTC access. As mentioned before, by inserting the “*attribution of income*” requirement, the OECD aims at ensuring that only those persons that fulfill the “*attribution of income*” requirement may benefit from DTC access (provided the other requirements for DTC access are met).

The author, however, suggests that this “*attribution of income*” rule shall not be applicable to CISs. In this sense, the Partnership Report sheds light on the definition of the term “*paid to*”. As mentioned above, however, those conclusions do not apply to any hybrid entities other than Partnerships²²⁰¹. Since the BEPS Action No. 2 Report is not applicable either, the analysis should be referred to the CIV Report. But the CIV Report, unlike the Partnership Report, is silent in regard to the “*attribution of income*” criteria. Even though

²¹⁹⁹ It should be noted that this is an hypothetical situation, and does not reflect the trust’s tax treatment in Switzerland. Under Swiss tax law, trusts are not considered “*liable to tax*”.

²²⁰⁰ OECD Commentary 2014, nr. 6.12 ad. Art. 1.

²²⁰¹ See Chapter 6.1.3.2.

the fulfillment of this criteria is a mandatory requirement for trusts in order to benefit from DTC access, the author suggests that its fulfillment is not necessary for CISs. In other words, CISs may be granted access to DTCs without having to fulfill the "*attribution of income*" requirement based on the CIVs Report conclusions. This statement is further supported by the fact that, as explained in previous chapters, the Partnership Report cannot simply be applied (by analogy) to CISs²²⁰².

It should be noted that if each contracting state were to rely on the domestic "*attribution of income*" rules of the source country when applying the DTC, a deduction for the withholding tax paid in the source country would not be feasible for two reasons. First, it would be impossible to attribute the income to the CIS/trust because the source country S considers them as fiscally-transparent ("*flow-through*") and therefore, not liable to tax. Secondly, the tax subjects would not be identical depending on which domestic rules are applied.

Nevertheless, CISs/trusts should be able to claim a deduction for the taxes paid in the source country S²²⁰³. To argue this, one can rely on the spirit of the treaty, which explains why the residence country R may not rely on the source country S qualification of the CIS/trust as a tax subject. Furthermore, upon closer examination, Art. 23 B para. 1 and Art. 23 A para. 2 OECD Model does not require a CIS/trust to be a tax subject. Rather, regarding the deduction in the residence country, the articles merely mention a deduction "*on the tax paid in the other state*". Consequently, the wording of these articles does not exclude such a deduction.

The impossibility for CISs/trusts to deduct taxes paid in the source country S, as explained above, may seem to be a case of tolerable "*economic*" double taxation. However, in reality, there is not just "*economic*" double taxation (meaning taxation of two different taxpayers with respect to the same income or capital) but - even if not immediately recognizable - "*concealed*" or "*real*" double taxation (meaning that the same person is taxed twice on the same income by more than one state) for which there is no rational argument. In other words, from the perspective of the residence country R, there

²²⁰² See Chapter 6.1.3.2.

²²⁰³ Amongst others: WASSERMEYER/DEBATIN, Commentary, nr. 27 ad. Art. 1.

is in our view no valid reason to refuse the deduction of taxes paid in the source country S, as provided for by the treaty²²⁰⁴.

The CIVs Report does not explicitly treat the question of avoiding double taxation in the residence country in the context of the comparable Example 5 of the Partnership Report²²⁰⁵. A deduction on the withholding tax paid, however, is likely to correspond to the principles of the Partnership Report, as, due to the uniform reliance on the “*attribution of income*” rules of the residence country for the purpose of applying the DTC, identical tax subjects exist²²⁰⁶. In the context of a trust, the “*attribution of income*” requirement used in the distribution articles must be interpreted according to the domestic law of the person’s residence country.

In the author’s view, it would be illogical if the source country, for purposes of applying the DTC, had to rely on the domestic “*attribution of income*” rules of the residence country of the CIS/trust. The latter could refuse a tax deduction based on the argument that its domestic “*attribution of income*” rules are not identical to those of the source country S. The non-application of the domestic “*attribution of income*” rules of the residence country of the CIS/trust can further be justified by the fact that the CIVs Report is silent in regard to the “*attribution of income*” requirement. As a result, it must be concluded that the “*attribution of income*” criteria is not relevant in regard to CISs. In other words, it is suggested that CISs may be granted access to DTCs without having to fulfill the “*attribution of income*” requirement²²⁰⁷.

²²⁰⁴ GLÄSER, thesis, p. 172.

²²⁰⁵ GLÄSER, thesis, p. 172.

²²⁰⁶ OECD, Partnership Report, para. 63 (Example 5) and Partnership Report, para. 59-62 (Example 4). The legal explanation of this viewpoint is provided in OECD, Partnership Report, para. 53: “*One broadly based approach would be to recognize as implicit in the structure of the Convention the principle that the source State, in applying the Convention where partnerships are involved, should take into account, as part of the factual context in which the Convention is to be applied, the way in which an item of income arising in its jurisdiction is treated in the jurisdiction of the taxpayer claiming the benefits of the treaty as a resident (...)*”. In the OECD Partnership Report, para. 48, in the context of Example 1, the OECD explains why the source country must take the “*attribution of income*” rules of the residence country into consideration.

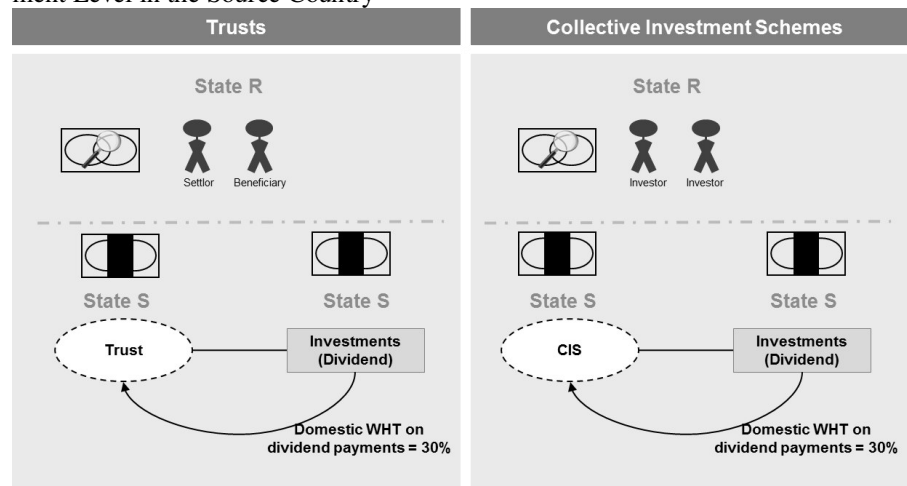
²²⁰⁷ See Chapter 6.1.2.3.5.3.

As a result, the author considers that in this scenario, the residence country of the CIS/trust (country R) is obliged to deduct the tax paid in the source country S at the level of the investments. Consequently, withholding tax paid in the source country S on dividends (Art. 10 OECD Model) or interest (Art. 11 OECD Model) is deductible from the tax burden of the CIS/trust pursuant to Art. 23 OECD Model. Profits from the alienation of fund assets (Art. 13 para. 5 OECD Model) and other income (Art. 21 OECD Model), however, may be taxed at the full amount in the residence country of the CIS/trust (country R).

7.1.2.3 *Differential Treatment of CISs and Trusts: Fiscally-Transparent in the Residence Country of the Investor/Beneficiary, but Fiscally-Opaque in the Residence Country of the CIS/Trust or at the Investment Level in the Source Country*

This paragraph assumes that the CIS/trust has differential treatment in the countries involved. In one hand, in the residence country of the investor/beneficiary (country R) treats the CIS/trust as fiscally-transparent. On the other hand, in the source country of the income (country S) and the residence country of the CIS/trust (also country S) treat the CIS/trust as intransparent. Under these scenarios, if the CIS/trust is considered as fiscally-transparent (“flow-through”) in the residence country of the investor/beneficiary (country R), income is directly attributable to the investors/beneficiaries and taxed at their level. If, conversely, the CIS/trust is considered as fiscally-opaque (intransparent) under the domestic law of the source country (country S), the income from investments is attributed to the CIS/trust itself. This different qualification of the CIS/trust under domestic law of each country results in taxation of different subjects. On the one hand, the investments are taxed at the level of the CIS/trust. On the other hand, the income of the investments is taxed at the level of the investors/beneficiaries.

Figure 7.2: Differential Treatment of CISs and Trusts: Fiscally-Transparent (“*flow-through*”) in the Residence Country of the Investor/Beneficiary, but Fiscally-Opaque (intransparent) in the Residence Country of the CIS/trust or at the Investment Level in the Source Country



Source: Own figure

Under this scenario, the state of source (country S) considers that CIS/trust as fiscally-opaque (intransparent), and therefore “*liable to tax*” while the country of residence (country R) of the investor/beneficiary considers them as “*liable to tax*”. The source country would refuse to grant tax DTC benefits, because it does not consider the investor/beneficiary as “*resident*” in the sense of Art. 4 OECD Model, resulting in double taxation.

