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Foreign tax credit modifications

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In my view, it is likely that Article 13(1) CITA does hinder the freedom of establishment, but that the hindrance may be seen as caused by a disparity and/or it may be justified by the need to protect the coherence of the Netherlands tax system. In my view, Article 13(1) CITA also hinders the free movement of capital. The Netherlands should start considering an alternative. A good direction for a Netherlands solution would be to subject the deduction of expenses relating to the holding of subsidiaries to certain restrictions. The restrictions should be the same for domestic and foreign subsidiaries.

Switzerland

Foreign Tax Credit Modifications

Rolf Wüthrich*

INTRODUCTION

The Swiss cantons had to bring their cantonal (and, where applicable, their municipal) tax laws into line with the Federal Law on the Harmonization of Cantonal and Municipal Direct Taxes (*Bundesgesetz über die Harmonisierung der direkten Steuern der Kantone und Gemeinden*, StHG) of 14 December 1990 by 1 January 2001.[1] As one of the consequences of this harmonization, legal entities are now assessed using the current year assessment method.[2] For individuals, the cantons of Ticino, Valais and Vaud still use the preceding-year assessment method,[3] and all of the other cantons use the current-year assessment method.[4] As a result of this "partial harmonization" of the assessment periods, the method of calculating foreign tax credits has been simplified. Until 31 December 2000, a simplified and an exact method existed in respect of the calculation of foreign tax credits. Following the changes, the simplified method has, in general, been abolished with effect from 1 January 2001 for income that matures after 31 December 2000. For individuals in the cantons of Ticino, Valais and Vaud (the cantons using the preceding-assessment year), however, temporary provisions have been implemented that still permit a choice between the simplified and exact methods. The Federal Tax Administration issued Circular No. 6 of 6 June 2001 regarding the modifications of 9 March 2001 made to the ordinance of 22 August 1967 on foreign tax credits. The Circular describes the foreign tax credit granted in respect of dividend income, the minimum amount of foreign tax that must be paid in order to be entitled to a tax credit, the computation of the maximum amount of the tax credit available and the procedure for claiming the tax credit.

METHODS FOR THE ELIMINATION OR MITIGATION OF DOUBLE TAXATION

In the absence of a tax treaty, Switzerland provides for two methods to eliminate or mitigate double taxation: the exemption method and the deduction method. Under the deduction method, foreign taxes paid are deductible from taxable income in Switzerland. It is the net income received from the source state that is taxable in Switzerland. Under the exemption method, foreign-source income is exempt from income tax. Such income is only subject to taxation in the source state. Where progressive tax rates apply, however, foreign-source income is taken into consideration in determining the tax rate applicable to the taxable income of a taxpayer (exemption with progression method).

Switzerland has concluded more than 60 income (and capital) tax treaties and several treaties concerning the taxation of frontier workers and the taxation of profits from sea and air transport activities. Most of the treaties follow the principles of the OECD Model Tax Convention (OECD Model). None of Switzerland's treaties apply the credit method for the elimination of double taxation.[5] Generally the following (or a similar) formulation applies:

> In the case of Switzerland, double taxation shall be avoided as follows:
>
> a) Where a resident of Switzerland derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, Switzerland shall, subject to the provisions of subparagraph b, exempt such income or capital from tax but may, in calculating tax on the remaining income or capital of that resident, apply the rate of tax which would have been applicable if the exempted income or capital had not been so exempted.
>
> b) Where a resident of Switzerland derives dividends, interest or royalties which, in accordance with the provisions of Article 10, 11 or 12, may be taxed in the other Contracting State, Switzerland shall allow, upon request, a relief to such resident. The relief may consist of:
>
> (i) a deduction from the tax on the income of that resident of an amount equal to the tax levied in the other Contracting State in accordance with the provisions of Articles 10, 11 and 12; such deduction shall not, however, exceed that part of the Swiss tax, as computed before the deduction is given, which is appropriate to the income which may be taxed in the other Contracting State; or

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1. For an overview of tax harmonization, see Toni Amonn, "Tax Harmonization", 41 *European Taxation* 4 (2001), p. 132 et seq.

