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Transfer Pricing

Switzerland: Law & Practice
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Switzerland: Trends & Developments
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practiceguides.chambers.com

2021

SWITZERLAND

Law and Practice

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1. RULES GOVERNING TRANSFER PRICING

1.1 Statutes and Regulations

Preliminary Remarks

In Switzerland, transfer pricing issues arise mainly in connection with the federal and cantonal corporate income taxes and the federal withholding tax law. With respect to corporate income tax, it should be noted that cantons have the authority not only to assess the cantonal and municipal but also the federal corporate income tax. This means that the cantons can issue advance rulings (so-called tax rulings), in particular also with regard to federal income taxes. However, the Federal Tax Administration (FTA) exercises an important supervisory function over the cantons and can also intervene in individual cases. In practice, it can be seen that the FTA is becoming increasingly involved in discussions, especially in large transfer pricing cases.

While in the area of corporate income tax there is a parallel competence of the federal government and the cantons, the federal government has the exclusive competence to levy withholding tax, stamp duties and value added tax. In the area of withholding tax, the FTA established a competence centre for transfer pricing in 2019. It is, hence, no surprise that in practice it can already be seen that transfer prices are increasingly being critically scrutinised during tax audits from a withholding tax perspective as well. This applies, in particular, in connection with the relocation of functions abroad and in the case of controlled transactions between Swiss companies and related companies domiciled in tax havens or low-tax countries.

As far as legislation in the field of transfer pricing is concerned, it should be noted that there are no specific regulations on the determination and documentation of transfer prices, neither at the federal level nor at the cantonal level.

One major reason for the lack of specific transfer pricing rules is that Switzerland has comparatively low corporate income tax rates and, in the past, there has generally been little incentive for Swiss-based companies to shift profits abroad. A second reason is that Switzerland, as a member state of the Organisation for Economic Co-operation and Development (OECD), adheres to the OECD's Transfer Pricing Guidelines (OECD's TPG). Switzerland has accepted the initial version and all updates of the OECD's TPG without reservation. There is now full consensus in Swiss tax law practice that the OECD's TPG are an important interpretative tool for the application of the at arm's-length principle in Swiss tax law.

In exercising its supervisory role over the cantonal tax administrations, the FTA instructed the cantonal tax administrations in 1997 and 2004 with a circular letter to directly apply the OECD's TPG. The Federal Supreme Court (FSC) tends to apply a static approach regarding the version of the OECD's TPG. Hence, the arm's-length principle and the methods to determine the transfer prices will be assessed according to the OECD's TPG as they were published at the time the transaction in question was settled.

Statutes

Overview

Even though transfer pricing issues arise primarily regarding corporate income and withholding tax, stamp duties and VAT must always be analysed as well in a comprehensive transfer pricing advice.

Corporate income tax

From a corporate income tax perspective, the following two scenarios must be distinguished: (i) controlled transactions between the corporation and its shareholders, and (ii) controlled transactions between other related parties. The latter includes, in particular, transactions between group companies that are under the

same management and control. In both situations, the arm's-length principle is to be applied.

Under Swiss law, a tax authority may make an adjustment only if the following three conditions are met:

- the company received evidently no adequate compensation for its services or deliveries;
- the compensation in question was in favour of the shareholder or a related party and would not have been provided to unrelated parties at the same conditions; and
- the evident discrepancy between the service or delivery and the compensation was recognisable for the company or the persons representing the company.

The first two conditions concern the question of whether the agreed transfer prices fall within the range of prices that independent third parties would have agreed on for the services or goods received. The third condition, however, is a Swiss peculiarity: the tax authority may only make an adjustment if the violation of the at arm's-length principle is obvious and thus recognisable for the management or the board of directors. This has to be determined on the basis of the concrete facts and circumstances of the case at hand.

If profits are shifted from the subsidiary to the parent company due to an obvious violation of the arm's-length principle, there is a deemed dividend. The tax authority is authorised to adjust the profit of the subsidiary. In addition, income is attributed to the shareholder to the extent of the deemed dividend. If, on the other hand, the violation of the arm's-length principle leads to an increase of income at the level of the subsidiary, there is a so-called informal capital contribution. The tax treatment of such an informal capital contribution at the level of the shareholder and the beneficiary company depends on the facts and circumstances of the case.

