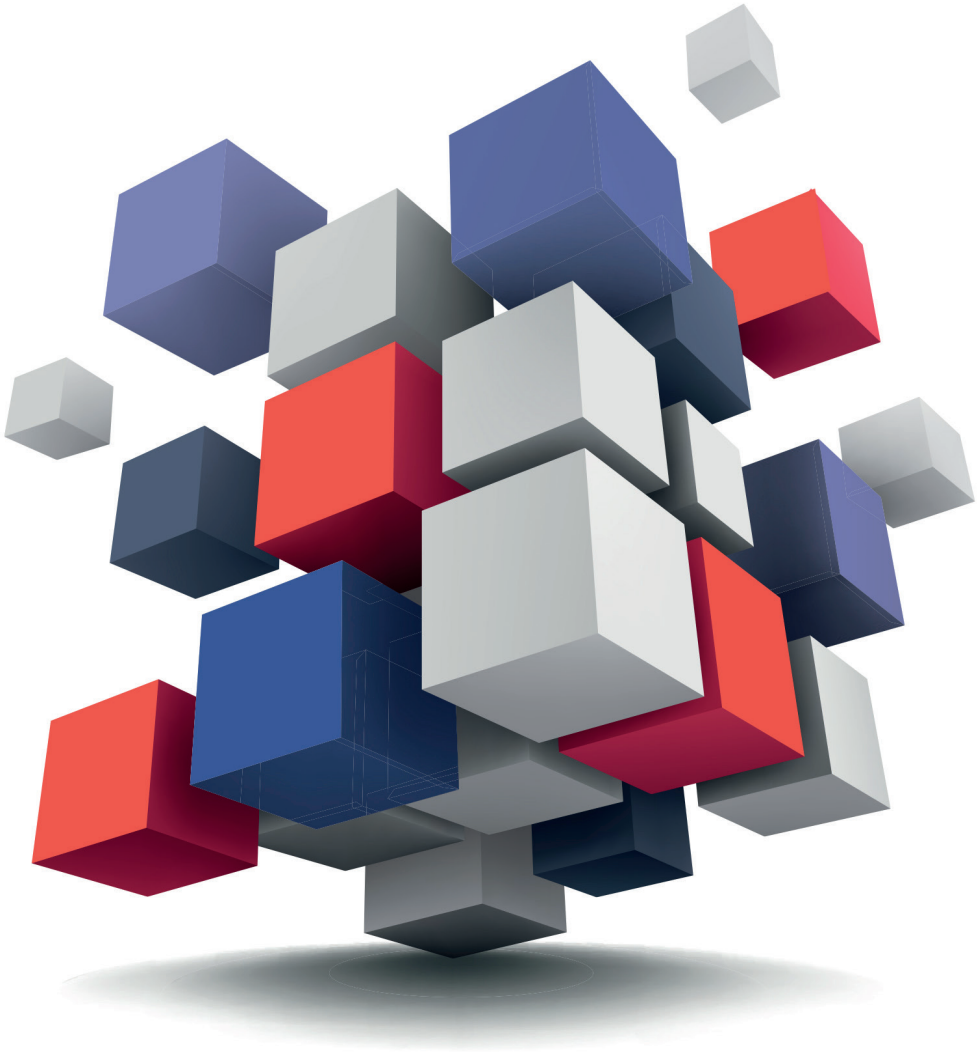
Giedre Lideikyte Huber

Conceptual Problems of the Corporate Tax

Swiss-US Comparative Analysis



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Conceptual Problems of the Corporate Tax

Why this book?
What do we really know about corporate tax? Who does it affect and why? Does it somehow impact shareholders, as originally intended? Is it consistent with the fundamental principles governing the taxation of individuals?

This book, based on the author's PhD dissertation, explores these questions via a thorough analysis of the Swiss and US corporate tax systems, considering legal, economic and philosophical aspects. To begin, the book analyses the conceptual difficulties in defining a corporate taxpayer. In particular, it demonstrates that an optimal definition of a taxable corporation does not exist. An entity that is taxed as a corporation in a certain country may be considered a flow-through vehicle in another jurisdiction. This entity classification mismatch creates infamous cross-border complications, giving rise to hybrid entities that may lead to either double taxation or the creation of "homeless income".

This impossibility to define a corporate taxpayer in a satisfactory manner relates to deeper corporate tax problems, which are explored further in this book. It guides the reader through the historical development of corporate taxation, with specific emphasis on the concepts of economic double taxation and the ability to pay. The author also presents contemporary economic and philosophical approaches to corporate taxation. For instance, the research on the economic incidence of corporate tax shows that corporations shift their tax burdens onto various groups of persons that cannot always be precisely identified. Can a tax be considered legitimate when its bearers cannot be clearly established? Analysing fundamental taxation principles, this book argues that the mechanisms of contemporary corporate tax are very far away from producing their initially intended effect, i.e. affecting mainly – or only – shareholders.

This publication was subjected to a single-blind peer review by international academic experts in the field and topic area.

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Table of Contents

Sample Content

Chapter 1

General Introduction

> "From a practical point of view, tax law, like private law, is an art."[1]
> Pierre Aeby, 1933
>
> "This is too difficult for a mathematician. It takes a philosopher."
> Albert Einstein (on filing tax returns)

Above are two quotes on the concept of taxes. The first quote is from a lawyer, and the second one from a physicist. Neither of these quotes refers to law, economics or political theory; they describe tax law in terms of art and philosophy. Representing the expressions of human creativity and intelligence, in a somehow ultimate manner, these domains rely heavily (although not exclusively) on subjective insight. Projecting them on tax law may seem extreme or even comical; however, that was not the intention. To the author, taxation represents something more substantial than numbers and legal concepts. It largely develops around human values that are ultimately subjective, such as solidarity and cooperation between the members of a social community, helping the weaker and, ultimately, building the common future. As cold as the term "corporate taxation" may sound, it eventually seeks the same goals and touches the same people. The ultimate purpose of this book is therefore to remind us of this fact.