Looking at the domestic scenario perspective and assuming the CIS/trust cannot claim a reimbursement and taxation from the source country (country S) cannot be avoided, then the avoidance of double taxation could only be achieved at the level of the investor/beneficiary (resident of country R). It should be noted that under a pure domestic tax scenario, (for instance if the investor/beneficiary was a resident of state S) no claim under a double tax convention could be made as DTCs only apply between two different jurisdictions but not when the double taxation occurs at a pure domestic level. This would be the case where the trust/CIS and the investor/beneficiary were residents of state S and state S taxed both individuals. Here, not DTC could be applicable.

As mentioned, when, the CIS/trust would not meet the criteria for application of the method article, the avoidance of double taxation of the CIS's/trust's income can only be achieved at the level of the investor/beneficiary. This situation is comparable to the case laid out in Example 4 of the Partnership Report, which conclusions, although strictly applicable only to partnerships and not to CISs/trusts, are explained below²²⁰⁸.

If every contracting state would also, for the purpose of DTC access, rely on the respective domestic rules of "*attribution of income*", a deduction of the taxes paid in the source country could be impeded by a bilateral attribution conflict. The withholding tax paid in the source country could not be deducted in the residence country of the investor/beneficiary due to the lack of identical tax subjects. In cases where the CIS/trust is a resident of a third-country, an attribution conflict in a triangular scenario arises (it should be remembered that so far the author has analyzed cases where only two countries are involved). This scenario is comparable to that laid out in Example 7 of the Partnership Report²²⁰⁹.

In the following paragraphs, the author will analyze and outline which the results would be for the scenarios where the source country follows the other country's interpretation as to whether the conditions to access a DTC have been fulfilled. Because the Partnership Report proposes such a solution, the author will analyze the Partnership Report for comparison purposes only.

7.1.2.3.1 The Source Country Follows the Other Country's Interpretation Regarding DTC Conditions (Solution Comparable to that of the Partnership Report)

The Partnership Report sheds some light on the conflict of attribution cases as applied to partnerships (but, as mentioned above, not to CISs). In this

²²⁰⁸ Partnership Report, Example 4: "*P is a partnership established in State P. A and B are P's partners who reside in State P. State P treats P as a transparent entity while State S treats it as a taxable entity. P derives royalty income from State S that is not attributable to a permanent establishment in State S*".

²²⁰⁹ Partnership Report, Example 7: "*P is a partnership established in State P. A and B are P's partners who reside in State R. P owns shares in X, a company that is a resident of State S. X pays a dividend to P. States R and S treat P as a taxable entity while State P treats it as fiscally transparent*".

sense, according to Example 4 of the Partnership Report, in the case of attribution conflicts, the source country would have to follow the “*attribution of income*” rules of the other contracting state, i.e. the residence country. Consequently, income from the source country could be attributed to the investors/beneficiaries. For instance, if the investors/beneficiaries are resident persons pursuant to Art. 4 para. 1 OECD Model, the source country is obliged to grant them the treaty benefits provided by the relevant DTC, even if the source country does not consider the investor/beneficiaries as “*liable to tax*” under its domestic law.

It should be noted that although in principle this solution should not only be linked with the “*attribution of income*” rule and should clearly be extended to the interpretation of the other required conditions to access a DTC for a CIS or trust.

It should be kept in mind that, in the author’s view, problems relating to the “*attribution of income*” condition may only arise in scenarios involving trusts and not for other hybrid entities such as CISs, since according to the CIVs Report the “*attribution of income*” criteria does not find application for CISs.

The scenario laid out in Example 4 of the Partnership Report does not treat the question of avoiding double taxation in the residence country. According to the principles of the Partnership Report, however, a deduction of the withholding tax paid in the residence country would be appropriate as, due to the uniform interpretation of the “*attribution of income*” rules in the residence country for the purpose of applying the DTC, the tax subjects are identical. It would be illogical if the source country, for the purpose of applying the DTC, had to rely on the “*attribution of income*” rules of the residence country, but on the other hand, the residence country could refuse a deduction on the grounds that its “*attribution of income*” rules are not identical to those of the source country.

Consequently, the withholding tax paid in the source country on dividends (Art. 10 OECD Model) or interest (Art. 11 OECD Model) are deductible from the income tax burden of the investors/beneficiaries pursuant to Art. 23 OECD Model. Profits from capital gains (Art. 13 para. 5 OECD Model) and other income (Art. 21 OECD Model), however, may be taxed to a full extent in the residence country.

7.1.2.3.2 “*Attribution of Income*” Rules of the Source Country are Decisive

An opposite solution to the one laid out in the Partnership Report for the case of partnerships is to apply, for qualification purposes, the “*attribution of income*” rules of the source country²²¹⁰. Although the conclusions of the Partnership Report do not apply to CISs and trusts, the author analyzes this hypothetical and explain the possible consequences.

Even though from a Swiss domestic tax law perspective a CIS/trust is fiscally-transparent and the CIS/trust’s assets are attributable to the investors/beneficiaries, the source country of the income is not obliged to follow the Swiss attribution rule. Thus, for example, assuming that the CIS/trust and its investors/beneficiaries are not located in the same country, under the source country attribution rules, the CIS/trust (resident of Switzerland) would be the entity entitled to treaty benefits, despite the fact that the attribution rules of the residence (Switzerland, which considers the CIS/trust as fiscally transparent) and the source country (country S, which considers the CIS/trust as taxable entity) do not result in an identical qualification.

This, however, would only be possible insofar as the CIS/trust meets the criteria of Art. 4 para. 1 OECD Model, regardless of the fact that the CIS/trust is considered a tax subject in the other contracting state²²¹¹. Within an international context, if the CIS/trust fulfills the criteria of Art. 4 para. 1 OECD Model, the DTC between the source country and Switzerland as the residence country is applicable. The source country would be obliged to grant the treaty benefits.

Thus, the withholding tax paid in the source country on dividends (Art. 10 OECD Model) or interest (Art. 11 OECD Model) could be deducted from the income tax burden of the CIS/trust pursuant to Art. 23 OECD Model. However, if the CIS/trust is considered as fiscally-transparent (“*flow-*

²²¹⁰ Amongst others: AIGNER, thesis, p. 91-92.

²²¹¹ This line of reasoning is mirrored in the recent “*Madeira*” judgment in which the Court expressly stated that, for corporate entities such as a fiscally-transparent SICAV, “*effective recognition as a taxpayer*” with a locality-related or territorial attachment to the jurisdiction is sufficient to found residence for DTC purposes from a Swiss perspective, irrespective of whether any income taxes are in fact paid in that state by the corporate entity.

through”) in the source country, then the CIS/trust could not benefit from a DTC between the source country and Switzerland as the residence country since the CIS/trust would not fulfil the “*residence*” requirement under the laws of the source state. Thus, as one of the requirements to access a DTC (to be a “*resident*”) would not be fulfilled under the state that grants the benefit (source country), no DTC access and the corresponding withholding tax reduction would be granted.

7.1.2.3.3 Avoidance of Double Taxation at the Level of the Investor/Beneficiary

Double taxation may not only be avoided at the level of the CIS/trust, but also at the level of the investor/beneficiary. To be able to gain access to a DTC, the investor/beneficiary needs fulfill the relevant criteria.

In Switzerland, an investor/beneficiary is considered a “*resident*” for purposes of access to a DTC when the investor/beneficiary is subject to unlimited tax liability in Switzerland. The relevant criteria are whether the place of permanent home and habitual abode in Switzerland. An investor in a CIS and a beneficiary of a trust with an unlimited tax liability in Switzerland would therefore have access to all DTCs between Switzerland and the residence country of the CIS/trust, provided that the other DTC requirements, namely person, attribution of income and beneficial ownership, are fulfilled. Furthermore, an investor/beneficiary with unlimited tax liability in Switzerland meets the application criteria for the method article.

Since the CIS/trust is considered a tax subject in its residence country, the CIS/trust is considered as a “*resident*” entity for purposes of Art. 4 OECD Model. This is particularly important for the qualification of the investor’s/beneficiary’s income (distribution/forwarding), which, according to the criteria described above, is mainly qualified for a resident CIS as income under Arts. 10, 11 or 21 OECD Model²²¹² or, for a resident trust, as distributions under Arts. 10, 11 or 21 OECD Model²²¹³.

When under their domestic laws both contracting states qualify CISs/trusts as fiscally-opaque (intransparent), the investor’s/beneficiary’s income will

²²¹² However, in Switzerland the Federal Tax Administration applies the “*predominant income test*” determining the qualification of income either as dividend or interest payments. See for further details Chapter 2.3.6.5.1.

²²¹³ See the analysis above.

usually be qualified uniformly, as earnings do not retain their original character, but instead represent a separate category of income. The respective DTC with the distribution rule agreed upon between the residence country of the investor/beneficiary and the residence country of the CIS/trust will be applicable.