2. Art. 31 StHG. Under the current year assessment (postnumerando) method, the assessment period is one year. Tax is then computed on income of the current year. If a canton has chosen this method, the federal income tax liability of its residents is also calculated on the current year basis. The tax is assessed in the following year.

3. Under the preceding-year assessment (praenumerando) method, the normal assessment period is two years (e.g. 1999 and 2000; but the assessment period may also be one year), but tax is levied each year. The tax is computed on the basis of the average income of the preceding two years (e.g. 1997 and 1998). If a canton has chosen this method, the federal income tax liability of its residents is also calculated on the preceding-year basis. This system causes several problems, especially at the beginning or end of a taxable period or in the case of significant changes in the amount of taxable income.

4. See Arts. 15 and 16 StHG.

5. X. Oberson and H. Hull, *Switzerland in international tax law*, (Amsterdam: IBFD Publications BV, 1996), p. 128.

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(ii) a lump sum reduction of the Swiss tax; or
(iii) a partial exemption of such dividends, interest or royalties from Swiss tax, in any case consisting at least of the deduction of the tax levied in the other Contracting State from the gross amount of the dividends, interest or royalties.

Switzerland shall determine the applicable relief and regulate the procedure in accordance with the Swiss provisions relating to the carrying out of international conventions of the Swiss Confederation for the avoidance of double taxation.

c) A company which is a resident of Switzerland and which derives dividends from a company which is a resident of the other Contracting State shall be entitled, for the purposes of Swiss tax with respect to such dividends, to the same relief which would be granted to the company if the company paying the dividends were a resident of Switzerland.

Therefore, double taxation is, in general, avoided through the exemption method, but with respect to dividends, interest and royalties, a foreign tax credit is granted. Swiss treaty exemption provisions permit taking the exempted income into account in determining the tax rate applicable to the non-exempted income, as is done internally under domestic law.[6] Under some treaties the exemption is only granted if the source state effectively levies taxes on such income.

Under Swiss domestic law a credit is allowed for dividends, interest and royalties that are effectively subject to tax in the source state according to the domestic law of the source state and the tax treaty concluded with it. Dividends from a substantial participation in a non-resident company are treated the same as a holding in a Swiss resident subsidiary to avoid economic double taxation arising through the taxation of profits first at the level of the foreign subsidiary and later at the level of the Swiss parent company.[7]

FOREIGN TAX CREDITS

In general

In the past, a foreign tax credit[8] was not available under Swiss law. In order to implement the recommendations of the OECD and fulfil its obligations under Art. 23 A(2) of the OECD Model, Switzerland implemented the foreign tax credit in 1967.

The general rule according to which Switzerland grants an income exemption in the case of foreign-source taxation does not apply to income from dividends, interest and royalties; instead a foreign tax credit is granted. The legal basis for granting a foreign tax credit is a treaty provision; the regulatory statutes, however, are found in three federal ordinances concerning the foreign tax credit.[9] Switzerland makes treaty relief subject to domestic law relief rules in the double taxation relief articles of its treaties. These domestic law rules apply only when the treaty provides for a credit; there are no unilateral credit provisions.[10] Thus, a credit for non-recoverable foreign withholding taxes is only granted if it is provided for in a tax treaty. In the tax treaties concluded with Austria and Germany, special credit provisions for frontier workers can be found.[11]

If a foreign tax credit is granted, each of the Swiss political levels authorized to levy taxes (federal, cantonal and municipal) have to bear one third of the credit granted. In allocating this one third, the amount of tax effectively levied by these bodies and the ratio between the federal, cantonal and municipal taxes is of no importance. A foreign tax credit eliminates only the effective double taxation, which means that the taxpayer suffers the higher of the Swiss or the foreign tax due. Foreign tax credits cannot be carried forward.