1.1. General research framework

1.1.1. Scope and objectives

This book analyses fundamental theoretical controversies related to the concept and the justification of corporate taxation. It focuses on legal, historical and public finance aspects of two legal systems: a continental one and an Anglo-Saxon one. In particular, this book analyses the Swiss taxation theory, based on the individual ability-to-pay principle, which is a typical characteristic of the "western" taxation philosophy. Furthermore, it carries out a comparative analysis of US law on selected theoretical issues, such as research on the economic incidence of corporate tax.

1. "*Au point de vue pratique, le droit fiscal, comme le droit privé, est un art*." (Unofficial translation.)

One of the objectives of this book is to offer a universal, in-depth analysis of a number of fundamental tax law concepts, such as legal personality, double economic taxation and the ability to pay. Thus, this book does not limit its scope to Swiss and US authors and provides a wider view of the subject matter.

This book consists of two major parts that are intrinsically related. Both seek to define the justification of corporate tax, analysing the form-related and substance-related arguments. Firstly, the author analyses the classification rules for corporate tax purposes, seeking to define a unanimously distinctive feature of a business entity that would justify the corporate tax itself. Secondly, she proceeds to carry out a substantial and economic analysis of corporate tax rationale. Part I of this book, which is described as a formal approach, is the analysis of the entity classification rules for corporate tax purposes. The principal question the author seeks to answer is that of *which entities* are subject to corporate tax, and under which rules. One of the main conceptual criticisms of corporate tax is that it does not provide a consistent theoretical explanation about why certain entities are subject to corporate tax whereas others are exonerated. Business income is taxed in two fundamentally different ways, depending on whether it is generated at the level of a pass-through entity or an entity that tax law defines as a corporation for tax law purposes. The author will analyse entity classification rules and will try to establish, to a certain extent, whether they provide a justification for corporate tax.

Part 1 covers several legal questions. The first chapter analyses Swiss law. Firstly, it discusses the relationship between tax and private law in Swiss legal thought, both from historical and contemporary perspectives. Secondly, the book proceeds with the analysis of the concept of a taxable corporate entity for Swiss tax purposes and the so-called “principle of separation”, which is the basis for such a rule. Furthermore, the multiple exceptions to the principle of separation in Swiss law are reviewed. Such exceptions are built on the substance-over-form approach, disregarding the private-law qualification of an entity or transaction for tax purposes. Such exceptions derive from judicial practices and formal legal norms. Chapter 4 provides a comparative overview of the US entity classification rules for tax purposes. In contrast to Switzerland, the United States disregards the criterion of legal personality for corporate tax purposes. The author reviews the historical origins of entity classification rules, the departure from commercial law rules, as well as the current classification of domestic and foreign entities for tax law purposes. Furthermore, the author analyses the substance-over-form

approach in the US judicial doctrine and compares it with the Swiss tax avoidance judicial doctrine.

Part 2 of this book, which is described as a substantial approach, looks into legal, philosophical and economic justification and criticisms of corporate tax. In particular, it tries to answer why those entities are subject to such taxation.

Chapter 6 (in Part 2) analyses the role of economic double taxation in the corporate context. It reviews such subjects as various concepts of economic double taxation, the genesis of contemporary corporate tax and the current extent of economic double taxation in the Swiss legal system, as well as its conceptual justification. Chapter 7 (in Part 2) analyses the place of the ability-to-pay principle in the context of corporate taxation. Firstly defining its limits and theoretical justification, it further examines a very controversial argument regarding the ability to pay of a legal entity. Almost entirely absent in the United States, this argument is frequently used in certain European countries, notably in Switzerland. In fact, the majority of Swiss legal doctrine supports the idea that a corporation does have a certain ability to pay. Chapter 7 therefore (i) compares those two positions, firstly reviewing the concept of an individual's ability to pay and its underlying justification; and (ii) analyses the possibility of its application to the level of a legal entity. In the framework of this discussion, the author will also review the theory of the economic incidence of corporate tax. This question, intensively explored in the United States for several decades already, is practically non-existent in Swiss tax law literature. The author will therefore describe it and provide an evaluation of the findings of this theory in light of Swiss corporate taxation.

1.1.2. Comparative framework

This book focuses on the Swiss and US legal theories. The comparison is asymmetrical. The principal objective is to analyse the Swiss tax system, putting into perspective the key theoretical aspects through a comparative analysis. Thus, the author refers to the US legal system only in respect to the legal issues that are considered useful to compare due to some of their characteristics (originality of the legal argument, similarities with or differences from Swiss law, etc.).

The author chose the comparison with the US legal system for several reasons. Firstly, the tax systems of those two jurisdictions have similarities

that are relevant in the framework of this research, even though, naturally, they are far from being identical. The most important similarity is that both Swiss and US taxation rely on a social-welfarist philosophy that endorses the ability-to-pay principle as the fundamental justification for levying taxes. This principle, deriving from the humanistic philosophy of the Age of Enlightenment, has an identical meaning in both legal systems and thus establishes a common ground for a substantial comparative evaluation. In addition to the similarity in the philosophical fundamentals justifying taxation, Switzerland and the United States have more features in common. In particular, both governmental systems are federalist structures, reflecting that fact in their tax systems, and both have direct democracy mechanisms significantly influencing tax legislation.[2] The United States and Switzerland both have a single law for corporate and individual income tax. The historical development of corporate tax is also similar in those countries, which emerged at more or less the same time and for the same reasons (*see* section 6.2.). At present, both Switzerland and the United States serve as home countries for a great number of multinational corporations, and corporate taxation questions never disappear from the political agenda.

