Switzerland

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# Swiss Individual Shareholder Relief Rules Found Incompatible with the Swiss Federal Constitution

**On 25 September 2009, the Federal Tribunal delivered important judgments concerning cantonal shareholder relief rules. It, inter alia, rejected the scheduler approach to federal and cantonal direct taxes; specific cantonal requirements, such as in regard to the domestic seat and minimum fair market value; as well as the cantonal shareholder relief rules for net worth tax purposes, based on the equal treatment principle in Arts. 8 and 127 of the Federal Constitution. This note discusses the judgments and their implications.**

## 1. Introduction

On 23 March 2007, the Federal Parliament passed the Federal Act on the Improvement of Tax Law for Entrepreneurial Activity and Investments (Business Tax Reform Act II).[1] The draft act was subject to referendum. On 24 February 2008, the Swiss electorate approved the draft act. The act introduces amendments to several federal tax acts, in particular the individual shareholder relief rules under the Federal Act on the Federal Direct Tax (DBG) and the Federal Act on the Harmonisation of Cantonal and Communal Direct Taxes (StHG), both of 14 December 1990. The DBG covers individual and corporate income taxes, as well as income taxation at source for individuals and legal entities. The StHG is a framework law that sets out detailed rules on individual income and net wealth taxes, corporate income and capital taxes, as well as income taxation at source for individuals and legal entities. The tax acts of the Cantons must comply with the federal guidelines of the StHG. In accordance with the cantonal tax acts, the communes of each of the 26 Cantons levy additional individual income and net wealth taxes and corporate income and capital taxes.

In particular, the Business Tax Reform Act II added the following rules to Art. 7(1) of the StHG, which were enacted by the federal government with effect from 1 January 2009:

> For dividends, profit distributions, liquidation distributions and payments in kind from participations of all kind that amount to at least 10% of the pre-determined or stated capital (qualifying participations), the Cantons may mitigate the economic double taxation of legal entities and shareholders.

These federal harmonization tax rules grant discretion to the Cantons ("the Cantons may mitigate") to introduce individual shareholder relief rules for dividends derived from participations in domestic and foreign companies and cooperatives. Within a transitional period of two years, the Cantons have to comply with the StHG if they adopt or have already adopted individual shareholder relief rules.[2] After this transitional period, the new federal harmonization tax rules of the Business Tax Reform Act II will be directly applicable if the cantonal tax law does not comply with these rules.[3] Most Cantons, in particular the German speaking ones, implemented individual shareholder relief rules prior to the Business Tax Reform Act II being enacted. The StHG contains a requirement that the participation reflect a capital quota of at least 10%. This requirement was one of the most controversial issues during the legislative process. It was argued that the requirement is arbitrary and does not comply with the constitutional principle of equal treatment. The federal harmonization tax rules in the amended Art. 7(1) of the StHG are technically structured as a measure that addresses the tax base. As shareholder relief taxation may be understood as a measure that operates at the level of the tax base (*Teilbesteuerungsverfahren*), or at the level of the tax rate (*Teilsatzverfahren*) and as the income tax rates are set by the Cantons, the federal harmonization tax rules in the amended Art. 7(1) of the StHG do not take account of the extent of tax relief (for example, relief of 50%).

On 25 September 2009, the Federal Tribunal delivered its judgments concerning the cantonal shareholder relief rules of the Cantons of Zurich, Schaffhausen, Basel-Land and Berne.[4] The Federal Tribunal was given the opportunity to test the cantonal individual shareholder relief rules against the principle of equal treatment in the Federal Constitution. The question arose as to the extent

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1. *Bundesgesetz über die Verbesserung der steuerlichen Rahmenbedingungen für unternehmerische Tätigkeiten und Investitionen (Unternehmenssteuerreformgesetz II)* of 23 March 2007, AS 2005 1057. See Marcel R. Jung, "Business Tax Reform Act II Approved in Referendum – Measures and Entry into Force", *European Taxation* 6 (2008), pp. 326-330; Peter Reinarz and Oliver O. Schmid, "Taxation of Private Investment Income under the Second Business Tax Reform", *Derivatives & Financial Instruments* 5 (2008), pp. 215-219.
2. See Art. 72h(1) StHG.
3. See Art. 72(h)(2) StHG.
4. Federal Tribunal, 25 September 2009, *Dorothee Jaun v. Canton Zurich*, 2C_30/2008; Federal Tribunal, 25 September 2009, *X and Y v. Canton Schaffhausen*, 2C_49/2008; Federal Tribunal, 25 September 2009, *Susanne Leutenegger Oberholzer, Irene Meier-Heid, Annette Stähli-Kurtze v. Canton Basel-Landschaft*, 2C_62/2008; Federal Tribunal, 25 September 2009, *Rudolf Hausherr v. Canton Berne*, 2C_274/2008.

