Swiss Supreme Court Rules on Pension Qualification Under Tax Treaty

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Tax Issue Under Review

On 6 February 2020 (case no. 2C_510/2018), the Swiss Federal Supreme Court rendered a decision on the tax qualification of a pension plan benefit paid from a Swiss pension plan to an individual resident in Thailand, for the purposes of Swiss federal and cantonal withholding taxes on pension benefits paid to non-Swiss residents, considering the relevant provisions of the Thailand-Switzerland double taxation treaty on income taxes dated 19 December 1996 (the „Treaty").

Specifically, the Supreme Court had to decide whether the pension benefit in question fell under the special provision of Treaty Article 18 para. 2, which governs pensions paid by, or out of funds created by, a Contracting State or a political subdivision or a local authority thereof to an individual in respect of services rendered to that State or political subdivision or local authority. Under subparagraph (a) of that provision, that State (the « source State ») has the exclusive taxation right for such « public » pensions, except where the individual receiving the pension resides in the other State *and* is a national of that other State. Any pensions not falling under the special rule of Treaty Article 18 para. 2 subpara. (a) are dealt with Treaty Article 17. The same holds true for pensions paid in respect of past services rendered in connection with a business carried on by a Contracting State or a political subdivision or a local authority thereof (Treaty Article 18 para. 3). Treaty Article 17 provides that such « private » pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment shall be taxable only in that State.

Facts and History of the Case

Prior to his retirement as of 30 April 2011, the individual taxpayer A. had been an employee of B. AG, a private Swiss company which had previously been a controlled subsidiary of the Swiss Postal Service, a public enterprise owned by the federal government. Already during the second half of the year 2010, A. had de-registered as a Swiss resident in order to live in Thailand. On 2 May 2011 the pension institution of the Swiss Postal Service made a lump-sum capital payment (in lieu of a periodic pension) to A. in the amount of CHF 1,169,225, from which it deducted federal and cantonal withholding taxes of CHF 108,738 in accordance with applicable rules of the Federal Direct Taxes Act and the Tax Law of the Canton of Berne, which was confirmed by a tax assessment decision of the cantonal tax authority of Berne on 13 April 2012. A. raised an objection and made a request for a full refund of the taxes withheld, which the cantonal tax authority rejected on 24 October 2013. An appeal by A. against that decision was essentially approved by the first instance tax court of the canton Berne (decisions of 13 December 2016). A further appeal lodged by the Cantonal Tax Administration against that first instance court ruling was dismissed by the Administrative Court of the canton Berne (judgment dated 1 May 2018). Upon a public law appeal made by the Cantonal Tax Administration (supported by the Federal Tax Administration), the Federal Supreme Court confirmed the decisions of the prior two judicial instances and ruled in favor of the taxpayer.

In the context of its legal considerations, the Supreme Court reiterated the fact that the taxpayer's last employment prior to his retirement was with B. AG, which at the time of A.'s retirement was a Swiss corporation organized under private Swiss corporate law. It had not been asserted or determined that A.'s services as an employee of B. AG were in effect not rendered to B. AG, but rather to the Swiss state, or one of its political subdivisions or local authorities, and even if so, that his services were not rendered in connection with a business in the meaning of Treaty Article 18 para. 3.

Considerations of the Federal Supreme Court

In the proceeding before the Supreme Court the administration – apparently for the first time – raised doubts about the tax residence of A. in Thailand. The Supreme Court held that residence in the other Contracting State is a fundamental pre-condition for any tax treaty application. The Court found that the cantonal courts had ascertained that A. was indeed fiscally resident in Thailand, where he was subject to unlimited income tax liability. On that basis, the Supreme Court rejected the new assertion raised by the administration that A. was not paying any taxes in Thailand and should, therefore, not be treated as a tax resident of Thailand. The Supreme Court held that the local tax liability was a question of Thai tax law, which the Federal Supreme Court is not competent to review, according to article 96 letter b of the Federal Supreme Court Act. In a separate consideration, the Supreme Court pointed to Article 105 para. 1 Supreme Court Act, according to which the Supreme Court bases its judgment on the facts determined by the lower judicial instance, from which it can only deviate if the facts determination was manifestly wrong (arbitrary) or based on a violation of law and the correction of the defect can be decisive for the outcome of the case. The Supreme Court concluded that the statement by the Cantonal Administrative Court that A. was a tax resident of Thailand was binding on the Supreme Court.

Further, the Supreme Court pointed to the different tax treatment of "private" and "public" pensions under the Treaty with Thailand (similar to some other Swiss tax treaties). While "private" and other pensions falling under Treaty Article 17 can only be taxed by the Contracting State of which the beneficiary is a tax resident, "public" pensions falling under Treaty Article 18 para. 2 subpara. (a) may exclusively be taxed by the source State.

The Supreme Court referred to the conclusion reached by the Cantonal Administrative Court, which had found, based on the literal meaning of Treaty Article 18 para. 2 subpara. (a) and a comparison with similar provisions contained in other Swiss double taxation treaties, as well as considering the purpose and objective of the Treaty, that units of the objective, horizontal de-centralization of the state organization, whereby certain tasks of the public administration are outsourced to (para)statal enterprises do not fall under the notion of "Contracting State or a political subdivision thereof or a local authority" as adopted by Treaty Article 18 para. 2 subpara. (a). Therefore, the cantonal court had concluded that the pension payment in question fell under Treaty Article 17 and accordingly, Switzerland had no taxation right for that payment. That interpretation was challenged by the Cantonal Tax Administration.