The qualification of the investor's income follows the assessment provided by the country of residence of the CIS: as dividends pursuant to Art. 10 para. 3 OECD Model, as interest pursuant to Art. 11 para. 3 OECD Model or, as it is certainly the case in connection with a trust relationship, as other income pursuant to Art. 21 OECD Model.

For the purpose of applying the DTC, it is significant in this context whether the residence country of the investor/beneficiary ties the domestic tax claim to the actual distribution of income by the CIS/trust, or whether it taxes (for example at the end of each fiscal year) the retained income of the investment fund or the accumulated income of the trust. As soon as the domestic tax claim becomes available, income pursuant to the DTC between countries R and S is present. Consequently, the residence country R is obligated to grant treaty benefits as provided by the method article in connection with the applicable distribution rule.

Should taxation of the investor/beneficiary in the source country occur in a different taxation period than the one in the residence country, the residence country is still, according to the conventional view, obliged to grant a deduction on the domestic tax burden, insofar as the income is not already tax-exempt according to the applicable DTC.

7.1.2.4 Equal Treatment of CISs and Trusts: Fiscally-Transparent in the Residence Country of the CIS/Trust or its Investor/Beneficiary, and Fiscally-Transparent at the Investment Level in the Source Country

Under this scenario the CIS/trust has the same tax treatment in both the residence country of the CIS/ trust or its investor/beneficiary (country R); and in the source country of the income (country S). Both countries treat the CIS/ trust as fiscally-transparent ("*flow-through*").

In this case, thus, if a CIS/trust is considered fiscally-transparent ("*flow-through*") in both the residence and the source country, then the income at

the investment level is attributed to and effectively taxed at the level of the investors/beneficiaries in its original character.

Consequently, the question of how to avoid double taxation does not arise at the level of the CISs/trusts, but at the level of the investors/beneficiaries. Due to the fact that the CIS/trust is not “*liable to tax*” in the residence country (country R) where it is located because country R considers the CIS/ trust fiscally-transparent (“*flow-through*”), the latter is not considered “*resident*” in such country in terms of Art. 4 OECD Model. Therefore, no deduction under the DTC between the residence country (country R) of the CIS/trust and the source country (country S) of the investment can be granted.

The CIS/trust thereby does not meet the application criteria of the method article. Thus, an exemption from taxation of the CIS’s/trust’s income or a deduction of the withholding tax paid in the source country is only possible at the level of the investors/beneficiaries pursuant to an applicable DTC between the source country of the investment (country S) and the residence country of the investor/beneficiary (country R).

The “*person*” criteria pursuant to Art. 1 in connection with Art. 3 para. 1 (a) or (b) OECD Model is fulfilled. Moreover, the “*residence*” criteria of Art. 4 para. 1 OECD Model should also be fulfilled, provided that the person demonstrates a local relation to the country of residence, in our example, Switzerland. For DTC purposes, fulfilling the criteria of residency for the investors of a CIS or for the beneficiaries of a trust with an unlimited tax liability in Switzerland seems unproblematic.

Since the income retains its original character, the appropriate distribution rule for each category of income must be determined. This is also linked to the respective tax treatment in the residence and source country. Withholding tax paid in the source country on dividends (Art. 10 OECD Model) or interest (Art. 11 OECD Model) can be deducted from the effective income tax burden of the investors pursuant to Art. 23A or Art. 23B OECD Model. Capital gains from the alienation of fund or trust assets (Art. 13 para. 5 OECD Model) and to a full extent at the level of the investor/beneficiary.

For the “*beneficial owner*” of income to be able to reduce the withholding tax, he needs also to be a “*resident*” in the other contracting state. The investors/beneficiaries are usually considered the “*beneficial owners*” when they have discretionary powers over the income. Should the principles of the

Partnership Report find application, the simple taxation of the investors/beneficiaries may already justify “*beneficial ownership*”²²¹⁴, as has been explained above.

7.1.2.5 *Differential Treatment of CISs and Trusts: Fiscally-Opaque in the Residence Country of the Investor/Beneficiary, but Fiscally-Transparent at the Investment Level in the Source Country and in the Residence Country of the CIS/Trust*

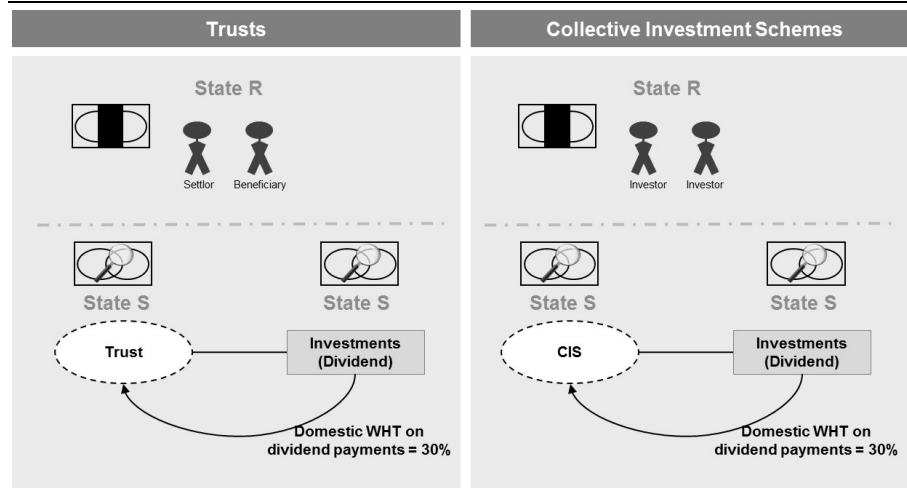
In the paragraph above the author discussed the case of a CIS/trust that has differential treatment in the residence country of the investor/beneficiary (country R treating the CIS/trust as fiscally-opaque) in one hand; and in the source country of the income (country S) and in the residence country of the CIS/trust (also country S) on the other hand (treating the CIS/Trust as fiscally-transparent (“*flow-through*”)).

In the following paragraphs, the author will discuss the opposite situation. That is, if the source country (country S) and the residence country of the CIS/trust (also country S) consider the CIS/trust to be fiscally-transparent (“*flow-through*”), Therefore, the income from investments is attributed to and taxed at the level of the investor/beneficiary (residents of country R). If country R considers the CIS/trust to be fiscally-opaque (intransparent), the investment income would directly be attributed to the CIS/trust.

Figure 7.3: Differential Treatment of CIS and Trust: Fiscally-Opaque (intransparent) in the Residence Country of the Investor/Beneficiary, but Fiscally-Transparent

²²¹⁴ OECD, Partnership Report, para. 54.

(“flow-through”) at the Investment Level in the Source Country and in the Residence Country of the CIS/Trust



Source: Own figure

The investors/beneficiaries are considered residents (and thus subject to unlimited taxation) pursuant to the DTC between the residence country R and source country S. Therefore, they meet the application criteria of the method article. Because the CIS/trust is not “liable to tax” in the source country S (who considers the CIS/trust fiscally-transparent), the CIS/trust is, in turn, not considered a “resident” by the source country (country S).

This is of particular importance for the qualification of the investors’/beneficiaries’ income. Conversely, the residence country of the investors/beneficiaries (country R) considers the CIS/trust to be a tax subject (since country R considers the CIS/trust as fiscally-opaque/intransparent). The result is that both contracting states tax the investors/beneficiaries under their respective domestic laws but on different income. While the source country (country S) follows a flow-through approach and taxes the investors/beneficiaries directly on income from investments, the residence country of the investors/beneficiaries (country R) attributes that same income to the CIS/trust and taxes the investors/beneficiaries only on income distributed by the CIS/trust (but not on the investments themselves).

Consequently, the effective avoidance of double taxation essentially depends on the application of the DTC by the residence country of the investors/beneficiaries (country R).

The following two sub-chapters will discuss the application of the distribution rules. Firstly, in the case of the chart described above where the CIS/trust is not considered as a tax subject by the residence country of the investors/beneficiaries (country R). Secondly, in the case the CIS/trust is considered as a tax subject by the residence country of the investors/beneficiaries (country R).

7.1.2.5.1 Application of the Distribution Rule when the CIS/Trust is Not a Tax Subject (Fiscally-Transparent) in the Residence Country of the Investors/Beneficiaries (country R), while Fiscally-Transparent at the Source Level

In the first scenario, the investors/beneficiaries' country of residence (country R), does not consider the CIS/trust as a tax subject. If the residence country R applies its domestic rules in order to attribute the income of its resident investors/beneficiaries, then the distribution rule for income from investment will be applied. By applying its domestic attribution rules, the residence country of the investors/beneficiaries (country R) disregards the existence of the foreign CIS/trust (which under its domestic laws is not considered a "*resident*" for the purpose of accessing a DTC).

Since the CIS/trust does not meet the entity definition of Art. 3 para. 1 lit. b OECD Model, the Arts. 10 or 11 OECD do not apply²²¹⁵. Therefore, the only remaining option is to assign the investors'/beneficiaries' income to the distribution rule of Art. 21 OECD Model, whereby solely the residence country (country R) has the right to tax that income (independently of its origin) to a full extent. The qualification of income from investments by the source country S is generally disregarded by the residence country R, as there is no right to tax under its domestic law anyway.