to which cantonal shareholder relief rules must comply with constitutional law.[5]

## 2. Principle of Observance of Federal Statutes

### 2.1. Judicial review *in abstracto* or *in concreto*

In all four cases, the Federal Tribunal commenced its analysis by referring to Art. 190 of the Federal Constitution. This provision enshrines the core principle of Swiss constitutional jurisdiction, which is that the Federal Tribunal and other judicial authorities must apply federal acts and international law. This constitutional rule relates to the principle of separation of powers and stipulates the application of federal statutes and international treaties. Norms of federal statutes and international treaties must be applied even if they conflict with federal constitutional law. The court clarified that Art. 190 stands for the principle of observance rather than the principle of prohibition of judicial review. This means that the Federal Tribunal and other judicial authorities may review whether or not a rule of a federal statute conflicts with federal constitutional law, but it has to apply this rule irrespective of whether it conflicts with federal constitutional law. The court argued that Art. 190 does not prohibit the preliminary question of whether or not a federal statute complies with constitutional law from being raised. If there is a conflict between a federal statute and constitutional law, the federal statute must be applied. In this event, the judge may only invite the legislative body to amend the federal rule at issue. Consequently, a court cannot refuse to apply a federal statute as a result of a judicial review of the federal statute itself (*abstrakte Normenkontrolle*) or a judicial review of a legal decision that in turn is based on the federal statute (*konkrete Normenkontrolle*). The *Schaffhausen* case involved a judicial review *in concreto*, the other three cases were judicial reviews *in abstracto*. The court pointed out that in the event of a judicial review *in abstracto*, a sufficient general interest is required to raise the preliminary question of whether or not the federal rule is compatible with constitutional law.

The Federal Tribunal noted that, in the cases at hand, the cantonal rule at issue does not, as a rule, come within the scope of Art. 190 of the Federal Constitution. Where such a cantonal rule, however, directly implements the federal harmonization tax rules of the StHG, the principle of observance must be applied. The court continued that a subsequent enactment of the federal harmonization tax law may also be taken into account in regard to both a judicial review *in abstracto* and a judicial review *in concreto*. This requires, however, a close connection between the cantonal rule and the later federal harmonization tax rule with regard to both scope and time.

### 2.2. Subsequent enactment of federal harmonization tax law

According to the federal harmonization tax rules in the amended Art. 7(1) of the StHG, the Cantons may introduce provisions to mitigate economic double taxation for participations with a capital quota of at least 10% for individual income tax purposes. The Federal Tribunal noted that, apart from the capital quota requirement, they have some discretion in respect of the individual shareholder relief rules. This is particularly true regarding the method of relief, either at the level of the tax base or at the level of the tax rate, and in regard to the extent of tax relief. In all four cases, the court noted that the cantonal income tax rules at issue correspond to the amended Art. 7(1) of the StHG and are, with regard to scope, covered by it effective 1 January 2009. The Federal Tribunal stated that even if the cantonal income tax rules at issue were unconstitutional, it would be disproportionate to repeal them and to force the Cantons to enact the identical individual shareholder relief rules again. Irrespective of whether or not the cantonal income tax rules at issue and the new federal harmonization tax rules in the amended Art. 7(1) of the StHG comply with constitutional law, they have been applicable since 1 January 2009.