In contrast, the principal differences between those two legal systems in the field of taxation that are interesting here are the theoretical divergences regarding the definition of corporate tax subjects (entity classification rules) and the theoretical basis for corporate tax justification, especially in light of a legal entity's ability to pay. In addition, the US legal and economic sciences have extensively developed the theory of the economic incidence of corporate tax, whereas it is almost non-existent in Switzerland.[3] The results offer interesting insights into taxation in general and may be relatively easily used in comparative research, as the US legal and economic sciences explore the basic economic premises of corporate taxation that are universal. This offers a rich field of comparison between different ways of seeing the conceptual problems of corporate taxation in the Swiss legal system. In the comparative analysis in this book, the author focuses on US federal corporate income tax.

2. 27 states have some form of direct democracy in the United States, and an increasing number of statewide tax issues are determined through initiatives and referendums. *See* Brunori, *The Limits of Justice*, p. 203. For direct democracy mechanisms in the United States, *see* Smith, *Direct Democracy*, p. 173. In Switzerland, an essential modification of an existing tax, as well as introduction of any new tax, should be submitted to an obligatory referendum according to arts. 140(1)a, 142(2) and 195 of the Swiss Constitution. *See* Auer et al., *Droit constitutionnel*, Vol. I, p. 404.

3. MacDaniel et al., *US International Taxation*, p. 31; and Gustafson, *US Tax Treaties*, p. 207.

Even though the analysis concentrates on Swiss and US law, the findings of this book apply beyond those jurisdictions. The summary of such findings, as well as future research proposals, are in chapter 8 of this book.

1.1.3. Sources

As this book analyses tax law issues in the context of two different legal families (the continental and the Anglo-Saxon), some preliminary remarks will follow regarding the legal sources used in this research.

The general definition of "tax law" refers to any legal norm directly related to public contributions levied by a state based on its territorial (and equivalent)[4] sovereignty.[5] According to the principle of legality, which is further discussed in this book (*see* section 1.2.2.2.), the "basic" tax law norms define such fundamentals as the taxing authority and the tax obligation, as well as its validity in time.[6] Nonetheless, tax law, in a broader sense, encompasses a whole range of other norms. Those are, for instance, the constitutional norms defining a state's administrative and economic principles,[7] international conventions that touch upon the issues that relate indirectly to taxes and the vast field of norms governing taxation procedures and tax disputes. Thus, in the context of this book, such norms will also be referred to as forming the body of tax law.[8]

In the continental law tradition, to which the Swiss legal system also belongs, case law does not formally create a binding legal precedent and

4. The United States subjects individual and corporate taxpayers to worldwide tax liability based on their citizenship, civic status or place of incorporation. This is "equivalent" to territorial sovereignty, as the United States is a unique jurisdiction adopting these practices in individual and corporate taxation. Individuals worldwide taxation was first upheld in 1924 in *Cook v. Tait*, p. 607. The effect of US citizens' worldwide taxation is, in fact, very similar to residence-based taxation. *See* Lideikyte Huber, *Taxation*, p. 568 et seq.

5. Ruedin, *Droit des sociétés*, p. 3. For the definition of "public contribution" *see* Oberson, *Droit fiscal*, pp. 3-5.

6. This would be the case of the majority of democratic countries, where the principle of legality serves as a basis for the democratic legitimacy of state actions. On democratic legitimacy in Swiss law through the principle of legality, *see* Moor et al., *Droit administratif*, p. 652; and for its meaning in tax law, *see* Oberson, *Droit fiscal*, p. 30.

7. The Swiss Federal Supreme Court expressly states that taxation is governed by the fiscal, social and public finance principles; *see* ATF 133 II 206, in RDAF 2007 II**,** pp. 505 and 513.

8. The major part of tax law is the administrative law (the latter governing public administration and, in particular, its organization, the scope of activities and procedural rules). *See* Tanquerel, *Manuel de droit administratif*, p. 3.

is not a source of law. Nevertheless, it plays a very important role in the interpretation of law, sometimes making the line between interpretation and creation of legal norms blurry. In Switzerland, this is particularly clear in the field of public law. A great number of interpretations of constitutional law norms of the Swiss Federal Supreme Court have been codified in the Federal Constitution or other legal acts.[9] In the field of tax law, one of the most notorious examples is the interpretation of the principle of equality before law, which is now embodied through the principles of generality and equality of taxation, as well as by the principle of proportionality of the tax burden based on the economic ability of a taxpayer.[10] For this reason, the author will analyse a number of Swiss Supreme Court cases in this book.

Administrative documents, such as governmental dispatches and circular letters, do not traditionally count as formal sources of law.[11] However, some of them are of extreme practical and theoretical importance in Swiss law. The dispatches of the Swiss Federal Council, for example, are often of utmost importance for interpreting the reasoning behind the law reforms, i.e. their legal, economic and philosophical justifications. The circular letters of the Swiss Federal Tax Administration are used as an important source of reference for practitioners, academics and judges, despite their non-binding character. Although they resolve the questions of fact and not of law, administrative practices create legal consequences in an indirect way.[12] Notably, due to the principles of good faith or equal treatment, changes in administrative practices should be based on relevant, serious and objective grounds, and even announced in advance; they cannot have a retroactive effect.[13] For those reasons, administrative documents constitute a large basis for the Swiss law analysis in this book.