Requirements for granting a foreign tax credit

To benefit from a foreign tax credit a taxpayer must be a resident of Switzerland. In the following situations a foreign tax credit cannot be granted:

– there is no obligation to grant a credit under a tax treaty;[12]
– no tax is due in the source state; however, some tax treaties provide for a matching credit;
– no tax is levied in Switzerland or the taxpayer is exempt from taxation in Switzerland;
– an individual is taxed according to his living expenses;[13] or
– the foreign tax credit does not exceed CHF 50.[14]

In addition, any person not entitled to a treaty benefit, either by reason of a tax treaty or by reason of the Decree of 14 December 1962 concerning measures against the improper use of tax conventions, is not entitled to a foreign tax credit.[15]

6. J. F. Avery Jones et al., "Credit and exemption under tax treaties in cases of differing income characterization", 36 *European Taxation* 4 (1996), p. 124.
7. This provision is in the treaties with, e.g. Australia, Belgium, China, Ecuador, Finland, Iceland, Ireland, Jamaica, Japan, Korea (Rep.), Kyrgyzstan, Luxembourg, Malaysia, Mexico, New Zealand, Norway, Pakistan, the Philippines, Portugal, Singapore, the Slovak Republic, Slovenia, Spain, Thailand, Trinidad and Tobago, Tunisia, the United Kingdom and Venezuela.
8. *Pauschale Steueranrechnung; imputation forfaitaire d'impôt; computo globale d'imposta*.
9. Ordinance on the foreign tax credit of 22 August 1967 (*Verordnung über die pauschale Steueranrechnung vom 22. August 1967*; *Ordonnance du 22 août 1967 relative à l'imputation forfaitaire d'impôt*; *Ordinanza del 22 agosto 1967 sul computo globale d'imposta*)(SR 672.201; hereafter: VO PStA); Ordinance 1 of the Federal Ministry of Finance on the foreign tax credit of 22 August 1967 (*Verordnung 1 des EFD über die pauschale Steueranrechnung vom 6. Dezember 1967*; *Ordonnance 1 du DFF du 6 décembre 1967 relative à l'imputation forfaitaire d'impôt*; *Ordinanza 1 del DFF del 6 dicembre 1967 sul computo globale d'imposta*) (SR672.201.1; hereafter: VO PStA1); Ordinance 2 of the Federal Ministry of Finance on the foreign tax credit of 12 February 1973 (*Verordnung 2 des EFD über die pauschale Steueranrechnung vom 12. Februar 1973*; *Ordonnance 2 du DFF du 12 février 1973 relative à l'imputation forfaitaire d'impôt; Ordinanza 2 del DFF del 12 febbraio 1973 concernente il computo globale d'imposta*)(SR 672.201.2; hereafter: VO PStA 2).
10. J. F. Avery Jones et al., see note 6, p. 120.
11. Art. 15(4) of the treaty with Austria of 30 January 1974 and Art. II of the protocol 1992 implementing Art. 15A in the treaty between Germany and Switzerland of 11 August 1971.
12. In the treaty with Pakistan, for example, or where a treaty provides for another solution.
13. Under certain conditions, however, a tax credit may be granted under the treaties with Austria, Belgium, Canada, France, Germany, Italy, Norway and the United States.
14. As from 1 January 2001; until 31 December 2000 the minimum amount was CHF 30.
15. Art. 6 VO PStA.

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A foreign tax credit is only granted if the foreign-source income is subject to ordinary taxation in Switzerland. Where a foreign tax credit is granted, a taxpayer may credit:
- one third of the credit against the federal tax levied; and
- two thirds of the credit against the cantonal and municipal taxes levied.

The credit is granted only if the income is taxable at the relevant level (federal, cantonal or municipal). In other words, if at the federal level the income is not subject to taxation, the part of the credit attributable to the federal taxation right (one third of the credit) will not be credited against the federal tax due because there is no double taxation. At the cantonal and municipal levels, the same principle applies; thus, if the income at the cantonal and/or at the municipal level is not subject to taxation, the attributable parts of the credit (two thirds of the credit) are not creditable.

In the following situations, among others, income of a company may be exempt from taxation in Switzerland and, as a consequence, no foreign tax credit is granted:
- if participation relief for dividend income (at the federal, cantonal and municipal levels) is available; or
- in the case of the holding company privilege[16] (at the cantonal and municipal levels only).