As regards the interpretation of international treaties, the Supreme Court first referred to articles 31 *et seq.* of the Vienna Convention of 23 May 1969 on the Law of Treaties ("Treaty Law Convention"), which in the Swiss Supreme Court's opinion represents codified customary law. Therefore and based on a prior judgment dated 26 July 2019 (case no. 2C_306/2017, cons. 4.4.2), the Supreme Court considers those rules to be applicable in spite of the fact that Thailand is not a signatory state of the Treaty Law Convention. The Supreme Court summarized the interpretation principles set forth in Articles 31 and 32 of the Treaty Law Convention, in particular the rule of Art. 31 para. 1, according to which international treaties have to be interpreted in good faith in accordance with their common meaning, the context and considering the purpose and objectives of the treaty. While Treaty Law Convention Art. 31 para. 1 does not define any hierarchy among the interpretation principles, the starting point of the interpretation is the common meaning of the provisions. Such common meaning is to be determined in good faith and due consideration of the purpose and objectives of the treaty. Among several possible interpretations, the meaning that ensures the most effective application of the treaty and which does not counteract the purpose of the engagements of the contracting parties is to take precedence.

Given that A. had been employed by a number of different employers during his career and the capitalized pension payment was hence funded by varying services of A., the Supreme Court first had to clarify the time aspect of Treaty Article 18 para. 2. In particular, it had to be clarified whether the source State has a taxing right under Treaty Article. 18 para. 2 even in a situation where the pension beneficiary had provided services to the source State (or to one of its political subdivisions or local authorities at an earlier stage, but worked for another employer immediately prior to his retirement, or exercised an activity in connection with a business of the source State at such point in time. The wording of Treaty Article 18 para. 2 is not clear with regard to this time aspect. The Supreme Court found that the language " … in respect of services rendered to that State …" might indicate that the timing of the services is not decisive and hence the source State could tax pensions paid for earlier services. However, Treaty Art. 18 para. 2 also requires that the relevant State entity itself, or a separate entity established by such State for such (pension) purpose pays the pension benefit. According to the Supreme Court, this requirement is not fulfilled where the pension beneficiary, while having rendered services to the source State, has moved on to a different employer and transfers his accrued pension entitlement to the private pension institution of the new employer. (It should be noted that Swiss employers must provide for an occupational pension plan for all their employees earning at least a certain minimum annual salary and fund at least 50% of the future pension benefits with employer contributions, while the balance is funded by employee contributions, which are deducted from the employee's gross remuneration. Occupational pension plans in Switzerland are run through separate, tax-exempt special purpose entities, which usually take the legal form of a foundation.)

The Court considered further that one could think of an allocation of the pension benefit paid among the source State and the pensioner's State of residence, where the State in question or a separate entity of that State pays a combined, unified pension which is in part also based on services rendered by the pensioner in connection with a business of the source State, or based on services rendered to other (private) employers. However, such a fractioning could be very complex and cause significant administrative expenses (the Supreme Court referred to the Commentary, note 5.5, on OECD Model Tax Treaty Article 19 and various international commentators). It would also be unclear which factors should be determining the fractioning (such as duration of the various employment relations, or amount of contributions made under each employment) and should be driving the allocation. Therefore, the Supreme Court adopted the view of the Swiss commentators *Züger/Teuscher* (in Commentary on the Swiss Tax Law, 2015, note 97 on OECD Model Tax Treaty Art. 19), who suggested to refrain from any fractioning and to determine the taxation right exclusively on the basis of the employment activity performed immediately prior to the employee's retirement.

The Cantonal Administrative Court had considered that units of de-centralized public administration, such as the Swiss Postal Service, do not fall under the Treaty notion of "Contracting State, political subdivision thereof or local authority", regardless of the legal form of such unit. The Supreme Court however held that the sole decisive question to answer was how to characterize legal entities organized under private law, which perform delegated public tasks or are controlled by the State (although not explicitly mentioned in the decision of the Supreme Court, we assume that B. AG indeed performed delegated public tasks, even though the company was apparently no longer owned or controlled by the Swiss Postal Service or the federal government by the time of A.'s retirement – which may explain the fact that A.'s occupational pension plan was still run through the pension institution of the Swiss Postal Service).

The Supreme Court pointed to the jurisprudence of other countries and international legal doctrine, according to which any corporate entities organized under private law cannot be considered to be a "Contracting State, political subdivision thereof or local authority". The Court argued that in the light of the text of Treaty Article 18 para. 2 there is no reason for the State of residence of the pension beneficiary to waive its taxation right in a situation where the source State has outsourced the activity performed by the former employee to an entity governed by private law, even if the source State owns all shares in such private entity or exercises control otherwise. Given that A.'s last employment was with a company organized as a corporation under Swiss private law, the Supreme Court concluded that the lump-sum pension payment made by the pension institution of the Swiss Postal Service fell under Treaty Article 17 and was hence exclusively taxable in Thailand.

Final Comment

It is remarkable that the Swiss Federal Supreme Court decided fully in favor of the taxpayer and of the exclusive taxation right of Thailand for a substantial pension benefit, which had not insignificant "points of attachment" to the Swiss public service. The taxpayer's last employer was at least formerly a subsidiary of a

state-owned enterprise, which is mainly active in the public service in an area where it used to have a monopoly for a long period of time. The subsidiary that had employed the taxpayer was still participating in the occupational pension scheme of the Swiss Postal Service, i.e. a public pension fund. Although this could not be read directly from the facts description by the Supreme Court, the discussion by the Court of the time aspects and the situation where a taxpayer had been employed by the source State or a political subdivision or a local authority thereof might indicate that the taxpayer in question had indeed been employed directly in the public service at some earlier stage, so a portion of his pension claims may have been funded by state contributions. Nonetheless, the Court based its ruling exclusively on the fact that the taxpayer's last employer prior to his retirement was a company organized under private law, regardless of the nature of the services performed for that private employer.