Legal sources of US federal corporate tax law, which is the focus of this book, structurally resemble the Swiss system. In general, federal tax law derives from different branches of the government; however, not all of them are of equal hierarchical authority. The most important source of federal tax law (after the Federal Constitution) is the Internal Revenue Code (IRC), which is the foundation of every other source of federal tax law. Its provisions are clarified by the Treasury Regulations, which explain and illustrate

9. Moor et al., *Droit administratif*, pp. 78-79.
10. CH: Federal Constitution of the Swiss Federation of 18 April 1999, arts. 8 and 127(2); ATF 132 I 153 para. 3.1. and cited references; ATF 99 Ia 638 and cited references; and Oberson, *Droit fiscal*, p. 34.
11. Moor et al., *Droit administratif*, p. 89.
12. Id.
13. Id.

the IRC's sections. Similar in nature to Swiss administrative circulars, the Treasury Regulations are, however, much more extensive and cover every provision of the IRC. In addition, various federal courts exercise jurisdiction over federal tax claims, namely the US Tax Court, the US Court of Federal Claims, federal district courts or bankruptcy courts and, as a last resort, the US Supreme Court.[14] Their decisions carry significant legal authority, even though – as will be seen in section 4.3.3.2. – some doctrines developed by those courts are criticized as lacking what in Switzerland would be called "legality". Finally, it is widely acknowledged that the US Internal Revenue Service (IRS) has immense influence on tax-related practices in the United States, for instance, in the field of accounting.[15] Its authority is based on the provisions of the IRC, as well as its regulations, and it has produced a significant body of legal interpretations.[16] In this book, the author will refer to all those legal sources as comprising the general body of US federal tax law.

1.2. Guiding legal principles of the Swiss tax system

The purpose of section 1.2.1. is to introduce the guiding legal principles that are of particular relevance for Swiss corporate taxation.

1.2.1. Ability to pay and the distributive justice principles

Like in all western democracies embracing the social welfare ideology, Switzerland has structured its taxation system in accordance with the principle of an individual's ability to pay.[17] This principle is recognized as a cornerstone of the Swiss taxation system and the central element of the fair taxation system.[18] It is anchored in Swiss constitutional law. Article 127(2) of the Swiss Constitution states that the ability-to-pay principle, as well as the principles of uniformity and universality of taxes, apply to all taxes, "provided the nature of the tax permits it". The ability to pay, the uniformity

14. Froelich, *Tax Disputes*, p. 340.
15. Martin, *Accounting*, §1.02 1-17.
16. Id.
17. Swiss legal writers, as well as the judiciary, use two slightly different French terms to define the ability to pay: *capacité contributive* and *capacité économique* (the literal translation of such terms would be "paying capacity" and "economic capacity", respectively). They are synonyms in the Swiss legal system describing the ability to pay, etymologically perhaps trying to reflect the German term for the ability-to-pay concept, which is *wirtschaftlichen Leistungsfähigkeit*.
18. Vallender/Wiederkehr, *Kommentar ad. Art 127, no. 17*; Oberson, *Droit fiscal*, p. 24; and Obrist, *Réalisation systématique*, p. 154.

and the universality of taxes are the three maxims of distributive justice in Swiss tax law, embodying the general constitutional principle of equality before the law of article 8 of the Swiss Constitution.[19]

The delineation between these three principles is not always clear. This is especially the case for the principle of uniformity of taxes,[20] which, according to certain academics, has lost its substance due to the extensive development of other taxation principles, especially the one of the ability to pay, which essentially embodies its content.[21] It is true that the Federal Supreme Court defines the principle of uniformity in terms of horizontal and vertical equity – the key measures of the ability to pay – stating that individuals in similar situations should bear a similar tax burden, and those in different situations should bear a different tax burden.[22] It is therefore difficult to see any practical or theoretical need for the principle of uniformity of taxes.

The principle of universality of taxes has more independent content, requiring that all individuals or groups of individuals are taxed according to the same legal rules.[23] It forbids the exemption of certain individuals without objective reasons, as every member of society has to share the financial burden of the state resulting from public tasks.[24] To a certain extent, this principle gives constitutional protection to minorities, forbidding the requirement of sacrifices for society only by certain groups of individuals and not from others (based on race, religion, etc.).[25]

It is evident that this principle also partly overlaps with the ability-to-pay principle. The latter excludes discrimination by definition, requiring the structuring of the system of taxation in such a manner that every member of society makes equal sacrifices. Nonetheless, as "equal sacrifice" is

19. Torrione, *Justice distributive*, p. 133; Glauser, *Apports*, p. 7; and Oberson, *Droit fiscal*, p. 42. The Swiss Federal Supreme Court has never analysed the relationship between those three principles; it has been done only by Swiss legal writers. *See* Yersin, *Remarques préliminaires*, p. 30, n. 65.
20. French: *égalité d'imposition*; German: *Gleichmäsigkeit*.
21. Yersin, *Egalité*, p. 165 and quoted references.
22. ATF 122 I 314; ATF 144 Ia 221; Oberson, *Droit fiscal*, p. 35; and Glauser, *Apports*, p. 14.
23. ATF 122 I 314; ATF 144 Ia 221; and Oberson, *Droit fiscal*, p. 35.
24. ATF 133 II 206, ATF 114 Ia 224; Yersin, *Egalité*, p. 166-167; Oberson, *Droit fiscal*, p. 35; and Glauser, *Apports*, p. 13.
25. Yersin, *Egalité*, p. 166; Oberson, *Droit fiscal*, p. 35; and Glauser, *Apports*, p. 13. Certain authors considered that the principle of uniformity of taxes could, to a certain extent, be the opposite of the ability to pay, due to which an important part of resident population could be exempt from taxes for having insufficient means. *See* Müller, *Commentaire ad Art. 4*, p. 47, footnote 201, with reference to Höhn, *Schranken*, p. 249.

ultimately a normative judgement depending on various social values, the principle of universality is useful as an additional safeguard against discrimination between various groups of taxpayers.