The court raised the question as to whether or not the ruling would be different if the challenged cantonal income tax rules had excessive effect (*überschiessende Wirkung*) and exceeded the constraints of the new federal harmonization tax rules. This would be the situation if the cantonal income tax rules not only avoided economic double taxation, but also granted further tax benefits that were not covered by the StHG. The court noted that the constitutionality of the Business Tax Reform II had been subject to controversy. The draft was then approved by the Swiss electorate taking into account this controversial constitutional issue. The court further noted that it was also clear that individual shareholder relief, to the extent of up to 50%, should be acceptable. Tax relief to this extent is, therefore, covered by the StHG. The court concluded that there is *no sufficient general interest* to answer the preliminary question of whether or not the cantonal shareholder relief rules are compatible with constitutional law within the scope of the StHG.

With the exception of the *Schaffhausen* case, which is discussed further below, the court also confirmed the close connection *with regard to time*. The court noted that the cantonal shareholder relief rules recently introduced by the Cantons of Zurich, Basel-Land and Berne, which were enacted with effect from 1 January 2008, were initiated as a result of the legislative process of the Business Tax Reform Act II. This means that the purpose of these cantonal income tax rules was the quick implementation of the federal harmonization tax rules. The court concluded that these cantonal shareholder relief rules are covered, with regard to time, by the StHG irrespective of the fact that the federal law was enacted with effect from 1 January 2009.

5. See also the principle of equal treatment in the context of Swiss tax treaty law and the Switzerland-EC Agreement on the Free Movement of Persons: Marcel R. Jung, "The Switzerland-EC Agreement on the Free Movement of Persons: Measures Equivalent to Those in the EC Treaty – A Swiss Income Tax Perspective", *European Taxation* 11 (2007), pp. 508-528.

In contrast, in the *Schaffhausen* case, the court refused to find a close connection in time between the cantonal shareholder relief rules and the subsequent enactment of the federal harmonization tax rules in the amended Art. 7(1) of the StHG. These cantonal shareholder relief rules had been enacted with effect from 1 January 2004, five years before the enactment of the amended Art. 7(1) of the StHG. Therefore, the court refused to apply Art. 190 of the Federal Constitution and, consequently, reviewed whether or not the individual shareholder relief rules of the Canton of Schaffhausen, on which the challenged tax assessment was based, comply with constitutional law.

## 3. Unconstitutionality of Cantonal Shareholder Relief Rules

### 3.1. Income taxes

As noted above, in the *Schaffhausen* case, the Federal Tribunal reviewed the constitutionality of the individual shareholder relief rules because it did not find that there was a close connection between the cantonal rule and the later federal harmonization tax rule *with regard to time*. In that case, the claimants held different participations in corporations and cooperatives. Since no participation reflected a capital quota of at least 20% or a fair market value of at least CHF 2 million, the tax administration refused to apply the cantonal shareholder relief rules. The claimants argued that the cantonal rules conflict with Arts. 8 and 127(2) of the Federal Constitution. They challenged the tax assessment and argued that they were entitled to the same tax benefits as those granted to shareholders who fulfil the cantonal shareholder relief requirements. The claimants asked for equal treatment in injustice (*Gleichbehandlung im Unrecht*) of their dividend income from non-qualifying participations. According to the Federal Tribunal's case law, equal treatment in injustice is exceptionally accepted if the authority has engaged in an illegal practice and reveals that it does not intend to deviate therefrom in future. The fundamental requirement of the equal treatment in injustice is that the claimant is in a comparable situation as the third person to whom the illegal benefit was granted. The court pointed out that such a request for equal treatment in injustice is subject to specific requirements. The court went on to state that the preliminary question of the judicial review *in concreto* is whether or not the cantonal shareholder relief rules are compatible with constitutional law.

The court continued its analysis with Arts. 8 and 127(2) of the Federal Constitution. Art. 8(1) stipulates the principle of equal treatment: Everyone shall be equal before the law. Art. 127(2) then gives concrete form to this principle in the field of taxation and stipulates the principles of universality and uniformity of taxation, as well as the ability-to-pay principle. The court then argued that the federal and cantonal direct taxes follow the system of total income taxation (*Gesamteinkommenssteuer*). Thus, if income derived from participations is not or only partially subject to tax or taxed at a different tax rate, it conflicts with the principles of universality and uniformity of taxation, as well as the ability-to-pay principle of taxation. The court pointed out that such a conflict can only be justified based on objective reasons.