Conversely, from the perspective of the source country (country S), the payment of income from investments and from a transparent CIS/trust constitutes a "*cross-border*" transaction for the purpose of assigning the investors'/beneficiaries' income to the distribution rules. Irrespective of whether

²²¹⁵ See Chapter 6.2.3.1.

income is attributed to investors/beneficiaries (from the view of the residence country of the investors/beneficiaries), the source country will apply the relevant distribution rules to the investors'/beneficiaries' income from investments.

Nevertheless, this does not constitute a conflict of qualification as both contracting states simply evaluate the tax objects differently. The specific problem is not that the same income is *qualified differently* for the purpose of the DTC, but that *different income* is being qualified. In the author's view, this conflict of attribution cannot be solved with the principles for avoiding (objective) conflicts of qualification pursuant to Art. 23 Abs. 1 OECD Model. The source country's consideration of the qualification of income from fund investments will usually be disregarded in the residence country. Although the author does not agree with this result, this is due to treaty based tax liberation or tax deduction obligations not restricting the domestic right to tax investors. Moreover, it is due to the fact that no further domestic right to tax income from fund investments exists.

The distributions from investment funds are, however, of no significance for the attribution of income pursuant to distribution rules in the source country. A deduction of the withholding tax paid on income from fund investments therefore regularly fails. The result is double taxation at the level of the investors, contradicting the purpose of a double taxation treaty and becoming an unacceptable solution.

7.1.2.5.2 Application of the Distribution Rules when the CIS/Trust is a Tax Subject (Fiscally-Opaque) in the Residence Country of the Investors/Beneficiaries (country R), while Fiscally-Transparent at the Source Level

In this case, as opposed to the one explained above, the investors/beneficiaries' country of residence (country R), considers the CIS/trust as fiscally-opaque, that is, a tax subject. The country of source, however, considers the CIS/trust as fiscally-transparent.

By applying the principles described above in this scenario, double taxation of the investors/beneficiaries that would otherwise be contrary to the DTC ultimate purpose, can be avoided. The solution to the above-mentioned conflict of attribution is confirmed by the fact that both contracting states evaluate the same income (i.e. the same tax object) at the treaty level and uniformly assign the income to the same distribution rules. These distribution

rules may, in connection with the method article, restrict the domestic right to tax and therefore, only one state could exercise its taxing rights.

For the purpose of qualifying the income of the investors/beneficiaries, the residence country (country R) takes into account that this income derives from a CIS/trust. As mentioned before, Art. 21 para. 1 OECD Model is only applicable to income that does not fall under the scope of any of the more specific distribution rules outlined in the preceding OECD Model articles. Therefore, from the perspective of the residence country of the investors/beneficiaries (country R), the question arises as to whether the income falls under the scope of one of the more specific distribution rules of Arts. 6 to 20 OECD Model.

In the author's view, the residence country R has to take into account that, in this scenario, the CIS/trust is not a "*resident*" under DTC terms because the residence country of the CIS/trust (country S) treats the CIS/trust as fiscally-transparent ("*flow-through*"). The fact that the CIS/trust is not "*liable to tax*" pursuant to Art. 4 para. 1 OECD Model has a binding effect for the investors/beneficiaries' country of residence (country R) at a DTC level. In this sense, for the purpose of applying the DTC there is no separation between income of the CIS/trust and income of the investors/beneficiaries. Rather, the income flows through the CIS/trust to the investors/beneficiaries since the CIS/trust's country of residence (country S) considers it fiscally transparent. According to the applicable distribution rule on the income from investments and the method article, the domestic right to tax is restricted for both the source country and the residence country.

Insofar as income from investments stems from the residence country of the CIS/trust (country S), the factually more specific distribution rules take precedence over the "*catch-all rule*" of Art. 21 OECD Model. Only the investors'/beneficiaries' income stemming from another country than the residence country of the CIS/trust is (country S), as pertains to the relationship between the residence country of the investors/beneficiaries (country R) and that of the CIS/trust (country S), to be treated pursuant to Art. 21 para. 1 OECD Model.

The view described above according to which the CIS/trust is not "*liable to tax*" and, therefore, disregarded for the qualification of income, resulted in double taxation. The interpretation made here, on the contrary, can prevent double taxation of the investors/beneficiaries, which would otherwise be contrary to the DTC purpose. In this scenario,, income from fund invest-

ments is for the purpose of the DTC, directly attributed to the investors/beneficiaries because the CIS/trust does not fulfill the “*residence*” criteria. Accordingly, no income from investments can be attributed to the CIS/trust for the purpose of the DTC, pursuant to the domestic rules of attribution.

At treaty level, no income from investments can be attributed to the investors/beneficiaries. Consequently, the contracting states’ respective domestic right to tax the investors/beneficiaries is assigned, for treaty purposes, to the relevant distribution rules in both the source country and the residence country. At a treaty level in residence country R, the domestic right to tax income from investment can only be restricted to the method article in connection with the distribution rules that are to be assigned to income from the investment funds. This is, however, only valid for treaty law and is thus not contrary to the principle whereby treaty law does not have an influence on the domestic rules of attribution. That is to say, in a domestic context, the rules of attribution remain unchanged.

Accordingly, there are convincing arguments to allow the country applying the distribution rules to consider the decision of the CIS’/trust’s country of residence (country S) for the purposes of gaining access to DTC benefits. This seems to be the only way to efficiently avoid double taxation resulting from the evaluation of different tax objects by the respective contracting states signatures of a DTC.

Consequently, for the purpose of avoiding double taxation, the DTC between the residence country of the investor/beneficiary (country R) and the source country of the income from investments (country S) is applicable. Any withholding tax paid in the source country of the investment on dividends (Art. 10 OECD Model) or interest (Art. 11 OECD Model) has to be deductible from the income tax burden of the investor pursuant to Art. 23 OECD Model. Problems may arise in regard to the verification of the deductible amount by the investor.

Part 4

Conclusion

Part 4 - Conclusion

8 Identification and Evaluation of Possible Conceptual Solutions in relation to the Tax Treatment of CISs and Trusts under DTCs

Things should be made as simple as possible, but not any simpler
(Albert Einstein, 1879-1955)

8.1 General Remarks

The question of whether and how DTCs may be applied to hybrid entities such as CISs and trusts is controversial and debated in jurisdictions across the world. The answer to such question necessarily requires one to take a position on several difficult issues regarding the interpretation of DTCs. As has been shown, in order for DTCs to be applied, the OECD Model criteria of “person” and “resident” must be met. Depending on the hybrid entity at issue, the fulfillment of other conditions, such as “attribution of income” and “beneficial ownership”, also needs to be proved. Determining whether a CIS or trust fulfills each of these criteria is a difficult process. This is due to a number of factors, for example, ambiguity in DTC drafting, coupled with lack of clear directives from the OECD as to how to interpret and apply the OECD materials. Additionally, it is not yet conclusive which is the scope of the OECD Reports in this area, and therefore, which principles apply to the hybrid entity at issue has yet to be determined. Moreover, certain key terms in the OECD Model have been interpreted differently, resulting in additional ambiguities. Also, the differences under the domestic tax laws of both the residence and the source states result in DTCs being applied to CISs and trusts in diverse ways. In order to answer these questions, the author has followed a symmetrical analysis when analyzing the conditions for hybrid entities such as CISs and trusts to gain access to DTCs. The proposals in this thesis to amend the OECD Model and/or the OECD Commentaries are

asymmetrical, mainly due to the inconsistencies in the OECD materials dealing with these hybrid entities, and because the OECD has opted to leave some areas, such as trusts, mainly unregulated.

The preceding chapters of this analysis have shown that the interpretation of the conditions which must be satisfied for hybrid entities to gain access to DTCs is ambiguous. Even though the OECD has introduced some clarifications in regard to CISs by releasing the CIV Report and including it in the Commentaries of the OECD Model, the issue is far from being resolved in the context of trusts. This is especially true because the CIV Report provides a separate definition of collective investment vehicles²²¹⁶, but does not do the same with trusts. Therefore, a trust that does not fall within the definition of collective investment vehicle as outlined in the CIV Report and therefore is not subject to the conclusions of the CIV Report. The CIV Report acknowledges that fund structures are not subject to uniform treatment. The Report, thus, defers the decision of trusts' entitlement to DTC access to bilateral negotiations²²¹⁷.

As can be seen, the lack of clear reports and the presence of ambiguous definitions have resulted in legal uncertainties. In this sense, for example, it is unclear what is the hierarchy or the scope of each the Partnership Report and the CIV Report. This issue becomes relevant since given that a CIS can take the legal form of a partnership, there may be situations in which the findings of both the Partnership Report and the CIV Report could be applicable²²¹⁸. The situation can become even more complex if for example the Partnership Report and the CIV Report bring contradictory solutions. In the case of trusts, neither the Partnership Report nor the CIV Report applies, adding more uncertainty as to the application of DTCs to these entities.

²²¹⁶ CFA Report, para. 4 and OECD Commentary 2014, nr. 6,8 ad. Art. 1.

