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Swiss double tax treaty excludes thin capital rule

The Supreme Tax Court has held that the thin capital rules in force up to 2007 are in breach of the non-discrimination clause in the Swiss double tax treaty.

Up to the end of 2007 thin capital rules were in force. They disallowed interest on related party finance insofar as it was paid on loans of more than three times (later one-and-a-half times) the shareholders' equity brought forward from the previous year. A Swiss-owned company in Germany with a negative shareholders' equity fell foul of these provisions in respect of its loan finance from its parent. Its interest cost was disallowed as a hidden distribution. The company protested and has now won its case before the Supreme Tax Court on a plea of discrimination as excluded by the Swiss treaty.

The thin capital provisions only applied to the related party finance of companies owned by shareholders not fully chargeable to income or corporation tax. Mostly, this meant non-resident shareholders, the number of resident but not fully taxable corporations being limited. Discrimination against a body of shareholders who are mostly non-residents is also discrimination against Swiss-resident shareholders, given the treaty comparison with resident taxpayers as the measure for determining unequal treatment. This tax office was unable to defend its position with a reference to the transfer pricing adjustment clause in the treaty, as this referred only to the arm's length aspects of a transaction. That the loans had been at arm's length, though, was not in dispute. The non-discrimination clause in the OECD model treaty also refers to under-capitalisation as a reason for an exception from the non-discrimination provisions; however, this has not been taken up into the Swiss treaty and cannot be construed by implication.

From 2008 onwards, companies are subject to an interest limitation, rather than a thin-capital, provision. Since the interest limitation applies to all shareholders regardless of residence, it is not as such discriminatory. However, it does have aspects of sole, or main, foreign relevance and has not yet been tested before the Supreme Tax Court.(AM)

Supreme Tax Court judgment of September 9, 2010 published on December 8

Keywords

Non-discrimination, hidden distributions, related party finance, thin capital rules