The court argued that an individual who uses a legal entity must accept that it has a separate legal personality; the individual cannot argue that he or she and the legal entity must be regarded as an identical entity from an economic perspective. The court then argued that because an individual and a legal entity are different legal persons, non-taxation or partial taxation of dividend income at the level of the individual constitutes unjustified preferential tax treatment in relation to all other income, in particular employment income. If the legislative body wanted to remove the separation of individuals and legal entities for tax purposes and adopt a substance-over-form approach, the principles of universality and uniformity of taxation and the ability-to-pay principle would require that the principle of equal burden of taxes (*Belastungsgleichheit*) be complied with. Conclusively, the Federal Court rejected the scheduler approach to the federal and cantonal direct taxes on grounds of the constitutional equal treatment principle.

The court observed that the cantonal income tax rules at issue selectively tax dividend income in accordance with the half average tax rate regime if the participation meets a capital quota of at least 20% or has a fair market value of at least CHF 2 million. Such rules result in selective preferential tax treatment of substantial shareholders. The court criticized that the legislative body has engaged in method pluralism, relying on the legal form, on the one hand, and substance-over-form, on the other. The court stated that there is no objective reason for such a preferential tax treatment of substantial shareholders and rejected a justification based on the idea that a substantial shareholder qualifies as an entrepreneur who bears entrepreneurial risks.

The court concluded that the shareholder relief rules of the Canton of Schaffhausen violate the principle of equal burden of taxes. The claimant did not base the claim on a violation of the prohibition against arbitrariness in Art. 9 of the Federal Constitution. Nevertheless, the court noted that the dividing line between qualifying and non-qualifying participations is arbitrary. In the end the court held that the cantonal shareholder relief rules at issue violate Arts. 8 and 127 of the Federal Constitution, without referring to Art. 9 of the Federal Constitution.

The court then returned to the question of whether or not the court should apply equal treatment in injustice to the claimant and stated that such a treatment is, according to the case law, only applied in exceptional cases if the administration reveals that it does not intend to deviate from its illegal practice in future. The court argued that, in the case at hand, the administration no longer has any reason to change its practice because the unconstitutional cantonal shareholder relief rules are now covered by the subsequently enacted federal harmonization tax law in the amended Art. 7(1) of the StHG. Therefore, the unconstitutional cantonal shareholder relief rules now fall within the scope of the prin-

ciple of observance in Art. 190 of the Federal Constitution. The court concluded that the unconstitutional cantonal shareholder relief rules, as well as the tax assessments that are in turn based on these unconstitutional rules, can no longer be sanctioned.

### 3.2. Specific cantonal requirements

The claimant in the *Berne* case also argued that the specific cantonal requirements that the seat be in Switzerland and that the fair market value be at least CHF 2 million conflict with Arts. 8, 9 and 127(2) of the Federal Constitution. The court, however, did not take into account Art. 9 of the Federal Constitution because the claimant did not substantiate the claim regarding a conflict with the prohibition against arbitrariness.

The Federal Tribunal noted that these specific cantonal requirements are not covered by the federal harmonization tax law in the amended Art. 7(1) of the StHG. Therefore, Art. 190 of the Federal Constitution cannot be relied on to reject a judicial review under constitutional law. The court argued that the unequal treatment of participations of foreign companies compared with participations of domestic companies cannot be justified on grounds of promotion of the domestic economy since this issue is related only indirectly to the question of economic double taxation. The court pointed out that similar specific requirements stipulated in the shareholder relief rules of other Cantons conflict with the federal harmonization tax law. The court concluded that the domestic seat requirement violates Arts. 8 and 127(2) of the Federal Constitution and, consequently, is illegal. Furthermore, on the same grounds as in the *Schaffhausen* case, the court concluded that the minimum fair market value requirement violates Arts. 8 and 127(2) of the Federal Constitution and, consequently, is also illegal.

### 3.3. Cantonal net worth taxes

The claimant in the *Berne* case further claimed that the cantonal shareholder relief rules for net worth tax purposes conflict with Arts. 8, 9 and 127(2) of the Federal Constitution. As noted above, the claimant did not sufficiently substantiate the claim that the provision conflicts with the prohibition against arbitrariness.

