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Rejuvenating international tax competition

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Rejuvenating international tax competition

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Pasquale Pistone and Rolf Wüthrich of burckhardt want Switzerland to implement a new tax system allowing it to actively pursue its right to be tax competitive, while assuring the EU a level playing field with the prohibition of selective tax advantages in the internal market.

Corporate taxation is an important component of international competition between business locations. In the last decades Switzerland was able to build up a business location which was reliable and at the same time tax competitive. The attractiveness of Switzerland's corporate tax system is, however, also causing its international acceptance to be jeopardised, all the more in the light of the financial turbulence experienced by numerous countries.

In the framework of the announced Swiss corporate tax reform III, the Swiss tax system shall be adapted to internationally accepted standards, but nevertheless remain competitive. Concrete measures to be implemented under the tax reform III are worked out. It is not expected that the tax reform will enter into force before 2018. The authors of this article appeal to Switzerland to take the chance of the tax reform III to take the tax reform one step further than necessary and to implement a new tax system allowing Switzerland to actively pursue its right to tax competitiveness and the EU to be assured of a level playing field with the prohibition of selective tax advantages existing within the internal market.

Globalisation

Law is making significant steps towards globalisation also in areas that are inherently related to national sovereignty, such as taxation. States pay particular attention to what the other tax players do on the worldwide scenario. Sometimes frictions arise between their rules applicable in a purely domestic scenario and the ones that apply in cross-border situations, or that are designed for the purpose of attracting inbound investment.

From the late 1990s states have "voluntarily" accepted to comply with a soft limitation of their prerogatives, with a view to phasing out harmful tax competition worldwide. Yet, the OECD report on base-erosion profit shifting (BEPS), released on February 12 2013, indicates that harmful tax competition still exists under a different skin. This allows multinationals to obtain a considerable reduction of their tax burden through aggressive tax planning. Considering that this report was commissioned by the G20 for the purpose of technically backing up desirable action to address the shortcomings arising in this field, some major progress is expected for global taxation. We believe a further dramatic increase in the coordination of national tax prerogatives is expected in the near future, even leading to a reconsideration of the foundations of international taxation. Consistent indicators of this trend can be perceived in the soft law issued by the European Commission on December 6 2012 on aggressive tax planning and the reaction that member states are encouraged to take.

This global phenomenon is clearly reflected in the more complex bundle of tax issues that arise in some specific context, such as the one of the relations between

Switzerland and the EU. Knowledge of international law is necessary, but not sufficient to achieve a clear view of such issues, unless combined with a good understanding of the external implications of EU law and, more in particular, of the peculiar issues involving taxes and competition.

Switzerland is a sovereign state that has voluntarily accepted to conclude some agreements, governed by public international law, with the EU and its member states. The very rationale of those agreements is geared towards enhancing such relations, but some different nuances arise from a legal perspective.

Some agreements were specifically concluded to share with the EU some of the existing rights within the internal market, such as free movement of individuals or the tax treatment of intercompany flows of passive income. Such agreements certainly apply at the conditions listed therein, but their object and purpose is undeniably related to the EU internal market. Therefore, also their interpretation must be consistent with it, including the need to apply them in line with the progressive evolution of the internal market. After all, they were not signed to treat Swiss nationals as rights stood in the EU at the time of signature, but rather in a dynamic way, which preserves equal footing between Swiss and EU nationals at all times, subject to the clause contained in such agreements.

Some other agreements, such as the 1972 Free Trade Agreement, show a looser link with the EU, which is not implementing EU law outside its borders, but can still occasionally lead to have clauses of Union law influencing the drafting of clauses included in the agreement with Switzerland. This is fairly clear in the case of Article 23 (iii) of the 1972 Free Trade Agreement , which refers to the prohibition of public aid, following a wording that strongly resembles that of the provision included in Article 107 TFEU on state aid. The impressive tightening of the tax implications of the prohibition of state aid within the EU has taken such prohibition to achieve a dimension that was unthinkable when the 1972 Free Trade Agreement was signed. The interaction between such rules and the phasing out of preferential tax regimes leaves member states of the EU with little space to use taxation for non-fiscal purposes, in particular when this may alter the tax conditions for business to compete on the market. This has produced two major implications.