If the contracting parties of a transaction violating the arm's-length principle are sister companies, the so-called modified triangle theory applies. In a first step, the profit of the company that has distributed a deemed divided is adjusted. In a second step, the benefit is attributed to the shareholder, which in turn makes a hidden capital contribution to the beneficiary sister company.

Withholding tax

The hidden profit distributions described above, which result from the violation of the arm's-length principle, regularly also trigger withholding tax consequences for the company that has distributed the deemed dividend.

Under Swiss law, withholding tax of 35% must be passed on to the recipient of the deemed dividend. The taxable company must therefore, in principle, reclaim the withholding tax from the beneficiary company. Unlike in the case of corporate income tax, it is not the triangular theory that applies, but the direct beneficiary theory. In the case of payments to sister companies, this means that the reimbursement must be requested by the beneficiary sister company. If it is not possible to pass on the withholding tax, the deemed dividend is grossed up and the beneficiary is deemed to have effectively received only 65% of the deemed dividend. The corporation that provided the deemed dividend is therefore liable for the payment of the remaining 35%. This gross-up results in an effective withholding tax rate of 53.8% of the tax adjustment.

Foreign beneficiaries may request a full or partial refund of the withholding tax based on the applicable double taxation agreement (DTA). However, the application of the direct beneficiary theory regularly limits the treaty relief in cases where the

direct beneficiary is not the direct shareholder. The law entitles companies to fulfil the withholding tax liability by notification instead of paying if specific conditions are met. In practice, however, the application of the notification procedure in the case of deemed dividends is granted only very reluctantly. If the notification procedure is not possible, not only the full withholding tax but also an interest on late payment of 5% will be due.

Stamp tax duty

In the case of stamp duties, the arm's-length principle is only applied in certain cases. In principle, as in the case of withholding tax, the direct beneficiary theory also applies to the stamp duty. This means that only hidden capital contributions made directly by shareholders to the corporation are subject to the 1% stamp duty. In particular, this has the consequence that contributions to sister companies do not trigger stamp duty. Also, no stamp duty is triggered for so-called benefits periodically granted to the subsidiary, as is the case, for example, if the shareholder charges an interest rate that is too low according to the arm's-length principle for the loan granted to the subsidiary.

Value added tax

The Federal VAT Act, in contrast to the above-mentioned legislation, explicitly states that transactions between related parties have to be at arm's length. For VAT purposes, a related party is to be assumed if a shareholder holds at least 20% of the nominal share capital or an equivalent participation, or in the case of foundations and associations with which there is a particularly close economic, contractual or personal relationship.

Regarding the determination of the arm's-length transfer prices for VAT purposes, it can generally be referred to the principles applicable for corporate income tax. Though, according to administrative practice in specific cases, the arm's-length price can be calculated on a lump-sum basis. If, for example, a holding company does not have its own personnel to effectively manage the holding company and that management is carried out by personnel of its subsidiaries, the at arm's-length remuneration can be set at 2 or 3‰ of the average total assets held by the holding company.

Administrative Guidelines

As already set out, the FTA instructed the cantonal tax administrations by circular letter of 1997, which was renewed in 2004, to directly apply the OECD's TPG. Said circular explicitly states that the mark-ups for service companies must be determined in accordance with the arm's-length principle; ie, for each individual case on the basis of comparable uncontrolled transactions and with reference to the range of appropriate margins.

The most relevant administrative guidelines in Switzerland in the area of transfer pricing can be seen in the circulars published by the FTA providing safe harbour rules for thin capitalisation and for intra-group interest rates (see **11.1 Transfer Pricing Safe Harbours**) where the arm's-length principle is not adhered to.

1.2 Current Regime and Recent Changes

Overview

As Switzerland adheres to the OECD's TPG and has not established specific transfer pricing rules, the current regime and its development are, in general, reflected by the OECD's TPG. However, the arm's-length principle was already acknowledged before the first OECD TPG were published. Hence, in the matter of Bellatrix SA, the FSC confirmed in 1981 that for withholding tax purposes, the arm's-length principle is applicable with regard to transactions concerning the company's shareholders.

Nevertheless, it has to be noted that in recent years Switzerland used to apply a rather pragmatic approach when it came to the application of the arm's-length principle. For instance, the FTA published in 2001 the so-called 50-50 practice, according to which, foreign-controlled trading companies being predominantly active abroad could set off 50% of their gross earnings as commissions or provisions to related or third parties. This practice was abolished in mid-2005.

