

# TAXATION IN EUROPE

## IREF 2008

### What did 2007 bring in terms of fiscal reforms in Europe?

IREF, the Institute for Research on Economic and Fiscal Issues, asked eleven experts from the four corners of Europe to report on the main trends in their countries and neighboring countries. All the reports are available on IREF's website. Below you will find the most recent changes in the fiscal policy of **Switzerland** presented by **Pierre Bessard**.



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Tax policy in Switzerland underwent many changes in 2007, not least because of developments in some of the 26 cantons, which account for over two thirds of taxes in Switzerland. Tax reductions were implemented or approved in referenda during the year in several cantons. The dispute with the European Union over low-tax regimes for specific types of companies in some cantons will continue in 2008. The Swiss government has reiterated in November its refusal to enter into negotiations with Brussels and published a report on state aid in the EU.

Other tax policy issues in 2007 were the double taxation of dividends, the VAT reform and taxation according to expense for wealthy resident individuals deriving most of their income from abroad.

## 1.

The dynamism of cantonal tax policy in Switzerland is best exemplified by developments of the canton of Obwalden, where citizens at the end of 2005 voted with a majority of 86% in favor of a digressive tax regime, whereby tax rates decreased as taxable income increased (the absolute amounts, however, continued to rise as taxable income rose).

Following a court challenge from political groups condemning digressive taxation as “unconstitutional”, the Swiss supreme court ruled in a controversial decision on 1 June 2007 that digressive taxation in Obwalden was in violation of the “ability to pay” principle. The Obwalden government reacted quickly by announcing it would replace its digressive regime by flat rate taxation, in effect further reducing the tax burden on its residents. In December 2007, Obwalden citizens approved the new law with a majority of 91% and adopted a flat tax of 12% at cantonal and communal level, with a tax-free income deduction of CHF 10,000. Since 2005, the tax burden in the canton of Obwalden decreased by 25% on average.

In 2006 Obwalden had also introduced Switzerland’s lowest corporate tax at 6.6%. Yet the first year of the reform overall tax revenues in Obwalden went up by over 6% despite the tax cuts, as new residents moved into the canton. During 2006, the number of firms registered in Obwalden quadrupled, and in 2007 significant growth was also reported. In the December 2007 referendum citizens cut the corporate tax rate down to 6%, following the lead of another canton, Appenzell Ausserrhoden, where citizens voted in favor of the same rate only three months before.

Together with the federal income tax the corporate income tax burden in the cantons of Obwalden and Appenzell Ausserrhoden is now on par with that of Ireland, at



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*Obwalden: from digressive taxation to a flat rate tax and record low corporate tax rate in Switzerland*

*corporate income tax burden in the cantons of Obwalden and Appenzell is now at par with that of Ireland.*

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12.5%, roughly three times as low as the rates prevailing in France or Germany, and comparing favorably with the Swiss average of approximately 21%.

## 2.

On 13 February 2007 the European Commission informed Switzerland of its unilateral decision by which it considers certain tax arrangements applied by the cantons to certain types of firms (holding, administrative and mixed companies) to be state aid. In the view of the Commission, these arrangements distort competition and impair trade in a manner not compatible with the 1972 Free Trade Agreement between Switzerland and the EU. On 14 May 2007 the European Council then instructed the EU Commission to begin negotiations with Switzerland on this issue.

The Swiss government, however, immediately rejected this interpretation and consequently rejects negotiations with the EU, judging the European Commission's decision "unfounded" for the following reasons:

- The tax provisions criticized by the EU do not fall within the scope of the Free Trade Agreement. The Free Trade Agreement only covers trade in certain goods and does not aim to harmonize competition law.
- Given that Switzerland is not an EU member, or part of the Single European Market, neither the competition regulations of the EC Treaty (in particular those on state aid), nor the code of conduct agreed between the EU member states on company taxation are applicable to it.
- Even if they were covered by the Free Trade Agreement, the tax provisions criticized do not constitute state aid because they do not favor certain companies or sectors of production, but are in fact open to all economic actors that meet the legal criteria regardless of economic sector or of whether they are under domestic or foreign control.
- The provisions cannot restrict the bilateral trade in goods between Switzerland and the EU because the types of firms criticized have no, or at most subordinate, business operations in Switzerland (in which case these operations are taxed normally).

The Swiss government has nonetheless initiated a dialogue with the EU on the issue at a technical level. One meeting took place in November 2007. The discussions centered on the issue of whether the cantonal company taxation regulations in question fall within the scope of 1972 Switzerland-EU Free Trade Agreement, whether they restrict trade in goods between Switzerland and the EU and distort competition, which according to the Swiss delegation they do not. The discussions also considered the question of differences in the way in which revenues from domestic and foreign sources are handled. The Swiss delegation stated that in the case of holding companies, revenues from Swiss sources are taxed in the same way as those from foreign

*Dispute with the European Union: no reason to negotiate.*

*the tax provisions criticized by the EU do not fall within the scope of the Free Trade Agreement....*

*... the provisions cannot restrict bilateral trade*

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sources. Furthermore, it emphasized that both domestic and foreign-controlled companies are entitled to take advantage of holding-company privileges. There is no difference of treatment between Swiss and non-Swiss firms. A further meeting is scheduled for early 2008.