The changing shape of EU tax systems

On the one hand, various EU member states have changed the shape of their tax systems. Instead of geared tax incentives (as such incompatible with the selectivity criterion intrinsic to the prohibition of state aid under Article 107 TFEU and, when involving some schemes of inbound investment, also the standards for countering harmful tax practices) tax regimes keep their consistency in purely domestic situations, but in fact enhance the possibility for business taxpayers to fully exploit the advantages that arise across the borders as a consequence of the disparities existing between national tax systems of the member states. Clear examples of these types of measures are all the different forms of box regimes that exist in the EU. The effects of such regimes are the source of a potential problem for free competition in the EU, but potentially difficult to address, since they arise from the interaction between national tax systems of two or more states. Past practice of the European Commission has endorsed them in at least one case, but the author wonders whether a different position should be taken in light of the effects of the Gibraltar judgment of the European Court of Justice (ECJ) on state aid.

On the other hand, the Commission should act in a consistent way between what it imposes on member states and the conditions for free competition that arise in the relations with its closest partners, including Switzerland in particular.

The implications of this are difficult to predict for Switzerland and the desirable policy line of development for the relations with the EU in tax matters for the years to come is highly uncertain.

From a technical perspective, legal interpretation of the 1972 agreement in consistency with the evolution of the concept of public and state aid in the EU could theoretically lead to endorse the view of the EU. The opposite view has been held from the Swiss side on grounds that ignore such alignment. The controversy between Switzerland and the EU is not new. In 2007, the Commission criticised certain cantonal tax practices as constituting state aid which is incompatible with the 1972 Free Trade Agreement. In June 2010, the EU put forward a proposal to Switzerland to cultivate a dialogue on the adoption of the EU's Code of Conduct for business taxation. In exploratory talks, Switzerland and the EU established the framework for initiating a dialogue. After consulting the parliamentary committees and the cantons, the Swiss Federal Council adopted the mandate in a dialogue with the EU on July 4 2012. The Swiss Federal Council has defined the following three objectives for the dialogue:

- Preservation and further development of the tax attractiveness of Switzerland as a business location;
- Promotion of international acceptance of the Swiss tax system; and
- Safeguarding of sufficient receipts for the Confederation, cantons and communes to finance government activities.

From the Swiss official perspective, the dialogue must focus on distortionary tax regimes, particularly those that exhibit ring fencing aspects, as well as on the defensive measures adopted by the EU or its member states.

A new philosophy

A solution to the EU-Swiss friction on the preferential cantonal tax regimes should rather (and hopefully will) be found

at the level of bilateral negotiations within a framework that secures a constructive development of tax conditions that secure free competition. The authors believes that Switzerland has full rights to keep the competitiveness of its tax system at the international level, but it should no longer ignore that its close ties with the EU and the general international tax climate are likely to create problems whenever selective measures are used that make some preferential treatment apply to non-Swiss sourced income (mainly or) only. Such problems can generate legal uncertainty in the short and medium-term, which business is unlikely to find appealing.

The authors plead for a new philosophy that Switzerland should actively pursue at the international level and which should allow the Swiss tax system to keep its international competitiveness within a new dimension that better conforms with the changed world scene. The sooner this change takes place, the more Switzerland will be allowed to be an active player in building up international standards. Hesitating in this process could force Switzerland to accept changes under the pressure of the rest of the world.

Various measures are being discussed to be implemented in the course of the tax reform III. A rather new and not yet deeply discussed and analysed suggestion for a reform of Swiss taxation on businesses could be to consider the introduction of a group internal trading box regime, which gives taxpayers the right to replace the existing levying of taxes in Switzerland with a brand new mechanism that systematically prevents double taxation from occurring within groups of companies. Indeed, the introduction of such a taxation system would have to be considered to be a fundamental change of the Swiss tax system towards a group taxation system, which is not yet known in Switzerland.

This optional tax system would apply on a non-selective basis, making Swiss resident and non-resident business taxpayers eligible for it. Because of such structure, a competitive advantage for business would arise from the fact that, simply explained, income would not be taxed within the group in Switzerland if not in the hands of the group company that trades with non-related companies in Switzerland and elsewhere. Single taxation within groups of companies is at present very attractive for multinationals.