According to the shareholder relief rules of the Canton of Berne, participations in corporations or cooperatives having their seat in Switzerland are taxed at 4/5 of the tax rate applicable to the total net worth if the capital quota of the participation amounts to at least 10% or the participation has a fair market value of at least CHF 2 million. The court argued that such a tax benefit is not provided for in either the federal direct tax law or the StHG. The court held, therefore, that federal harmonization tax law does not cover the cantonal shareholder relief rules for net worth tax purposes. They do not come within the scope of Art. 190 of the Federal Constitution.

The court stated that it is clear that the seat requirement and the minimum fair market value requirement are also illegal for purposes of the cantonal net worth taxes. The court noted that the dividing line between qualifying and non-qualifying participations conflicts with the ability-to-pay principle. The court also noted that the unequal treatment of non- qualifying participations compared to qualifying participations cannot be justified on grounds of economic double taxation. The court held that the challenged cantonal shareholder relief rules for net worth tax purposes are unconstitutional and, consequently, illegal.

## 4. Conclusions

In the *Schaffhausen* case, which was a judicial review *in concreto*, the Federal Tribunal did not extend the cantonal shareholder relief rules to taxpayers that were treated unequally due to holding non-qualifying participations. Equal treatment in injustice was refused on the grounds that there is no longer a reason to change the illegal administrative practice.

In the other three cases, the court repealed the cantonal individual shareholder relief rules in so far as they were not covered by the StHG and, consequently, did not fall within the scope of the principle of observance enshrined in Art. 190 of the Federal Constitution. The Cantons are being forced to repeal specific requirements such as the domestic seat requirement and the minimum fair market value requirement, as well as the cantonal individual shareholder relief rules for net worth tax purposes. These rules are not covered by the StHG and, consequently, come within the scope of Art. 190 of the Federal Constitution. By repealing the domestic seat requirement, the court has extended the scope of cantonal shareholder relief rules to foreign participations.

If a particular cantonal shareholder relief regime does not include the 10%-capital quota requirement of the amended Art. 7(1) of the StHG, it is illegal. Such a Canton is now forced to adjust its cantonal shareholder relief regime in accordance with the federal harmonization tax rules, in particular to adopt the 10%-capital quota requirement. In contrast, if a particular cantonal shareholder relief regime includes the 10%-capital quota requirement it may serve as an (unanticipated) "fallback position", such as in the *Berne* case. Such a regime is only partially illegal. Such a Canton is now forced to repeal other specific cantonal requirements, such as in regard to the domestic seat and minimum fair market value.

In light of the reasoning of these cases, a dual income tax system seems to conflict with the principle of equal treatment in Arts. 8 and 127(2) of the Federal Constitution. However, if the Federal Parliament introduces such a tax system by virtue of an amendment of both the federal direct tax law in the DBG and the federal harmonization tax law in the

StHG, the hands of the Federal Tribunal will be tied by Art. 190 of the Federal Constitution.

The principle of observance of federal acts and international law that is enshrined in Art. 190 of the Federal Constitution relates to the principle of separation of powers. It stipulates the application of federal statutes and international treaties even if they conflict with federal constitutional law. The judge does not have the power to repeal rules of federal acts and international treaties enacted or approved by the Federal Parliament. However, this constitutional rule significantly hinders the development of a sophisticated case law by the Federal Tribunal regarding the constitutional equal treatment principle in the field of taxation. It appears from modern Swiss legal methodology and the Federal Tribunal's case law that, according to the constitutional concept of practical concordance (*Konzept der praktischen Konkordanz*), the prohibition against arbitrariness in Art. 9 prevails over the principle of observance in Art. 190 of the Federal Constitution in certain cases (for example, in regard to a case involving an abuse of rights).[6] Because the claimants in all four cases did not rely on the prohibition against arbitrariness, or did not substantiate such a claim, the Federal Tribunal was not given the opportunity to test the cantonal shareholder relief rules under both Arts. 9 and 190 of the Federal Constitution and to give further clarification on this constitutional issue.

6. See Thomas Gächter, *Rechtsmissbrauch im öffentlichen Recht* (Zurich: Schulthess, 2005), p. 369 et seq.; Felix Uhlmann, *Das Willkürverbot (Art. 9 BV)* (Bern: Stampfli, 2005) at pp. 249 and 252.

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