²²¹⁷ CFA Report, para. 26 and OECD Commentary 2014, nr. 6,10 ad. Art. 1.

²²¹⁸ STEVENS, Comparison between Partnership and Collective Investment Schemes Report, p. 102.

The CIV Report, for example, refers in several parts to the solutions provided by the Partnership Report, which opens the door to question about the extent to which the principles laid down in the Partnership Report are applicable to CISs in the form of a partnership. Scholars have taken different positions regarding this question. Some scholars have stated²²¹⁹ that the CIV Report should be seen as some sort of “*lex specialis*” in relation to the more generally applicable Partnership Report²²²⁰. As demonstrated in a previous chapter, however, this view cannot be followed in every case. Even though the CIV Report does not mention partnerships as an example of the legal forms a CIS can adopt, some authors suggest that, if the partnership fulfills the requirements to be considered a CIS under para. 26 of the CIV Report and para. 6.10 ad. 1 of the OECD Commentaries, there should be no reason preventing the application of the findings of the CIV Report to such partnership²²²¹. In this case, the author suggests that both reports, and not only the CIV Report, shall in principle be applicable with regard to CISs in the form of partnerships²²²².

Despite some arguments to the contrary however, it seems that a balance of all the factors reveal that the OECD did not intend to have the findings of the Partnership Report directly applied to other hybrid entities such as CISs and trusts. For instance, the Partnership Report explicitly refers to partnerships only as “*entities that qualify as such under civil or commercial laws*” of each contracting state, limiting the scope of the Report to partnerships by its own terms. Thus, only those entities that domestic laws qualify as partnerships are under the scope of the Partnership Report.

Also, the Partnership Report acknowledges the difficulties that may arise when trying to apply the Report to partnerships with a large number of partners, who are residents of different states. This is a typical scenario in CIV

²²¹⁹ Amongst others: STEVENS, The 2010 CIV Report: A Comparison with the 1999 Partnership Report, p. 112.

²²²⁰ OECD, Partnership Report, para. 1.

²²²¹ STEVENS, Comparison between Partnership and Collective Investment Schemes Report, p. 104.

²²²² STEVENS, Comparison between Partnership and Collective Investment Schemes Report, p. 104.

cases. The structure of CISs, as seen, clearly cannot be assimilated to partnerships, which are usually comprised of a small number of partners.

Additionally, the publication of the CIV Report, dealing exclusively with CISs, might lead to the conclusion that the application of the Partnership Report, which only directly addresses partnerships, is not appropriate for other types of business schemes. The fact that the CIV Report was released after the Partnership Report of 1999 further weighs in favor of non-application of the principles contained in the Partnership Report to CIVs.

The crucial question of which Report should apply in such circumstances remains unanswered²²²³ and controversial amongst different scholars, and it reveals a lack of systematic consideration by the OECD as to how hybrid entities may be able to access DTC benefits in general.

Further, a more difficult and relevant current question to answer is how the BEPS Action Nr. 2 Discussion Draft could find systematic interpretation in the case of partnerships, CISs and trusts. As explained in previous chapters, the Discussion Draft aims at suggesting changes to the OECD Model Tax Convention in order to ensure that hybrid instruments and entities are not used to unduly obtain DTC benefits. The OECD, though, has not yet arrived at a final conclusion regarding the issues discussed in the Draft. The final outcome cannot be easily predicted, partially due to the fact that the Discussion Draft has been, to a large extent, politically driven. As seen, there is considerable uncertainty as to whether hybrid entities such as CISs and trusts may in some cases be able to claim tax treaty benefits. In this context, it is not always clear whether they would fulfill the requirement of “*person*” and “*resident*” under Arts. 1 and 4 OECD Model, and whether they would be able to fulfill (if required) the further test of “*attribution of income*” and the test of “*beneficial ownership*”. Therefore, the answer to the question of whether they can claim treaty benefits is not unequivocal and will depend on different factors, in particular on whether the hybrid entity is organized as a trust or a CIS. As previously mentioned, the objective of this thesis was to

²²²³ STEVENS, Comparison between Partnership and Collective Investment Schemes Report, p. 102.

pursue a symmetrical structure when analyzing hybrid entities, in order to ensure simplicity and clarity for the reader. This was done by demonstrating the issues arising from the domestic taxation of CISs and trusts, as well as the application of DTCs to CISs and trusts. Interestingly, the practical proposals in this thesis to amend the OECD Model and OECD commentary are mainly asymmetrical. This is due to the fact that the OECD has opted to regulate certain areas and leave others, such as trusts, mainly unregulated. This means that the proposals only will suggest changes to the extent they are needed to address unclear or unresolved areas.

The above mentioned uncertainties are caused by a number of factors, including ambiguity in the drafting of DTCs, the lack of clear and purposive guidance from the OECD regarding the interpretation and application of the different discussion drafts, and the diverging approaches to the meaning of certain key terms in the OECD Model. For instance, and despite the relevance of the terms in the application of DTCs, there are today still no mechanisms in place under the OECD Model to systematically and effectively ensure certainty for the contracting states as to whether a party should be considered a “*resident*” or “*liable to tax*”.

This is mainly due to the fact that the undefined term “*resident*” in the OECD Model is given its meaning through another undefined term - “*liable to tax*” - in accordance with domestic law. As a result, contracting states have adopted different approaches regarding the definition and scope of these terms. For example, some jurisdictions, such as Canada²²²⁴ and the Netherlands²²²⁵, interpret the “*liable to tax*” criterion literally and grammatically, e.g., as a “*subject-to-tax*” requirement²²²⁶, demanding the CIS or trust to be “*actually subject to taxation*” in at least one of the contracting states in

²²²⁴ Supreme Court of Canada, 22 Jun. 1995, nr. 23940 (Crown Forest Industries Ltd. v. Canada) (1995) 2 SCR 802. For a discussion of this case, see amongst others: LUKKIEN, nr. 3 as well as WARD, Crown Forest Industries, p. 408 et seq.

²²²⁵ Dutch Supreme Court, 28 Feb. 2001, nr. 35557, BNB 2001/295; Dutch Supreme Court, 4 Dec. 2009, nos 07/10382-07/10384, V-N 2009/63.17; and Dutch Supreme Court, 4 Dec. 2009, nr. 08/05071, V-N 2009/62.5.

²²²⁶ In this vein, see: LUKKIEN, nr. 6.

order to benefit from DTCs. Others also follow a literal and grammatical approach but consider simple recognition as a taxpayer without being “*subject-to-tax*” sufficient. Lastly, the teleological approach deems “*effective recognition as a taxpayer*” with a locality-related or territorial attachment to the relevant contracting state sufficient, irrespective of whether income taxes are in fact paid²²²⁷.

The continuing absence of provisions to determine whether a party should be considered a “*person*”, “*resident*”, and whether it would be able to fulfill (if required) the further tests of “*attribution of income*” and of “*beneficial ownership*”, is likely to harm the competitiveness of a global financial center such as Switzerland. Indeed, hybrid structures such as CISs and trusts are widely used for wealth planning purposes in Switzerland and other financial centers. The lack of certainty as to their tax treatment is likely to deter investors from using these types of hybrid entities in an increasingly tax transparent world.

It is therefore clear that solutions to these complex issues should, as Einstein put it, be made as simple and feasible as possible, but not any simpler. For this reason, the author does not suggest a “*radical restructuring of the OECD Model*”²²²⁸, but rather proposes solutions that are “*useful*”, “*practical*” and “*feasible*”. Thus, instead of a radical overall change in approach, it is suggested that uniformity could more simply be achieved by inserting provisions giving specific guidance in the Commentary and the inclusion of conclusive terms and references in the OECD Model. The OECD should clarify the scope of the Discussion Drafts, such as the BEPS Report, and specify to whom it shall apply and in which cases.

Such guidance would end the unnecessary inconsistencies and uncertainties regarding the DTC treatment of hybrid entities like CISs and trusts. At the same time, it would ensure that DTCs are effectively applied to eliminate or reduce double taxation in relation to the same income and capital.

²²²⁷ Federal Administrative Court of 7 September 2011 (A-813/2010). In this vein also: DE GRAAF/PÖTGENS, Worrying Interpretation of liable to tax, p. 169.

²²²⁸ WHEELER, The Missing Keystone of Income Tax Treaties, p. 247.

8.2 Proposal to Amend OECD Model and the OECD Commentary

In Chapter 6 of this thesis, the author set out the conditions which must be fulfilled to secure the application of DTCs. In order to develop a coherent, feasible and uniform tax system regarding the application of DTCs to CISs and to trusts, it is submitted that new guidance in the OECD Model and its Commentary should be added. It is also suggested that these changes would only be inserted in the OECD Model if those are indispensable but not to the extent that the solution could be achieved by getting clarity through adding a provision in the OECD Commentary. It is the author's opinion that the same coherent result can be achieved by inserting changes to the Commentary and the problem of having numerous states having to amend bilateral DTCs is avoided.