The EU is trying to achieve the introduction of one single set of rules for taxation of groups through the common consolidated corporate tax base (CCCTB) proposed directive. The prevention of economic double taxation is not a new feature for the EU either, because of the existence of the Parent-Subsidiary Dividend Directive. Though a similar regime already exists in Switzerland, the effects of the group internal trading box regime would be more far-reaching than any of the above measures, since they would affect, as a system to avoid economic double taxation, any type of income attributable to any entity within the group.

Biography

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Pasquale Pistone is a holder of an ad personam Jean Monnet Chair in European Tax Law and Policy at WU Vienna University of Economics and Business. He is associate professor of tax law at the University of Salerno.

He is a member of the Austrian Academy of Sciences (J. Kurie); 2005 EURYI Awardee of the European Science Foundation; co-editor of specialised tax journals in Europe and South America; and a member of the ECJ Task Force of the Confédération Fiscale Européenne.

He is also a frequent speaker at international tax conferences around the world; a visiting professor at numerous Universities (2013: University of Florida); founding member of the Group for Research on European International Tax Law (GREIT).

He is fluent in seven European languages, editor of 26 books, and author of two monographs and 140 articles on international and European tax issues. He has written and/or been translated in 10 languages.

Such a system would perhaps not entirely remove transfer pricing problems for multinational groups of companies, but it would at least simplify them in Switzerland, ensuring that taxes are levied in Switzerland only in the hands of the group company that trades with an independent entity. This may in fact structurally reduce the potential arising of abusive practices or the incentive to undertake practices targeted at base erosion and profit shifting. As an alternative, the system could preview that the profit exempt in the hands of a disposing company would be recaptured and taxed once the acquiring company resells the acquired goods. Under this alternative, the taxable profit would be shifted between affiliated companies and taxation would therefore be postponed.

The typical features of a box regime appear insofar as one considers that the application of this treatment for Swiss tax purposes would be regardless of taxes levied in other countries. Certainly, until the latent problems of compatibility of box regimes with the prohibition of state aid and harmful tax practices remain unaddressed within the EU, the latter cannot request Switzerland to prevent its

Biography

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Rolf is an international tax lawyer focusing his areas of expertise on national and international tax planning, inbound and outbound transactions, especially between the USA and Switzerland, corporate restructuring and acquisitions as well as general corporate secretarial services.

burckhardt provides its clients and their businesses with comprehensive, tailored advice on national and international tax planning issues and structuring, offers corporate secretarial and notary service, supports clients with professional expertise and broad international experience on restructurings, mergers and joint ventures, advises on inbound and outbound investments and in all matters related to compliance, employment, trade and transport law.

own system from shifting in that direction. However, the type of regime that is envisaged under the group internal income box goes further than the ones existing in the EU, since it would in fact combine the features of such regime with a structural reform of how Switzerland taxes income within the group. This shows that the solution would be EU-proof also in the long run.

Rights and assurances

Certainly, Switzerland has the right to be the master of its own decisions concerning international tax policy and law applicable on its territory now and in the years to come. Globalisation is gradually emptying the substance of national tax policies in cross-border situations. Catalysing international consensus on the consistency of tax measures with the internationally accepted standards for tax competition is of paramount importance with a view to ensuring long-lasting tax competitiveness of a tax system. Accordingly, Switzerland should on the one hand avoid ending up in an isolated position on the international arena, but, on the other hand, effectively exercise its right to achieve international tax competitiveness of its system.

Two main external conditions should be met, such as the compatibility with the rules applicable by its closest partner, the EU, and the need to comply with the internationally accepted tax standards that G20 is catalysing with the support of the OECD. Innovative solutions, such as the group internal trading box regime, comply with both such conditions and could be an important tool to include in a modern approach to be taken when designing the tax reform III to keep and further develop Swiss international tax competitiveness for multinational enterprises.

Such a regime would at the same time ensure consistency with the standards of prohibition of state aid applicable in the EU and set the pace for shifting the tax competitiveness from the philosophy of selective tax advantages for international business to a brand new tax framework for groups of companies. Further thoughts on this innovative tool could perhaps pave the way for a new solution in the relations with the EU, allowing Switzerland to actively pursue its right to tax competitiveness and the EU to be assured of a level playing field with the prohibition of selective tax advantages existing within the internal market.

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