In summary, the ability to pay is the most important and fundamental principle of distributive justice in Swiss law, with other constitutional principles of article 127 of the Swiss Constitution. having a more complementary role. For this reason, this principle retains all of the focus in this book. Its extensive analysis is carried out in Part 2, which discusses the substantial justification of corporate tax. The author discusses, in particular, the philosophical and economic rationale behind the ability-to-pay principle, as well as theoretical attempts to extend it to the field of corporate taxation.

1.2.2. Legality

The principle of legality is enshrined in the Swiss Federal Constitution. It is a subjective constitutional right, the sole violation of which opens the possibility of an appeal for a taxpayer.[26] This constitutional principle applies strictly in the domain of tax law.[27] Such a rigorous application of the principle of legality is due to the invasive nature of taxation, affecting various fundamental rights and liberties of an individual.[28] It compels the state to enact the fundamental features of taxation in formal laws enacted through democratic procedures, which ideally should confirm peoples' consent to taxation, and thus the legitimacy of such a state's intervention.[29] In reality, this principle, however, does not reach that far, as the constituencies of taxpayers and the individuals entitled to participate in democratic processes largely mismatch.[30] Thus, the principle of legality in the field of taxation confirms the democratic consent of only a part of the taxpayers. However, it performs other important functions, such as legal certainty and predictability, as well as the equal treatment of taxpayers, which largely justifies its strict application.[31]

26. Yersin, *Remarques préliminaires*, p. 20; and Glauser, *Apports*, p. 7.
27. Rivier, *Droit fiscal suisse*, p. 79; and Oberson, *Droit fiscal*, pp. 30-31.
28. Aubert/Mahon, *Commentaire*, p. 1009, *ad* art. 127; Auer et al., *Droit constitutionnel*, Vol. II, pp. 380 and 392; and Oberson, *Droit fiscal*, p. 44.
29. Rivier, *Droit fiscal suisse*, p. 78; Aubert/Mahon, *Commentaire*, p. 1009, *ad* art. 127; and Auer et al., *Droit constitutionnel*, Vol. II, pp. 380 and 392.
30. Lideikyte Huber, *Taxation*, p. 568 et seq. The author refers the reader to this article for further developments.
31. Rivier, *Droit fiscal suisse*, p. 79.

Swiss legal theory holds that the principle of legality comprises two aspects: (i) the supremacy of law; and (ii) the requirement of a legal basis.[32] Article 5(1) of the Swiss Constitution establishes its general framework, providing that "[a]ll activities of the state are based on and limited by law". Article 127(1) of the Swiss Constitution adapts the principle of legality to the field of taxation, stating, "The main structural features of any tax, in particular those liable to pay tax, the object of the tax and its assessment, are regulated by law".[33] Finally, article 164(1)(d) of the Swiss Constitution states that all significant provisions that establish binding legal rules must be enacted in the form of a federal act. In the field of taxation, those are the provisions defining the taxpayers, as well as the subject matter and assessment of taxes and duties. Thus, the state can levy no tax or any other public contribution (except in some rare cases) if such taxes or contributions do not have a sufficient legal basis, identifying at least the elements mentioned in article 127(1) of the Swiss Constitution, i.e. the taxpayer, the object of the tax, the amount and the taxable base.[34] In addition to that, a tax law norm must respect other constitutional principles, such as economic freedom and the right to property.[35] An essential modification of an existing tax, as well as the introduction of any new tax, should be submitted to an obligatory referendum according to articles 140(1)(a), 142(2) and 195 of the Swiss Constitution.[36]

According to the case law of the Federal Supreme Court, the requirement of defined normative content of a legal norm derives not only from the principle of legality, but also from the requirement of legal certainty and equality before the law.[37] Such requirement of normative density is, however, not absolute, as one cannot expect that the legislator completely stops using general concepts that are subject to interpretation.[38] A basic characteristic of any legal norm is a certain degree of abstraction, and such abstraction is necessary in order for the authorities to have a certain degree of latitude in the application of the norm.[39] In order to define the extent of the precision of a legal norm, one must consider the circle of the addressees of that norm

32. Tanquerel, *Manuel de droit administratif*, p. 15.
33. This constitutional norm was initially developed by the Federal Supreme Court and only later codified by the legislator. *See* ATF 127 I 60; and Oberson, *Droit fiscal*, p. 30.
34. ATF 131 II 562, p. 565; ATF 120 Ia 178; ATF 118 Ia 320, p. 323; ATF 112 Ia 39, p. 43; and id., at pp. 30-31.
35. Glauser, *Apports*, p. 8.
36. Auer et al., *Droit constitutionnel*, Vol. I, p. 404.
37. ATF 123 I 112, para. 7(a), p. 124; ATF 109 Ia 273, para. 4(d), p. 282; and ATF 117 Ia 341, para. 5(a), p. 346.
38. ATF 123 I 112, para. 7(a), p. 124.
39. Id.

and the level of the infringements on fundamental rights authorized by such norm.[40] Particularly serious infringements require a clear and precise formal legal basis, whereas the less serious ones could be enacted by the legislative delegation.[41]

1.2.3. Equivalence (benefit taxation)

In Swiss tax law, the principle of equivalence[42] incorporates, to a certain extent, the concept of so-called "benefit taxation" of the general theory of public finances. Benefit taxation defines public levies while taking the use of publicly supplied goods by taxpayers into account. Such taxation is the main theoretical alternative to taxation according to an individual's ability to pay.[43] The latter is, as discussed in chapter 7, the cornerstone of the Swiss tax system, and therefore, the principle of equivalence only applies to a limited number of public levies, usually related to specific services rendered by the state on a particular individual (for instance, certain administrative charges, like fees for issuing a passport).