Until recently, the FTA also maintained a practice for Swiss finance branches and principal companies. According to these practices, part of the earnings of the Swiss companies was not taxed. In the case of the Swiss finance branches, Swiss permanent establishments of foreign companies, a notional interest was calculated on the capital made available to the branch, which reduced the taxable profit in Switzerland. With regard to principal companies, the practice of the FTA allowed the partial apportionment of the earnings abroad, thus exempting part of the net profit from taxation. In the course of the comprehensive corporate tax reform, these practices have been abolished as of the beginning of 2019.

Recent Changes

Until recently, core transfer pricing issues were only seldomly touched by the tax administrations. Not least due to the BEPS project, transfer pricing issues increasingly form part of routine audits. Hence, in recent years, taxpayers have been more often confronted with detailed questions regarding transfer pricing matters (eg, requests regarding detailed transfer pricing documentation and explanations concerning comparables). In international cases, the main focus is on the transfer of functions, the transfer of intellectual property rights, financial transactions and asset management services. Transactions with foreign companies in low-tax jurisdictions, in particular, attract the tax authorities' attention.

2. DEFINITION OF CONTROL/RELATED PARTIES

2.1 Application of Transfer Pricing Rules

Swiss tax law does not include an explicit definition of the terms "associated enterprises", "related parties" or "controlled transactions".

According to the FSC, related parties are to be considered as entities with close commercial or personal relationships, whereas any close relationship between the parties involved in the transaction is enough. According to the Swiss understanding of the term of related parties, direct or indirect control (participation in management or capital) for itself is not decisive. The crucial question is if the tested transaction was conducted under the given conditions only as a consequence of the associated relationship or not. In practice, some cantonal tax administrations tend to apply the definition of "associated entities" set forth by the OECD. Further, according to the FSC, "associated enterprises" or "related parties" can be assumed if the conditions agreed upon by the involved parties apparently do not meet the at arm's-length standard.

3. METHODS AND METHOD SELECTION AND APPLICATION

3.1 Transfer Pricing Methods

Swiss domestic tax laws or practices do not provide specific transfer pricing methods. But as Switzerland adheres to the OECD's TPG, all the usual transfer pricing methods are admissible. However, according to the FTA circular of 2004, the cost plus method is, in general, not to be seen as an appropriate method for financial services or management functions.

3.2 Unspecified Methods

As Switzerland adheres to the OECD's TPG and the Guidelines do not exclude the use of unspecified methods, such methods can indeed be applied.

However, if an unspecified method is intended to be applied, as the Guidelines specify, it should be explained why the methods described by the Guidelines themselves are not considered appropriate for the case at hand.

3.3 Hierarchy of Methods

In accordance with the OECD's TPG, Switzerland does not have a specific hierarchy of the methods described in the Guidelines. The most appropriate method should be used. However, the three traditional methods – ie, the comparable uncontrolled price (CUP) method, the resale price method and the cost plus method – are still preferred by the tax administrations. Further, the CUP method enjoys preference over the other two traditional methods. In practice, however, the transactional net margin method is the most commonly used method in Switzerland to determine transfer prices.

It is to be noted that the hierarchy of transfer pricing methods as it was stipulated in the older versions of the OECD's TPG can still be of relevance. This is due to a static approach to the application of the Guidelines that means that the version of the Guidelines in effect at the time the transaction was settled is applied (see also **1.1 Statutes and Regulations**).

It is sometimes difficult, though, to assess whether an update of the OECD's TPG can be considered merely a more detailed explanation of the existing principles or a change in the guiding principles. If this is the case, a dynamic approach to the application of the Guidelines is permissible as well.

3.4 Ranges and Statistical Measures

The use of statistical tools that consider central tendency, such as the interquartile range or other percentiles, is not required. However, in practice, such tools are usually used to narrow the range.

With regard to the determination of the adequate transfer prices, the tax authorities generally consider the interquartile range as the arm's-length remuneration.

3.5 Comparability Adjustments

Swiss domestic tax laws do not provide specific guidance on comparable adjustments. However, the OECD's TPG on how and when to apply comparability adjustments is applicable.

4. INTANGIBLES

4.1 Notable Rules

Swiss domestic tax laws do not provide specific guidance on the pricing of controlled transactions involving intangibles. Rather, the OECD's TPG are to be consulted regarding transfer pricing of intangibles.