8.2.1 The Term “Person” under Article 3 OECD Model

The author considers that CISs and trusts are to be considered “*persons*” within the scope of Art. 3 para. 1(a) OECD Model without further inquiry as to their legal form. A designated or particular legal form should not be a prerequisite for DTC access and the term “*person*” should not be used to formalistically restrict the scope of application of the Convention without engaging with the substance of the underlying issues²²²⁹.

The CIV Report specifically states that the determination of whether a CIS is a person begins with its legal structure²²³⁰. In this sense, a CIS structured in a corporate form would clearly be considered a “*person*”²²³¹. The situation might not be all that clear when the CIS takes the legal form of a trust because some civil law countries might not recognize the concept of trust itself, denying the trust the characterization as a “*person*”²²³². However, it is submitted that the scope of the term should be analysed in light of paragraph 2

²²²⁹ DANON, thesis, p. 271.

²²³⁰ CFA Report, para. 23, OECD Commentary 2014, nr. 6,10 ad. Art. 1.

²²³¹ CFA Report, para. 25, OECD Commentary 2014, nr. 6,10 ad. Art. 1.

²²³² CFA Report, para. 26, OECD Commentary 2014, nr. 6,10 ad. Art. 1.

of the Commentary on Article 3, which states that the definition of the term “*person*” should be given a very wide sense²²³³.

Due to these different possible qualifications, it is important to introduce amendments to the OECD Commentary in order to clarify this issue. In particular, CISs (following the definition in the Commentary²²³⁴) and trusts (following the definition in the Hague Convention²²³⁵) should expressly be considered as “*persons*” for DTC purposes, irrespective of their legal form. Thus, the only decisive limitation for their access to DTCs should be contained in the requirements of “*residence*”, “*attribution of income*” (where applicable), and “*beneficial ownership*”²²³⁶.

8.2.2 The Term “Resident” under Article 4 para. 1 OECD Model

The key element in order to determine whether a person (such as a CIS or trust) is a “*resident*” in a contracting state for DTC purposes is the fulfillment of the “*liable to tax*” condition, which is closely linked to the requirement of “*comprehensive taxation*”. The meaning of the “*resident*” criterion is particularly controversial in relation to hybrid entities such as CISs and trusts. The lack of clear provisions and guidance has led to heterogeneous and inconsistent practices among jurisdictions. This is mainly due to two reasons. First, the different scholarly views on the meaning of the “*liable to tax*” requirement are not homogenous, and second, the tax treatment of CISs and trusts differs among the contracting states.

In some states, for example, CISs and trusts are regarded as fiscally-opaque, but are exempted from payment of taxes upon the fulfillment of certain conditions, whereas in other contracting states, such as Switzerland, they are considered as fiscally-transparent. In a third category of states, they are considered to be subject-to-tax but their taxable base is decreased in line with the distributions paid to their investors and beneficiaries so that, ultimately,

²²³³ and OECD Commentary 2014, nr. 2 ad. Art. 3.

²²³⁴ OECD Commentary 2014, nr. 6.8 ad. Art. 1.

²²³⁵ Art. 2 of the Hague Trust Convention.

²²³⁶ See Chapter 6.3, 6.4 and 6.5.

no tax is actually paid at the level of the hybrid entity. This wide range of possibilities and the lack of a clear dividing line between full transparency and non-transparency makes it extremely difficult to determine (i) whether CISs and trusts are “*liable to tax*”; and (ii) whether the closely-linked condition of “*comprehensive taxation*” is satisfied to an extent that they are considered “*resident*” in a contracting state under the current treaty framework²²³⁷.

The OECD Model and Commentary do not provide a uniform solution to fiscally-transparent hybrid entities. In the case of trusts, neither the OECD Model nor the Commentaries expressly state whether fiscally-transparent (“*flow-through*”) trusts are to be considered “*residents*”. For CISs and partnerships, however, the Commentary specifies who is to be considered “*resident*” and “*liable to tax*” when the CISs²²³⁸ or the partnership²²³⁹ is fiscally-transparent, thus clarifying who can claim access to DTCs.

In the case of fiscally-transparent CISs, the Commentary states that the holders of interests in the CIS are “*liable to tax*” on the income received by the CIS. In such case, the CIS would not be treated as a “*resident*” of the contracting state in which it is established because it is not “*liable to tax*” therein²²⁴⁰.

As for partnerships, the OECD Commentary clarifies that, where a state treats the partnership as fiscally-transparent, and taxes the partners on their share of the partnership income, the partnership itself is not “*liable to tax*” and may not, therefore, be considered as “*resident*” of that state. Since the income of the partnership “*flows through*” to the partners, the partners are

²²³⁷ In Italy, trusts are expressly included among the entities subject to corporation tax. This is especially the case for irrevocable discretionary trusts. Being subject to tax, they must clearly be considered “*resident*” for DTC purposes. However, whether trusts are entitled to DTC access is a more difficult question where trust income is taxed at the beneficiary level. In this vein, see: MAISTO, *Taxation of Trusts in Italy*, p. 181.

²²³⁸ OECD Commentary 2014, nr. 6.11 ad. Art. 1.

²²³⁹ OECD Commentary 2014, nr. 8.8 ad. Art. 4.

²²⁴⁰ OECD Commentary 2014, nr. 6.11 ad. Art. 1.

the persons who are “*liable to tax*” on that income. It is thus for the partners to claim tax treaty benefits²²⁴¹. Under Swiss domestic law, both the partnership and trusts are tax transparent entities and therefore, unlikely to be considered “*liable to tax*” from the OECD perspective²²⁴².

In an attempt to clarify the term “*liable to tax*”, the Federal Administrative Court ruled in the “*Madeira*” case of 2011 that, in the case of a corporate entity “*effective recognition as a taxpayer*” with a locality-related or territorial attachment to the jurisdiction is sufficient to find residence for DTC purposes, irrespective of whether any income taxes are actually paid in that state by the corporate entity. Therefore, from a purely Swiss law perspective, as opposed to the OECD’s view, it should be irrelevant whether the person is qualified as either fiscally-transparent (“*flow-through*”) or tax-exempt when a fund is organized in a corporate form. However, this judgment will only have a direct impact for corporate forms of CISs such as SICAVs²²⁴³, but certainly not for those organized in a non-corporate form, such as FCPs and LPs. It should be noted, however, that in relation to trusts, the Circular Letter 30/20 clearly states that trusts do not qualify as “*residents*” of Switzerland for DTC purposes²²⁴⁴.

For this reason and to avoid any uncertainty with regard to the application of DTCs to CISs and trusts and to establish uniform principles at an international level, it is important to introduce amendments to the OECD materials. In order to achieve this in the best possible way, it is suggested that these changes should go further than simply amending the OECD Commentary or publishing a further OECD report. In fact, legal certainty cannot only be achieved through these means, especially since not all countries are member states of the OECD, and not all OECD countries follow the OECD materials, as for instance, the Partnership Report.

²²⁴¹ OECD Commentary 2014, nr. 8.8 ad. Art. 4.

²²⁴² In this vein, amongst others: KOELE, *Trusts and the Application of the OECD Model Convention*, p. 88.

²²⁴³ OESTERHELT, *Steuerliche Entwicklungen*, p. 38 et seq.

²²⁴⁴ Para. 8.3 Circular 30/20.

Article 6.11 of the OECD Commentary currently confirms that the interpretation of the term “*resident*” depends on the tax treatment of the CIS in the contracting state in which it is established²²⁴⁵. It is suggested that this principle should be extended, for the sake of clarity, to trusts as well. Due to its importance, this amendment should also be made to the OECD Model and be imported into the current network of Swiss DTCs by inserting a new second paragraph into Article 4, providing clarity in relation to the interpretation of the term “*resident*”. This approach would be akin to that found in Art. 1 para. 6 of the US Model²²⁴⁶, the 1999 DTC between Switzerland and the US,²²⁴⁷ and the 1999 DTC between the Netherlands and Panama²²⁴⁸.

It is fair to say that US international tax policy has influenced this approach. Indeed, the US Model Tax Convention of 1996 already contained a provision in paragraph d) of Article 4 concerning “*Residence*”, stating that:

“An item of income, profit or gain derived through an entity that is fiscally transparent under the laws of either Contracting State shall be considered to be derived by a resident of a State to the extent that the item is treated for

²²⁴⁵ CFA Report, para. 27 and OECD Commentary 2014, nr. 6.11 ad. Art. 1..

²²⁴⁶ “*An item of income, profit or gain derived through an entity that is fiscally transparent under the laws of either Contracting State shall be considered to be derived by a resident of a State to the extent that the item is treated for purposes of the taxation law of such Contracting State as the income, profit or gain of a resident*”. See: Art. 1 para. 6 US Model of 2006.

²²⁴⁷ “*The term “resident of a Contracting State” means (...): a partnership, estate, or a trust, but only to the extent that the income derived by such partnership, estate, or trust is subject to tax in that State, in the same manner as the income of a resident of that State, either in its hands or in the hands of its partners or beneficiaries*”. See: Art. 4 para. 1 lit. d DTC between Switzerland and the United States of Mai 18, 1999.