As a consequence, the following combinations can result:

Taxation level	Relief/status of company	Relief/status granted	% of foreign tax credit granted
federal	participation relief	yes	0
cantonal/municipal	participation relief	yes	0
federal	participation relief	no	33 1/3
cantonal/municipal	participation relief	no	66 2/3
federal	participation relief	yes	0
cantonal/municipal	holding company	yes	0
federal	participation relief	no	33 1/3
cantonal/municipal	holding company	yes	0
federal	holding company	not possible	33 1/3
cantonal/municipal	holding company	yes	0
federal	holding company	not possible	33 1/3
cantonal/municipal	holding company	no	66 2/3
federal	holding company	not possible	33 1/3
cantonal/municipal	participation relief	no	66 2/3

In respect of the participation relief granted for dividends it should be noted that until 31 December 2000 such dividends were considered to be non-taxed and, as a consequence, no tax credit was granted. However, if the company receiving the dividends proved that the participation relief granted amounted to less than the foreign tax credit granted under the exact calculation method, the difference between the foreign tax credit and the amount of the participation relief was refunded to the company. Note that:
- the participation relief was applied, *de lege lata*, i.e. companies could not opt for the foreign tax credit in lieu of the participation relief.
- the above restriction was applied only to dividend income (and not to other income for which a tax credit is granted).

As long as the calculation of the participation relief was based on the gross dividend income, the participation relief granted could have been less favourable than the taxation of the dividend income in combination with the foreign tax credit. As a result of the federal corporate tax reform in 1997 the net income method for calculating the participation relief was implemented. As a consequence, the gross profit method no longer applied at the federal level; the cantons implemented the net profit calculation method beginning in 2001. Therefore, the possibility of getting a refund of the difference between the foreign tax credit and the amount of the participation relief has been abolished for income realized after 1 January 2001.

Calculation and limitations on the foreign tax credit

In general, the amount of the foreign tax credit is equal to the sum of foreign withholding taxes levied under a tax treaty on income that matures in the same tax year in which the foreign withholding tax is levied. The credit, however, is limited to the amount of Swiss taxes due on such income.[17] Due to the federal taxation system (federal, cantonal and municipal taxation; sharing of the tax credit granted by the taxing levels) and to the different assessment periods (current-year assessment vs. preceding-year assessment) the calculation of the foreign tax credit is problematic. Therefore, the Swiss tax due is calculated differently depending on whether the income is realized by an individual or by a company. Moreover, a simplified and an exact method of calculation still exist for individuals and for companies for income realized before 31 December 2000.

16. Distinguish, however, the taxation of a management company. At the federal level, a management company is subject to taxation as an ordinary company. At the cantonal/municipal level such a company is taxed as follows: (1) dividend income from substantial participations is exempt, (2) income from Swiss sources is taxed at ordinary rates and (3) the part of foreign-source income that is attributable to the activities of the management company is taxed at ordinary rates. In the case of foreign-source royalty income, it must therefore be determined if such income is attributable to the Swiss activities, and as a consequence whether or not it is subject to tax. Therefore, the foreign tax credit granted is calculated separately for federal and for cantonal/municipal tax purposes (Art. 5(3) VO PStA).
17. Art. 8(2) VO PStA.

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Income realized before 31 December 2001 – The simplified calculation method

For income realized before 31 December 2001 the simplified calculation method for individuals applies as follows: individuals must declare their gross income from foreign-source dividends, interest and royalties if the income relates to private assets. Thus, foreign withholding taxes paid are not deductible.[18] If the income is realized with business assets, the company rules apply.[19]

The foreign tax credit is limited to the tax due in Switzerland. The calculation of the tax due in Switzerland is based on the tax rate that applies to the taxpayer in the tax year concerned. To avoid burdensome calculations due to the federal tax structure (federal, cantonal and municipal taxation), the Federal Department of Finance has published a *simplified tax rate* scale for individuals,[20] which is based on the average tax rates applicable in Switzerland. These rates contain the federal, cantonal and municipal taxes and are, in general, applicable to all taxpayers. In calculating the tax due, related foreign interest payments and other expenses may be deducted. The relevant taxable income is the income used to determine Swiss federal income tax that is paid in the year that the treaty-favoured income falls due.[21]

For income realized before 31 December 2001, companies, when applying for a foreign tax credit, can apply the simplified method of calculation. They have the choice of declaring either the gross income from dividends, interest and royalties, or the net income at the moment such income is realized. In the latter case, a company accounts for:
– the net income (at the moment such income is received);
– the foreign withholding tax that is refundable (at the moment the tax is refunded); and
– the foreign tax credit granted by Switzerland (at the moment the credit is granted).