4.2 Hard-to-Value Intangibles

In general, due to the adherence to the OECD's TPG, the OECD's approach regarding hard-to-value intangibles is considered by the tax authorities to be applicable in Switzerland as well.

However, there is controversy as to whether this approach is, in fact, applicable, since it seems to collide with long-standing case law and the tax laws themselves. In particular, the question is whether or not ex post data can influence open or final tax assessments.

Open Tax Assessments

If a tax assessment is not yet final, a transfer pricing adjustment requires, inter alia, an obvi-

ous mismatch between the value of the transferred intangible and the compensation received, and that this mismatch was recognisable for the persons in charge (see **1.1 Statutes and Regulations**). This mismatch is evaluated ex ante, namely at the time the transaction was settled.

The hard-to-value intangibles (HTVI) approach, however, assesses the conditions of the transaction ex post and does not provide an answer to whether a potential mismatch was ex ante already obvious and, thus, recognisable. Hence, the HTVI approach does not seem to fit into pre-existing domestic law and the respective case law. So far, however, there is no precedent on this issue.

Final Tax Assessments

If a tax assessment is already final and legally binding, an adjustment is generally only possible if the tax administration becomes aware of new facts or evidence. As long as the taxpayer provided the tax administration with appropriate and correct transfer pricing documentation during the assessment relating to the ex ante valuation of the intangible in question, the administration is not entitled to come back to its own evaluation should it ex post turn out that the value of the intangible is, in fact, higher. In this case, the ex post data would not qualify as new fact or evidence to reopen and change the final tax assessment.

4.3 Cost Sharing/Cost Contribution Arrangements

Switzerland recognises cost contribution arrangements and applies the OECD's TPG correspondingly. However, Switzerland does not have special rules that apply to such arrangements.

5. AFFIRMATIVE ADJUSTMENTS

5.1 Rules on Affirmative Transfer Pricing Adjustments

Switzerland does not have specific rules regarding affirmative transfer pricing adjustments. In general, pursuant to Swiss tax law, the financial statements prepared in accordance with commercial law are, in principle, binding for tax purposes. The tax administrations can only deviate from the financial statements in order to determine the taxable base if the statements violate accounting principles as set forth in the federal Code of Obligations or specific rules of the tax law require an adjustment.

However, as long as the tax return had not yet been filed by the taxpayer, the balance sheet can, in accordance with the Code of Obligations, be adjusted without further restrictions. Once the tax return has been filed, however, according to case law, a balance sheet adjustment is only permissible if it violates commercial law. If a transfer pricing issue arises later that makes a proactive adjustment of the balance sheet necessary, an adjustment, in principle, will only be allowed if the original transfer prices also violate commercial law.

But as long as the adjustment increases the taxable profit, the tax administrations are nonetheless likely to accept such adjustments, even if the original transfer prices were in line with the accounting principles as set forth in the federal Code of Obligations. This is due to the fact that if a transaction is not conducted according to the arm's-length principle, the tax administration can make the respective adjustments (see Article 58 paragraph 1 of the Federal Act on Direct Federal Taxation, or FDTA, and Article 24 paragraph 1 of the Federal Act on the Harmonisation of Direct Taxes, or FTHA).

Neither transfer pricing-specific returns nor related-party disclosures along with the corporate income tax return are required to be filed.

6. CROSS-BORDER INFORMATION SHARING

6.1 Sharing Taxpayer Information

Exchange of Information on Request

In 2009, Switzerland committed to the internationally agreed standard regarding the exchange of information on request. By doing so, Switzerland renewed most of its more than 100 DTAs.

Moreover, in 2016, Switzerland ratified the Multilateral Convention on Mutual Administrative Assistance in Tax Matters, extending the network of jurisdictions to exchange information even further. Currently, Switzerland has implemented the legal basis for exchange of information on request with around 140 jurisdictions. In addition, Switzerland has signed ten tax information exchange agreements.

Practice shows that foreign tax authorities are increasingly submitting requests for administrative assistance to Switzerland when auditing transfer prices. Under current law, administrative assistance may only be provided if the requesting state demonstrates in its request that the information requested is foreseeably relevant and confirms that it will treat the requested information confidentially. Administrative assistance may be refused if the information is to be used for taxation contrary to the DTA or if the requested information could not be obtained by the Swiss tax authorities under domestic tax procedural law.