²²⁴⁸ “*A person, other than an individual, which has its place of incorporation or its place of management in a Contracting State, shall be deemed to be liable to tax in that State provided that income derived by that person is treated under the tax laws of that State as the income of that person and not as the income of its beneficiaries, members or participants*”. See: Art. 4 para. 2 DTC between the Netherlands and Panama of October 6, 2010.

*purposes of the taxation law of such Contracting State as the income, profit or gain of a resident*²²⁴⁹”.

The same provision appears in the revised US Model Tax Convention of 2006. Surprisingly, it was moved from Article 4 entitled “*Residence*” to Article 1 entitled “*General Scope*”. It should be noted, however, that the approach of including such provision in Article 4 might lead to improperly mixing the “*attribution of income*” and the “*liable to tax*” requirements. Although a person will generally fulfill the “*liable to tax*” condition when income is attributed to him, this is not always the case. Furthermore, from a systematic point of view both requirements should be distinguished from one another.

In order to distinguish from a systematic point of view both the “*liable to tax*” and “*attribution of income*” requirements and to clarify the issue, the author suggests introducing a new paragraph expressly dealing with the case of trusts.

The new second paragraph of Article 4 could be structured as follows:

“Any hybrid entity, such as a trust, collective investment scheme or a partnership, which is, by reason of the provisions of paragraph 1, governed by or established under the laws of a Contracting State, shall be deemed to be liable to tax in that State, but only in the context of trusts and partnership, provided that the attribution of income rule derived from Art. 1 is fulfilled meaning that each item of income derived by that person is treated under the tax laws of that State as the income of that person and not as the income of its settlor, beneficiaries (in the context of a trust) or participants (in the context of a partnership) (as applicable)”.

This approach would ensure that, in addition to the “*liable to tax*” requirement, the “*attribution of income*” requirement would have to be fulfilled in

²²⁴⁹ US Model Tax Convention, 1996.

the case of trusts claiming DTC benefits, but not in the case of CISs (as it results from the CIVs Report). The inclusion of this paragraph would also ensure that a hybrid entity, such as a CIS and trust will be considered “*liable to tax*” in the state in which its place of establishment or place of effective management is located, provided that income derived by the trust is also regarded by the tax laws of that state as attributed to the trust, and not as income of the trust’s settlor/beneficiaries. This proposal would be in line with the approach of the OECD Final Report on BEPS Action Nr. 2 (Treaty Issue) to the application of the attribution of income rule. It would also clearly define the scope of such rule and demonstrate that the attribution of income rule is an independent test that must be fulfilled in addition to Art. 4 under Art. 1.

In line with the OECD Final Report on BEPS Action Nr. 2 (Treaty Issue), therefore, hybrid entities would be regarded as “*resident*” in their state of establishment or effective management for DTC purposes if they are considered “*liable to tax*” under the domestic law of that state, irrespective of whether they are effectively taxed there. With respect to trusts, therefore, the “*attribution of income*” rule would have to be fulfilled independently.

8.2.3 The Term “Attribution of Income”

The objective of the “*attribution of income*” (“*Einkünftezurechnung*”; “*attribution du revenu*”) requirement is to attribute each single item of income, such as dividends or interest (tax object), to a tax subject in a contracting state (e.g. a hybrid entity, an individual or company) as a matter of domestic law. The fact that contracting states apply their domestic law when they “*attribute an item of income*” to a certain taxpayer, means that there is a potential for conflicts of attribution, since the residence and source states may attribute the same item of income to different tax subjects.

The scope and definition of the term have become more relevant since the entry into force of the BEPS Report, suggesting the inclusion of an express provision into Art. 1 of the OECD Model. The proposed provision is aimed at ensuring that each item of income is allocated to a resident for the purpose of benefitting from DTC access, and also that hybrid instruments and entities

are not used to unduly obtain DTC benefits. The suggested provision is based on the 2006 US Model Tax Convention²²⁵⁰.

As a consequence, the BEPS Report intends to include in the OECD Model and the Commentary a provision that would treat income of fiscally-transparent entities in accordance with the principles and conclusions of the Partnership Report²²⁵¹. The BEPS Report will therefore expand the application of the conclusions of the Partnership Report. Indeed, since the Partnership Report exclusively deals with partnerships, the proposed provision is specifically intended to deal with other entities that are treated as “*wholly or partly*” fiscally-transparent, but were not directly included in the Partnership Report, such as trusts²²⁵².

The proposed provision states: “*For the purposes of this Convention, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State shall be considered to be income of a resident of a Contracting State but only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State. [In no case shall the provisions of this paragraph be construed so as to restrict in any way a Contracting State’s right to tax the residents of that State]*”²²⁵³.

This provision confirms that, in order to apply the “*attribution of income*” rule, the requirement of “*resident*” needs to be fulfilled first. From a literal interpretation of the BEPS Report’s provision quoted above, it seems that the “*attribution of income*” rule only comes into play when the “*resident*” requirement has been first fulfilled. The BEPS Report also clarifies that this

²²⁵⁰ The US Model Tax Convention provides in Article 1: “*An item of income, profit or gain derived through an entity that is fiscally transparent under the laws of either Contracting State shall be considered to be derived by a resident of a State to the extent that the item is treated for purposes of the taxation law of such Contracting State as the income, profit or gain of a resident*”.

²²⁵¹ OECD Final Report on BEPS Action Nr. 2, para. 11 (Treaty Issues).

²²⁵² OECD Final Report on BEPS Action Nr. 2, para. 26.4 (Treaty Issues).

²²⁵³ OECD Final Report on BEPS Action Nr. 2, para. 11 (Treaty Issues).

“*attribution rule*”, when applied to hybrid mismatch “*entities or arrangements*”, should clearly be interpreted and seen in the context of the Partnership Report and the distributive rules of the OECD Model²²⁵⁴.

It is therefore important that Switzerland inserts provisions into its DTCs to provide clarity regarding cross-border conflicts of attribution of income. In particular, Switzerland should insert provisions to ensure that the source state follows the attribution principles of the residence state²²⁵⁵. Such a clarification would be in line with the meaning given to the “*liable to tax*” condition under Art. 4 OECD Model. The “*attribution of income*” condition is an independent requirement, but should be linked to the contracting state in which the place of establishment or place of effective management of the relevant hybrid entity is located. This approach would ensure that the “*attribution of income*” criterion is analysed by the same contracting state in which the hybrid entity has its place of establishment or place of effective management. It would thus avoid conflicts of attribution.

8.2.4 The Term “Beneficial Ownership”

As per today, neither the OECD Model nor the OECD Commentary contains a definition of “*beneficial owner*”. Thus, there is only scarce guidance available as to the specific meaning and the applicability of the term “*beneficial ownership*,” especially in the case of CISs and trusts.

In the context of trusts, the OECD Model and its Commentaries, and both Discussion Drafts provide little clarification (with a few exceptions²²⁵⁶) in regards to the interpretation of the “*beneficial ownership*” requirement.

²²⁵⁴ OECD Final Report on BEPS Action Nr. 2, para. 26.13 (Treaty Issues).

²²⁵⁵ DANON, Conflicts of Attribution, p. 217.

²²⁵⁶ Art. 3 (b) of the protocol of 6 June 1980 to the DTC Switzerland-New Zealand: “(...) dividends, interest or royalties in respect of which a trustee is subject to tax in New Zealand shall be treated as being beneficially owned by that trustee”. Also, the DTC between Italy and Germany defines the “*beneficial ownership*” requirement in Art. 9 of the protocol of 18 October 1989 as “*the recipient of the dividends, interest and royalties is the beneficial owner within the meaning of Articles 10, 11 and 12 if he is entitled to the right upon which the payments are based and the income derived therefrom is attributable to him under the tax laws of both States*”.

In the context of a CISs, the OECD Commentaries determine that a CIS as defined by paragraph 4 of the CIV Report is to be considered the “*beneficial owner*” of the income it receives, as long as the managers of the CIS have discretionary powers to manage the assets on behalf of the investors, and the CIS meets the requirements to be considered a “*person*” and a “*resident*” of the state in which the CIS is established²²⁵⁷. Considering the above, it can be stated that the CIV Report, unlike the Partnership Report, does not deem as “*beneficial owners*” whoever a certain item of income is attributed to according to the domestic law of the residence state. Indeed, the CIV Report is silent in regard to the term of “*attribution of income*”²²⁵⁸. In any case, and regarding the determination of who the “*beneficial owner*” is, the author suggests that definition of a CIS contained in paragraph 4 of the CIV Report should be followed.