Thus, if a company declares the net income, its income consists of:
– the net income from dividends, interest or royalties; plus
– the refunded foreign withholding tax of the actual year or any preceding year; plus
– the foreign tax credit granted in respect of the actual year or any preceding year.

To calculate the Swiss tax due, tax rates at the place of incorporation are applied to the taxable income as determined for both Swiss federal and cantonal/municipal tax purposes, even if a company might be subject to Swiss taxation in different cantons.[22] The relevant taxable income is the income used to determine federal, cantonal and municipal income tax that is paid in the year the treaty-favoured income falls due.

Income realized before 31 December 2001 – The exact calculation method

The exact calculation method is applied in the following situations:
– if a tax credit is requested on the basis that participation relief is less than the amount of unrefundable tax;
– upon request by a Swiss resident beneficiary or the Swiss Tax Administration if the non-recoverable foreign withholding tax exceeds CHF 1,000;
– upon request by the Swiss Federal Tax Administration in specific situations; or
– if required by cantonal legislation.

Even if a simplified calculation has been made, it is still possible to request an exact calculation within a two-year period.

In the case of individuals, under the exact calculation method, the ordinary tax rates at the place of residence of the beneficiary are applied to the taxable income as determined for both federal and cantonal/municipal taxation. For this purpose, the relevant taxable income is the income earned in the year that the treaty-favoured income falls due used to determine federal and cantonal income tax.

With respect to companies the tax rates at the place of incorporation are applied to the taxable income as determined for both Swiss federal and cantonal/municipal tax purposes. It is the taxable income earned in the year the treaty-favoured income is received that is taken into consideration.[23]

Method used for income realized after 31 December 2001 – Individuals

Only the exact method now applies except in the cantons of Ticino, Valais and Vaud where the simplified and the exact calculation method still apply, provided these cantons use the preceding assessment year.

Method used for income realized after 31 December 2001 – Companies

The simplified method has been abolished and thus the tax rates in the place of incorporation are applied to the taxable income used to determine the federal and cantonal/municipal tax that is earned in the year that the treaty-favoured income falls due.

18. Attributable interest for loans and other costs incurred, however, are deductible.
19. Art. 3(3) VO PStA.
20. See Appendix I to the VO PStA 1.
21. However, if the taxpayer proves that the taxable income used to determine cantonal and municipal taxes exceeds by more than half the taxable income as determined for federal tax purposes, the income as determined for federal tax purposes must be increased by two thirds of the difference.
22. X. Oberson and H. Hull, see note 5, p. 135.
23. Art. 2 VO PStA 1.

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Summary of methods

Individuals		Corporations
Methods used for income realized before 31 December 2000		
1. *Special tax rate* scale applied to 2. taxable income used to determine Swiss *federal income tax* 3. *paid* in the year that the treaty-favoured income falls due.	Simplified calculation	1. Tax *rates in the place of incorporation* applied to 2. taxable income used to determine Swiss *federal and cantonal/municipal income tax* 3. *paid* in the year that the treaty-favoured income falls due.
1. *Ordinary tax rates* in the place of domicile applied to 2. taxable income used to determine Swiss *federal and cantonal/municipal income tax* 3. *earned* in the year that the treaty-favoured income falls due.	Exact calculation	1. Tax *rates in the place of incorporation* applied to 2. taxable income used to determine Swiss *federal and cantonal/municipal tax* 3. *earned* in the year that the treaty-favoured income falls due.
Methods used for income realized after 31 December 2000		
1. *Ordinary tax rates* in the place of domicile applied to 2. taxable income used to determine Swiss *federal and cantonal/municipal income tax* 3. *earned* in the year that the treaty-favoured income falls due. *Exception*: Ticino, Valais and Vaud still use the simplified and the exact calculation method, see above.		1. Tax *rates in the place of incorporation* applied to 2. taxable income used to determine Swiss *federal and cantonal/municipal tax* 3. *earned* in the year that the treaty-favoured income falls due.

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