## 3.

In the context of the dispute opposing it to the European Commission, the Swiss government published at a parliamentary commission's request an interesting report in November 2007 on the developments of state aid in the European Union. The report highlights the fundamental cultural difference between Swiss and EU governance: while the EU pursues the approach of restricted tax competition and tolerates an extensive policy of direct state aid, in contrast Switzerland's stance on tax competition is positive and this is reflected accordingly in its regulatory framework. At the same time, Switzerland makes practically no use of direct state aid to individual firms. The report concludes that all forms of state aid constitute an intervention in the free workings of markets and can therefore as a rule not be competition neutral. This is also why European competition policy provides in principle for a ban on state aid. However, the EU's policy on state aid allows numerous exceptions which are deemed to be compatible with the Single European Market. Aid is not only allowed in the area of taxes, but above all in non-tax areas. Examples of admissible tax aid include direct or indirect aid in the form of subsidies to companies to develop certain economic sectors or encourage small- and medium-size enterprises. It may be interesting to note that 65% of state subsidies in the EU go to manufacturing and services, and only 26% to agriculture (which is generally well-known), the rest going to the coal industry (6%) and transportation (2%). In parallel, the European Commission has severely restricted the scope of action of member states in tax policy with the code of conduct on company taxation.

Switzerland, however, is less inclined to provide direct aid, preferring instead to ensure the provision of a business-friendly tax and legal framework. An essential part of this is a moderate tax burden for companies as well as for individuals. The Swiss government notes that tax competition "creates important incentives and promotes innovation in the public sector". On the other hand, Switzerland is less inclined to provide state aid because aid to individual companies or sectors effectively distorts competition and is detrimental to economic efficiency. With an eye on Switzerland's competitiveness, the Swiss government's overriding consideration is the continued capacity to shape its tax system on an autonomous basis. Given that over two thirds of taxes are levied by the 26 cantons – sovereign states with their own constitutions, governments and parliaments – it should be noted that the Swiss government could not act against cantonal tax regimes even if it wanted to.

Ironically, the EU also wishes to continue to strengthen the competitiveness of its member states, and to this end the European Commission presented in 2006 a State

*Swiss government report on EU state aid: the emperor has no clothes*

*...fundamental difference between Swiss and EU governance...*

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*Switzerland is less inclined to provide direct aid.*

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Aid Action Plan. A more centralized state aid policy should emerge from this reform, with the possibility of an expansion of state aid in key sectors.

## 4.

Over two thirds of Swiss cantons have implemented tax reductions on dividends or are in the process of doing so in order to limit the double taxation of distributed profits (first as profits at firm level and second as dividend income at investor level). The tax relief varies greatly from one canton to another. The rebate on the applicable tax rate varies from 30% to 80% depending on the canton. The minimal participation in the share capital for tax relief eligibility also varies from 5% to 20% depending on the canton. This threshold is meant to favor above all the owners of small- and medium-size businesses.

A similar reform is planned at the federal level and will need to be confirmed in a referendum on 24 January 2008. The proposed tax relief amounts to 60% for participations of at least 10% in the share capital. The bill is challenged by some political groups that view it as a “gift” to investors; however, considering that similar reforms have been passed easily in many cantons, including that of Zurich, the most populous in Switzerland, it is expected to win approval from a majority of voters.

## 5.

The Swiss government intends to overhaul the current legislation on the value added tax, most notably by replacing three rates by one. The standard Swiss VAT rate is 7.6%, or roughly half the minimal standardized rate in the European Union. Reduced rates of 3.6% and 2.4% apply to specific categories of products. These three rates lead to substantial allocation problems between products and could theoretically be replaced by a single rate of 6%. Also, 20 out of 25 exceptions would be abolished according to the project. Following a consultation with 500 organizations, as is the practice for legal projects in Switzerland, the answers received are being analyzed and will be compiled in a report before the government will present a final project to be handled by the parliament. Switzerland implemented the VAT in 1995 and on the occasion of its 10<sup>th</sup> anniversary criticism of the heavy bureaucratic burden implied by this tax already led to a series of minor reforms and to the current project of a major overhaul.

## 6.

Following some controversies of wealthy individuals opting to pay a lump-sum tax based on their living expenses, the Swiss government and parliament have rejected renewed calls to put an end to this practice.

*Income tax reductions on dividends have been implemented by over two thirds of Swiss cantons.*

*the federal government is planning a similar reform*


*VAT reform contemplated, replacing three rates by one (which could be 6%)*

*Taxation according to expense remains untouched*

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One of the latest cases re-igniting the debate happened in December 2006, when star singer Johnny Hallyday loudly left France, where up to 72 percent of his income was taxed away by the government, to settle down in the Alpine resort of Gstaad, in the canton of Bern. For a very long time Switzerland has seen itself as a refuge for persecuted people around the world, not least for victims of confiscatory taxation in neighboring countries with predatory socialist governments. In parallel, because of the high level of safety and quality of life generally available in Switzerland, the country attracts wealthy individuals from industry, sport, or the arts who choose it as a permanent residence, either for retirement or for living, earning revenues abroad that are difficult to evaluate for tax purposes.

Those residents who do not earn any regular income within Switzerland and have not done so for the previous 10 years can ask to be fully exempted from income and wealth taxes and pay instead a lump-sum tax based on their expenses in Switzerland. As a general rule, the tax is calculated as at least five times the rental value of the resident's house or twice residential expenses if the taxpayer lives in a hotel. International double tax treaties generally apply in order to take into account taxes paid abroad.

Although this system has been criticized as a privilege for wealthy foreigners seeking to avoid ordinary taxation in their own countries, strict conditions apply and may substantially vary, as always, depending on the canton. Currently, only about 3,600 residents benefit from this system (compared to a total population of 1.6 million non-Swiss residents in Switzerland). 

*Johnny Hallyday and the others...*

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