Despite the legal uncertainties related to the term “*beneficial ownership*” in the context of CISs and trusts, it should be clear that, if CISs or trusts are denied access to DTCs, the investors within CISs or the settlors/beneficiaries of trusts may generally be considered the “*beneficial owners*” of the income. Moreover, it should be remembered that the “*beneficial ownership*” requirement only comes into play if the CIS or trust is considered a “*person*”, “*resident*” and only (in the situation of a trust) if the relevant income has been “*attributed*” to it by the state of residence. Thus, there is no need to analyze whether the CIS or trust fulfills the “*beneficial ownership*” requirement if the income is attributed to and effectively taxed at the level of the investor (in the context of a CIS²²⁵⁹) or the settlor/beneficiaries (in the context of a trust²²⁶⁰). The Swiss Federal Supreme Court has clearly stated that the “*beneficial ownership requirement*” should be considered a qualifying condition

²²⁵⁷ CFA Report, para. 33 and OECD Commentary 2014, nr. 6.14 ad. Art. 1.

²²⁵⁸ See Chapter 6.1.2.3.5.3.

²²⁵⁹ A CIS is only fully-transparent for direct tax purposes when it is classified as an “*accumulating fund*”.

²²⁶⁰ This is the case in Switzerland for revocable and fixed interest trusts, since either the settlor or the beneficiary is the taxpayer. See: DANON, thesis, p. 328-329.

(in German: “*Anspruchsvoraussetzung*”) when determining DTC eligibility²²⁶¹.

Even after the issuance of the Partnership Report and the CIV Report and the OECD Discussion Drafts on Beneficial Owner, there are still questions regarding the definition of “*beneficial owner*”, and the conditions that must be fulfilled in order to gain access to a DTC. Having explained how the OECD has approached the definition of “*beneficial owner*”, the author will now explain the specific issues that the application of the term raise, and also suggests possible solutions to such issues.

The first issue that needs to be solved is whether the term “*beneficial ownership*” should be given an autonomous meaning (an international fiscal meaning) or a meaning according to domestic law²²⁶². The Revised Discussion Draft on Beneficial Owner of October 19, 2012 as well as the OECD Commentary state that the “*beneficial ownership*” requirement must be given an autonomous (international fiscal) meaning. However, from a systematic perspective, it would have been preferable to also refer to the meaning of “*beneficial ownership*” deriving from domestic law when the relevant domestic law meaning is within the limits of the international fiscal meaning. Indeed, such reference to domestic law seems to be preferable since some states give a precise definition to the term, without adopting a narrow technical interpretation (for instance, providing that agents, nominees and conduits do not qualify as “*beneficial owners*”²²⁶³), meaning which does not contradict the international fiscal meaning of the term. By permitting reference to domestic law definitions, it may be possible to achieve more legal certainty.

Second, it is submitted that the original approach of the OECD requiring the “*beneficial owner*” to be the full owner of the income²²⁶⁴ goes too far. In the

²²⁶¹ See Swiss Federal Supreme Court decision of 5 May 2015 (2C_364/2012, 2C_377/2012, 2C_895/2012) cons. 5.1 as well as BAUMGARTNER, Beneficial ownership, p. 723 et seq. for further details.

²²⁶² See Chapter 6.5.2.1.

²²⁶³ OECD Commentary 2014, nr. 12.4 ad. Art. 10; nr. 10.2 ad. Art. 11, nr. 4.3 ad. Art. 12.

²²⁶⁴ AVERY JONES/VANN/WHEELER, Response to the OECD Discussion Draft, p. 1.

author's view, the OECD should rather expressly delimit the definition, determining under which indicia, circumstances or degrees of ownership a person could be considered the "*beneficial owner*". A narrow definition would raise its own controversies.

If the criterion were defined in the way suggested by the OECD in the Discussion Draft on Beneficial Owner of April 29, 2011, a person lacking full ownership of the income - for example due to the fact that they are obliged to forward the income to another person - would not be considered the "*beneficial owner*". By focusing on the concept of the "*full right to use and enjoy*", the definition is clearly too narrow and improperly excludes any person with only limited rights to use and enjoy income²²⁶⁵. In the author's view, the only purpose of the concept of "*beneficial ownership*" should be to exclude situations where "*the person has no control over [the income] due to a legally enforceable obligation to pass the income on to another person*"²²⁶⁶. The revised comments in the Discussion Draft on Beneficial Owner of October 19, 2012 and the OECD Commentary are, therefore, certainly to be welcomed.

Third, with regard to CISs, the OECD Commentary states that CISs who have a "*widely-held and diversified portfolio of securities*" and who are subject to "*investor-protection regulation*"²²⁶⁷ should also be considered the "*beneficial owners*" of the income they receive, as long as their managers have discretionary powers to manage assets on behalf of their investors²²⁶⁸, powers which go beyond those undertaken by a mere nominee, agent or conduit²²⁶⁹. This small amount of guidance is welcomed. However, the terms used are imprecise and too vague. It is suggested that further indicators should be provided in relation to these issues. The same principles are also

²²⁶⁵ AVERY JONES/VANN/WHEELER, Response to the OECD Discussion Draft, p. 1.

²²⁶⁶ AVERY JONES/VANN/WHEELER, Response to the OECD Discussion Draft, p. 5.

²²⁶⁷ OECD Commentary 2014, nr. 6.8 ad. Art. 1

²²⁶⁸ OECD Commentary 2014, nr. 6.14 ad. Art. 1

²²⁶⁹ CFA Report, para. 35.

supposed to be applied in the case of trust relationships, and additions to this effect should be made in the OECD Commentary to clarify those situations.

Fourth, in order to qualify as “*beneficial owner*”, it should *prima facie* be irrelevant whether the CIS or trust has an incorporated or unincorporated legal structure; the legal structure could, at most, be a useful indicator²²⁷⁰. In general, whether or not a CIS fulfills the “*beneficial ownership*” requirement should be determined on the basis of its specific facts and circumstances, with regard to the relationship between the CIS and its investors²²⁷¹. The same may be stated, by way of analogy, for trust relationships. Moreover, it should be clarified that neither the fund management company nor the investment adviser, nor the custodian, nor the depository bank may be regarded as the “*beneficial owner*” of CIS or trust income.

Prior to drawing final conclusions as to whether trusts may be considered as “*beneficial owners*”, one should briefly analyze the cases of irrevocable discretionary accumulation trusts and accumulation trusts²²⁷². It should be reminded that the “*beneficial ownership*” criteria does not require the recipient of the income to be able to receive the economic benefit of the income and that it is sufficient for the recipient to be free to decide whether and to whom the income is to be distributed, gifted or passed. Therefore, under irrevocable discretionary accumulation trusts and, generally, accumulation trusts, trustees should be considered the “*beneficial owners*” of trust income if they have the power to control the attribution and disbursement of the trust income and are, therefore, neither an agent, nor a nominee, nor a conduit²²⁷³. In order to clarify how the “*beneficial ownership*” requirement is to be applied in the case of trusts, it is submitted that Articles 10, 11 and 12 of the

²²⁷⁰ In this vein: BONGAARTS/ED, General report on the taxation of investment funds, p. 45-46; GRILLI, Treaty entitlement of investment funds, p. 925.

²²⁷¹ In this vein: VIITALA, thesis, p. 92-95.

²²⁷² For instance, irrevocable fixed interest trusts often feature an accumulation period.

²²⁷³ In this vein: DANON, thesis, p. 340. Similar views are held by Philip Baker and John Prebble, in this vein: BAKER, The Application of the Convention to Partnership, trusts and other Non-Corporate Entities, nr. 18; PREBBLE, Accumulation Trusts and Double Tax Conventions, p. 76.

Commentary should be amended. Such amendments should derive from the Revised Discussion Draft on Clarification of the Meaning of “*Beneficial Owner*” and should be aimed at providing a uniform definition, leaving no room for ambiguity or uncertainty²²⁷⁴.

Such amendments should make clear that, based on the concept of the “*right to use and enjoy*”, the “*beneficial ownership*” criteria does not require the recipient of the income to be able to actually receive the economic benefit of the income. As said, all that should be required is that the recipient is free to decide whether and to whom the income is to be distributed, gifted or passed²²⁷⁵.

To clarify this point, it is submitted that the OECD Commentary should be amended as follows, which would be in line with the OECD Report on Beneficial Ownership:

“If a trust/trustee is, as a matter of true economic reality under the laws of the relevant Contracting State, directly or indirectly controlled by the settlor and/or the beneficiaries (e.g. where there is a revocable trust), the trust/trustee is constrained in its ability to disburse trust income and, therefore, does not have the right to use and enjoy such trust income for the purposes of Articles 10, 11 and 12. In this situation, the trust/trustee is not to be considered the beneficial owner of such trust income.

However, if a trust/trustee is not, as a matter of true economic reality under the laws of the relevant Contracting State, (directly or indirectly) controlled by the settlor and/or the beneficiaries (e.g. where there is an irrevocable discretionary or fixed interest trust with or without an accumulation period) and it is unconstrained in its ability to disburse trust income, it has the right to use and enjoy the trust income for the purpose of Articles 10, 11 and 12. In this situation, the trust/trustee is to be considered the beneficial owner of such trust income until the income is distributed, on the basis that the trustee is neither an agent, nor a nominee, nor a conduit”.

²²⁷⁴ DANON, Clarification of the Meaning of “Beneficial Owner” in the OECD Model Tax Convention, p. 438.

²²⁷⁵ DANON, thesis, p. 340.