In this respect, the principle of equivalence requires that the amount of the public levy is not clearly disproportionate to the value of the service or the advantage received by an individual as consideration for this payment.[44] The price should be established objectively and not create unreasonable differences.[45] In no way should the public levy be so high that it creates an obstacle for an individual to use a specific public service or institution.[46] The Federal Supreme Court, however, admits that a certain schematization in the definition of the public levies and their quantity is possible, as long as they do not lead to unacceptable results or discrimination that cannot be objectively justified.[47]

Even though Swiss taxation is based on the ability-to-pay considerations, the benefit taxation arguments – quite unconsciously – emerge in certain theoretical discussions, in particular the ones linked to corporate taxation. For this reason, the author will come back to this concept in the Part 2 of

40. Id.; and ATF 109 Ia 273, para. 4(d), p. 282.
41. ATF 122 I 360 consid. 5b/bb; and ATF 123 I 112, para. 7(a), p. 124.
42. French: *principe de l'équivalence*.
43. Fried, *Proportionate Taxation*, p. 150.
44. Yersin, *Egalité*, p. 173.
45. Id.
46. ATF 103 Ia 85, 89, para. 5(c); ATF 106 Ia 243, 252-254; and Yersin, *Egalité*, p. 173.
47. ATF 106 Ia 243, 244; Iand id., at p. 174.

this book, discussing the controversial concept of the corporate ability to pay (*see*, in particular, section 7.1.4.2.).

1.2.4. Economic freedom

Economic freedom is a fundamental right enshrined in the Swiss Federal Constitution. In particular, article 27 of the Swiss Constitution stipulates that economic freedom is guaranteed and includes, in particular, the freedom to choose an occupation, as well as the freedom to pursue a private economic activity. In general terms, this constitutional norm seeks to protect any private economic activity that seeks to generate profits.[48]

Economic freedom is one of the most complex and controversial constitutional freedoms.[49] Its importance in relation to other constitutional dispositions that aim at shaping the Swiss economic landscape (for instance, the consumer protection rules (article 97 of the Swiss Constitution) or the antitrust policies (article 96 of the Swiss Constitution)) is subject to theoretical and political disagreement.[50] The purpose and scope of economic freedom is largely indeterminate and raises multiple questions. In particular, it is unclear (i) whether it seeks to protect entrepreneurs, workers or both; (ii) whether it applies to the supply or to the demand; (iii) whether it is limited to the internal market or includes cross-border exchanges; and (iv) to what extent it encourages state interventions in the market.[51] In addition to those content-related indeterminacies, it is worthwhile mentioning that the Federal Supreme Court can only enforce this constitutional norm in cantonal laws.[52] As a result, the most important state interventions in the

48. Auer et al., *Droit constitutionnel*, Vol. II, p. 415.
49. Id., at p. 415-416.
50. Id, at p. 416.
51. Idm.
52. Id., at p. 417. Art. 190 of the Swiss Constitution contains an important limitation to the powers of control of legal norms by the Swiss Federal Supreme Court, stating that "[t]he Federal Supreme Court and the other judicial authorities apply the federal acts and international law". As a result, the federal and international law, in principle, has to be applied as such, regardless of its compatibility with the Federal Constitution. *See* Auer et al., *Droit constitutionnel*, Vol. I, p. 649. However, the strict application of art. 190 of the Swiss Constitution is gradually disappearing. Since 1969, the Federal Supreme Court has interpreted federal laws in conformity with the sense and purpose of constitutional norms (*see Jeckelmann*, ATF 95 I 330, 332). In its more recent case law, the Court went as far as analysing whether a federal law was compliant with constitutional norms (*see* ATF 137 I 128, 131). In the case of a negative answer, it cannot sanction such federal norm; however, it can encourage the legislator to make the necessary amendments. *See* id., at p. 656.

Swiss economy that are, in fact, carried out through federal legislation are, in principle, not controlled by constitutional judges and depend only on political authorities.[53]

Until recently, the principle of economic freedom was rarely used in the theory of tax law, perhaps partly due to all those controversies. Still, certain authors find such underuse surprising, bearing in mind the immense influence that taxation exercises over economic choices made by market players.[54] It appears, however, that tax law discussions are analysing this principle more often, for instance, in the field of corporate tax reforms.[55]

Overall, one could distinguish two theoretical approaches to the principle of economic freedom in Swiss tax law: the traditional and the contemporary ones. The author briefly introduces those points of view because they will be relevant in further discussions in this book.

Traditionally, Swiss legal theory considers that the principle of economic freedom applies only to certain categories of special-purpose taxes.[56] In Swiss law, special-purpose taxes are mainly (i) taxes levied in relation to a specific economic activity, i.e. earmarked taxes (*impôt d'affectation*); and (ii) incentive taxes (*impôt d'incitation*, or sometimes called *impôt d'orientation*).[57] The first category, i.e. taxes levied in relation to a specific economic activity and earmarked taxes, generally falls within the scope of application of article 27 of the Swiss Constitution, but has to be analysed on a case-by-case basis.[58] The situation is more complicated regarding taxes with incentive purposes, as usually, they specifically seek to alter economic behaviour. Certain authors consider that such taxes can be only levied at the federal (and not cantonal) level, or else they are unconstitutional.[59]

The Federal Supreme Court has repeatedly confirmed that one cannot have recourse to economic freedom in relation to general taxes,[60] such as taxes that the state collects in order to meet its overall financial needs, e.g. income or wealth taxes or VAT.[61]

53. Auer et al., *Droit constitutionnel*, Vol. II, p. 417.
54. Oberson, *Droit fiscal*, p. 45.
55. One of the most prominent example is the ERU Report, which will be discussed in greater detail in Part 2 of this book.
56. Oberson, *Droit fiscal*, p. 45.
57. Grisel/Neuenschwander, *Liberté économique*, p. 392.
58. Id., at pp. 395-396.
59. Id., at p. 395.
60. ATF 99 Ia 638; ATF 96 I 572; and Oberson, *Droit fiscal*, p. 45.
61. ATF 122 I 213, 215; and Grisel/Neuenschwander, *Liberté économique*, p. 391.

