Swiss Double Taxation Agreements:
Current Policy and Relevance for Development

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[1] Unless otherwise indicated, this document takes into account political developments until 30 September 2013.

Executive summary

At the beginning of the new millennium, the world community decided to halve the number of people living in absolute poverty by 2015. To this end, the stakeholders of the Financing for Development Agenda set themselves the goal of establishing transparent and effective tax systems in all developing countries, ensuring a fair division of tax revenues between states, and creating favourable conditions for investment in developing countries. Double taxation agreements (DTAs) can support or impede these goals, depending on how they are framed.

Illicit financial flows from developing countries, which can among other things be attributed to tax evasion or aggressive (and “dishonest”) tax avoidance practices, are estimated to have totalled USD 641- 979 billion in 2006. As the world's largest offshore asset management location, Switzerland bears a special responsibility – which it shares with developing countries – in this respect. This responsibility derives not least from the Swiss Federal Constitution and from Switzerland's participation in the international human rights system. Switzerland's international tax policy has accordingly drawn scrutiny from the international community and has also become a hot political issue in Switzerland itself. Developing countries are also becoming increasingly aware of this issue. Taking due account of this shared responsibility is not only imperative from the perspective of development policy, but is also in Switzerland's economic interest.

States have various instruments at their disposal to regulate their relations with other states in the field of taxation. These include legislation, bilateral double taxation agreements and tax information exchange agreements (TIEAs), as well as multilateral treaties. Because multilateral approaches have made little headway so far, the debate centres on DTAs. Two model double taxation conventions published by the OECD and by the UN are contributing to the partial harmonisation of DTA networks. However, many developing countries are only partially incorporated into the international tax system. Switzerland has a DTA with only one quarter of the world's 134 developing countries. Only four of those ratified DTAs contain a commitment to the internationally agreed tax standard on exchange of information developed by the OECD. The Federal Council prefers DTAs to the conclusion of TIEAs, with the caveat that the DTAs must be economically justified.

Various objectives are to be accomplished with DTAs. They should effectively prevent the double taxation of the same tax base, help create favourable conditions for foreign investment, ensure a fair division of tax revenues among the countries involved, and guarantee the effective collection of taxes where value is created in cross-border economic activities (i.e. by avoiding 'double non-taxation'). Current DTA practice achieves these objectives only partially, although the application of recognised legal principles would make it possible to set limits on the bargaining that goes on when agreements are negotiated.

The effective prevention of double taxation requires clear definitions and limits, as well as the widest possible application of DTAs. The large number of different types of DTA and an inadequate DTA network has led to legal uncertainty and, among other consequences, a negative impact on developing countries. Comprehensive multilateral approaches would, therefore, meet developing countries’ interests. In order to create more favourable conditions for foreign investment, Switzerland is pursuing, together with other OECD countries, a unilateral strategy of committing developing countries to low withholding tax rates. It fails to take due account of the fact that sustainable foreign investment depends on a sustainable tax system based on a good balance between excessively high and low tax rates. Lastly, a fair division of tax revenues from multinational actors requires a fair division of tax claims between source and residence countries. In this context it is important to determine when a permanent establishment is created and how the tax rights are allocated. Swiss DTAs with developing countries show a mixed picture. They are quite evidently the result of bargaining between stronger and weaker partners and tend to contain provisions that are more favourable to Switzerland.

After all, DTAs are intended to guarantee the effective collection of tax revenues where value is created and to prevent cases of double non-taxation resulting from tax evasion and dishonest tax avoidance practices. This issue is being hotly debated under the byword of BEPS, which stands for base erosion and profit shifting. Against the backdrop of aggressive international tax competition, various types of DTA networks are abetting BEPS. "Treaty shopping" and especially "transfer mispricing" are also drawing criticism. Preventing the former will require more robust provisions against treaty abuse in the DTAs. Also, the 'arm's length principle' contained in most DTAs is inadequate to prevent transfer mispricing. The international community has recently launched initiatives to tackle the problem of internal transfer pricing within corporate groups in a way that will also benefit developing countries. Effective instruments being proposed are proper withholding tax rates in the source country, transparency in financial flows and company structures, as well as unitary taxation. This also involves the fundamental question of how to set

appropriate limits on international tax competition in order to mitigate the problem of offshore tax havens.

DTAs are also intended to help states collect their tax claims when tax-relevant data are managed by the partner state. Some recently concluded Swiss DTAs incorporate the internationally agreed tax standard on exchange of information (in accordance with Art. 26 of the OECD's model convention) which provides for the exchange of information even when such information is relevant for the enforcement of domestic laws concerning taxes. Of the 45 DTAs containing the new standard, there are only four DTAs with developing countries (another six are expected to be ratified in the near future). Consequently, a large majority of developing countries obtain very limited information about data on assets managed in Switzerland even when they specifically request such data. Besides DTAs, it would also be possible to conclude tax information exchange agreements (TIEAs) to make the new standard quickly available to developing countries. As TIEAs are limited to the exchange of information, there is less of a risk that low withholding tax rates will have to be accepted in return for the exchange of information. Because it has not received any requests to do so, Switzerland has not yet concluded any TIEAs with developing countries. Yet given the shared responsibility, it is incumbent upon Switzerland to take proactive steps to conclude TIEAs and also to explore other options. This includes the reciprocal exchange of information based on a simple legal basis, not unlike administrative assistance in the field of financial market supervision. Another step Switzerland could take to meet developing countries' interests is to join the Convention on Mutual Administrative Assistance in Tax Matters as envisaged by the Federal Council. Given the practical problems of exchanging information upon request, proactive participation in efforts to construct a well-balanced global information exchange mechanism are urgently needed. Expanded due-diligence requirements for financial intermediaries to prevent them from accepting untaxed assets plays an essential role in this respect, too. Lastly, a key question is how the paying agent tax model can be harnessed for developing countries. The 'clean money strategy' the Federal Council has pursued since 2009 already incorporates some of these points and could be further developed in this direction.