However, a number of Swiss authors criticize such a restricted application of the economic freedom guarantee. Grisel, for instance, considers that the compatibility of *any* tax with this fundamental right should be analysed in relation to a specific economic activity.[62] According Grisel, the Federal Supreme Court implicitly adheres to this reasoning, but does not apply it in a coherent way.[63] Oberson presents a further-reaching interpretation of the guarantee of economic freedom. According to Oberson, the traditional interpretation of this fundamental right contradicts not only its aim of ensuring the free choice and exercise of a profession, but also the organization of an economic activity independent from the state's intervention. He finds it inconsistent that the constitutional guarantee of ownership (article 26 of the Swiss Constitution) applies to all types of taxes and their overall effect on a taxpayer, whereas economic freedom targets only specific taxes on economic activity.[64] Oberson also notes that the constitutionality of taxes in relation to the guarantee of ownership is determined through the examination of the cumulative effects of taxation. Consequently, one could also take into account the cumulative effects of general and special taxes in relation to the guarantee of economic freedom. Oberson considers that the present text of the Federal Constitution, in comparison with its previous version, supports such an interpretation: all public taxes, special and general, can potentially breach article 27 of the Swiss Constitution.[65]

The discussion about the scope of article 27 of the Swiss Constitution is very relevant in the field of corporate taxation and is closely linked to the legal discussion of the concept of corporate ability to pay. Article 27 of the Swiss Constitution was intensively analysed during the theoretical discussions in the framework of the Second Swiss Corporate Tax Reform (CTR II), which will be presented in Part 2 of this book (*see* chapter 7).

1.2.5. Cyclical taxation and the *Totalgewinn* theory

The question of the most appropriate timing of corporate taxes is subject to theoretical debate in Swiss legal theory that is closely related to the discussions about corporate ability to pay. Two competing theories come into play: the one based on the principle of cyclical taxation (*principe de périodicité*) and the so-called *Totalgewinn* ("overall gain") theory.

62. Id., at p. 394.
63. Idm.
64. Oberson, *Droit fiscal*, p. 47.
65. Id.

According to the principle of cyclical taxation, corporate tax is calculated on the basis of profits that were effectively generated during a specific taxing period.[66] In particular, it means that the tax base defines a company's capacity to make profits from investments and its overall economic production during a specific time, namely a tax year.[67] The so-called "corrective" tax law norms in Swiss law that seek to incorporate excessive provisions and depreciations back into taxable profits reflect the principle of cyclical taxation.[68] Those deductible expenses that create hidden reserves delay the taxation of profits and thus disrupt the periodicity of tax.[69]

Swiss legal writers disagree over the scope of the principle of cyclical taxation. The majority considers that this principle only has methodological importance: it simply helps the allocation of the taxable substance in conformity with the *Totalgewinn* (overall profits) principle, being subordinated to it.[70] The latter, which is the theoretical alternative to cyclical taxation, requires taxing all the profits generated during the life of an enterprise upon its liquidation only once.[71] The majority of Swiss legal writers consider that the *Totalgewinn* theory defines enterprises' economic capacity in the most precise manner; however, it cannot be applied for practical reasons, in particular due to the state's need to raise regular revenue.[72] The majority of commentators, however, still consider that the *Totalgewinn* theory plays an important role in the implementation of the principle of the ability to pay. In particular, it helps the definition of the elements that should be included in or excluded from taxable profits.[73] The principle of cyclical taxation comes into play only at a later stage, materializing the contents of *Totalgewinn* in a specific taxing period.[74]

66. Simonek, *Massgeblichkeitsprinzip*, p. 10; Cagianut/Höhn, *Unternehmungssteuerrecht*, p. 166; Obrist, *Réalisation systématique*, p. 16; Glauser, *IFRS*, p. 533; Gurtner, *Verdeckte Kapitaleinlage*, p. 552; Locher/Amonn, *Vermögensübertragungen*, p. 782; Behnisch, *Massgeblichkeit*, p. 30; and CH: Federal Supreme Court, 27 Nov. 2009, Case 2C_33/2009, paras. 2.2-2.3.
67. Glauser, *IFRS*, p. 533; Gurtner, *Verdeckte Kapitaleinlage*, p. 552; Locher/Amonn, *Vermögensübertragungen*, p. 782; and Behnisch, *Massgeblichkeit*, p. 30.
68. Simonek, *Massgeblichkeitsprinzip*, p. 10; Danon, *ad* arts. 57-58, p. 733, no. 757.
69. Danon, *ad* arts. 57-58, p. 733, no. 757.
70. Glauser, *Apports*, p. 18; Brülisauer/Poltera, *Kommentar ad Art. 58 DBG*, pp. 853-854, no. 843; Obrist, *Réalisation systématique*, pp. 16-17; Danon, *ad* arts. 57-58, p. 733, no. 759; Simonek, *Massgeblichkeitsprinzip*, p. 10; and Reich, *Ungerechtfertigte Vermögensübergänge*, p. 9.
71. Yersin, *Remarques préliminaires*, p. 35, no. 72.
72. Glauser, *Apports*, pp. 19-20; Rivier, *Droit fiscal suisse*, p. 361; Danon, *ad* arts. 57-58, p. 733, no. 758; and Obrist, *Réalisation systématique*, p. 17.
73. Danon, *ad* arts. 57-58, p. 733, no. 759.
74. Simonek, *Massgeblichkeitsprinzip*, p. 10; Brülisauer/Poltera, *Kommentar ad Art. 58 DBG*, p. 853, no. 842; and Danon, ad arts. 57-58, p. 733, no. 759.

Nonetheless, the Federal Supreme Court considers that the principle of cyclical taxation carries substantial – and not merely technical – content that simply aids in the perception of taxes.[75] The Court highlights that this principle is anchored in Swiss legal norms and is therefore a substantive law.[76] For this reason, and due to its importance, it must be considered an embodiment of the principle of the ability to pay, and thus superior to *Totalgewinn*.[77] On the contrary, due to the importance of this principle, legal norms that create exceptions to it (such as the carrying forward of losses) must be interpreted strictly.[78] This case law – confirmed on several occasions by the Court – receives controversial appraisal from certain legal commentators.[79]

In the author's view, the Court's position could also be supported by an argument related to the economic fact that long-term income tax deferral generates very inequitable effects. When the untaxed earnings are accumulated and reinvested at the corporate level, they produce higher returns than the taxed earnings. Thus, even when they are distributed and subjected to full individual income tax rates, the after-tax amount is higher than when such earnings are taxed every year at the same rate. This point was brought forward during CTR II and, in particular, the ERU Report, which described the inequitable effects of long-term deferral of corporate income and will be discussed in the Part 2 of this book (*see* chapter 6).

Consider the following example, which is, for the sake of simplicity, based on hypothetical tax rates: one individual invests CHF 100 directly, and another individual does the same through a corporation. The corporate income is untaxed. The individual income tax rate is 35%, and the investment for both the individual and the corporation will generate a return of 10%. The situation is expressed in table 1.1.

75. CH: Federal Supreme Court, 27 Nov. 2009, Cases 2C_33/2009, para. 2.2-2.3; and CH: Federal Supreme Court, 18 June 2008, Case 2C_101/2008, in RDAF 2008 II, p. 505 et seq.; and Obrist, *Réalisation systématique*, p. 17.
76. CH: Federal Supreme Court, 27 Nov. 2009, Cases 2C_33/2009, paras. 2.2 and 3.3; and CH: Federal Supreme Court, 9 Aug. 2011, Case 2C_429, para. 2.1 et seq.
77. CH: Federal Supreme Court, 27 Nov. 2009, Case 2C_33/2009, para. 3.3.
78. Id.
79. Obrist, *Réalisation systématique*, p. 17, with reference to De Vries Reilingh, *La jurisprudence fiscale du Tribunal fédéral en 2010*, p. 146 et seq. and Dzamko-Locher, *Der Verlustvortrag nach Aufgabe einer selbständigen Erwerbstätigkeit in der aktuellen bundesgerichtlichen Rechtsprechung*, p. 619 et seq.

Table 1.1

Year 1	Initial investment	Yield (10%)	Tax	After-tax balance and reinvestment
Individual investing through a corporation	100	10	0	110
Individual investing directly	100	10	3.5 (35% of 10)	106.5

Year 2	Yield (10%)	Tax	After-tax balance	Tax on distribution	Comparison: end of Year 2
Corporation	11 (10% of 110)	0	121	7.35 (35% of 21)	113.65 (Year 3: 121.515)
Individual	10.65 (10% of 106.5)	3.7275 (35% of 10.65)	113.4225	–	113.4225 (Year 3: 120.79)

The example in table 1.1 illustrates the advantages of deferral that are visible even after a short investment period of 2 years (a 0.2% higher return if invested through a corporation). However, in the following year, the gap is already 0.6%. In fact, the higher the individual income tax rates are and the longer the investment period is, the greater the advantages of investing through a corporate structure will be. This deferral effect also exists if the corporation tax is above 0 but inferior to individual income or capital gain tax rates.[80] If the corporate tax rate equals the individual tax rate and the tax rate on dividend distributions equals the rate on capital gains, the greater tax on the distribution will offset any benefit of deferring the individual tax.[81]

Due to such inequitable effects of deferral, even the proponents of integration of personal and corporate taxes do not argue for the abolition of taxes at the corporate level and levying them on individuals' income only upon realization. Such taxation would only reverse the economic inequality: the income generated through a corporate structure would be subject to more favourable treatment due to the untaxed reinvestment accumulation.[82] For the taxpayers who could afford to keep their investments in a corporate form for a longer period, this would be an important opportunity to lower their tax rates.[83] To eliminate deferral options that are inequitable, the timing of

80. Abrams et al., *Taxation*, p. 16, with reference to Warren, *The Timing of Taxes*.
81. Id.
82. Id., at p. 9.
83. Id.

income taxation is of utmost importance; in particular, corporate income should be taxed annually.[84]

As a result, cyclical taxation is needed not only to secure regular state income, but also to mitigate or eliminate the inequitable effects of income deferral. *Totalgewinn* taxation can only coexist with cyclical taxation if the rates applied to the "total profits" upon liquidation are adapted to the economic effects of long-term deferral.

84. Id.

Peer Review Process and Statement by the Publisher

This manuscript was subjected to a rigorous internal and external single-blind peer review. For the external single-blind peer review, two international academic experts in the field and topic area were tasked with reviewing the manuscript. In particular, the reviewers were asked to comment on whether the manuscript (i) achieved original research results; and (ii) is based on thorough knowledge of the existing literature on the topic(s).

After the review process was completed, the author was required to make changes in accordance with the reviewers' recommendations. Once the changes were satisfactorily made, the editorial and publishing teams made the final editorial, stylistic, grammatical, typographical and typesetting amendments.

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