Spontaneous Exchange of Information on Specific Tax Rulings

In December 2015, the Swiss Parliament approved the OECD/Council of Europe Convention on Mutual Administrative Assistance in Tax Matters (MAC). The MAC entered into force for Switzerland as of 1 January 2017 and laid the legal foundation concerning the automatic, as well as the spontaneous, exchange of information. According to the minimum standard defined in Action 5 of the BEPS project, it is incumbent on states to spontaneously exchange information on tax rulings in cross-border situations.

Switzerland has implemented the spontaneous exchange of information on tax rulings into domestic law as of 1 January 2017. In particular, it has also committed to the spontaneous exchange of unilateral rulings on transfer pricing and permanent establishments with the state of the direct parent, the state of the group top company and, if available, the state of the counterparty of the transaction.

Automatic Exchange of Information on Country-by-Country Reports (CbCRs)

In 2016, Switzerland also signed the Multilateral Competent Authority Agreement on the Exchange of Country-by-Country Reports, which entered into force on 1 January 2017.

Apart from voluntary CbCRs, the first reports had to be prepared for 2018 and information was first exchanged in 2020 with around 60 states. These countries include all the EU states, but also emerging economies such as Indonesia and Brazil, as well as developing countries such as Pakistan and Kazakhstan. Switzerland does not exchange CbCRs with the USA.

7. ADVANCE PRICING AGREEMENTS

7.1 Programmes Allowing for Rulings Regarding Transfer Pricing

Unilateral Rulings

Switzerland has a long-standing practice regarding the issuance of unilateral rulings. This practice also includes the issuance of unilateral transfer pricing rulings. These rulings may be subject to the spontaneous exchange of information (see also **6.1. Sharing Taxpayer Information**).

Advance Pricing Agreements

In Switzerland, advance pricing agreements (APAs) are available. APAs have become a favoured option for Swiss-based international groups with complex or high-volume transactions. In practice, the procedure starts with a presentation of the facts and a formal request to the State Secretariat for International Finance (*Staatssekretariat für internationale Finanzfragen*, or SIF), the competent authority in Switzerland.

In 2019, 105 APA proceedings were opened and 46 of the pending APA proceedings have been closed. The SIF has published guidance on mutual agreement procedures (MAPs) and APAs.

7.2 Administration of Programmes

With regard to bi- and multilateral APA procedures, the competent authority in Switzerland is the SIF.

Concerning unilateral transfer pricing rulings for corporate income tax purposes, the cantonal tax administrations and the FTA will be the competent authorities.

7.3 Co-ordination between the APA Process and Mutual Agreement Procedures

Since the SIF is also the competent authority for mutual agreement, co-ordination between a MAP and APA procedures is ensured.

7.4 Limits on Taxpayers/Transactions Eligible for an APA

In principle, the APA programme is open for all taxpayers that engage in cross-border intra-group transactions.

7.5 APA Application Deadlines

The application for an APA procedure can be filed at any given time, including after an audit.

7.6 APA User Fees

Under current practice, APA procedures and MAPs are free of charge. This may change in the future.

7.7 Duration of APA Cover

In practice, an APA will cover three to five years. However, Switzerland does not have specific time limitations an APA may or may not cover. Rather, the time period to be covered by an APA has to be decided depending on the characteristics of the particular case at hand and is subject to negotiations. Hence, the duration is typically a trade-off between an administrative-economical reasoning and the uncertainty associated concerning future developments of the affairs that are the subject of the APA.

7.8 Retroactive Effect for APAs

Unilateral rulings cannot have retroactive effect, as according to domestic law, ruling requests can only be accepted if they concern future affairs.

However, as bi- and multilateral APAs have another legal basis, said restriction does not apply for these agreements. Hence, APAs can,

depending on the involved countries, have retroactive effect. The retroactive reach depends on the case at hand and on the restriction that the facts of the case have not changed significantly over the past years. In practice, the retroactive effect of APAs will usually not be extended beyond five years.

8. PENALTIES AND DOCUMENTATION

8.1 Transfer Pricing Penalties and Defences

Transfer Pricing Penalties

Switzerland does not impose penalties that apply specifically in the transfer pricing context, except for violations of the CbCR.

In cases of unlawful tax evasion or tax fraud, penalties can nevertheless also be imposed concerning transfer pricing issues. This is, in particular, true for cases where basic principles of transfer pricing were grossly neglected and, thus, the violation of the arm's-length principle was not only recognisable for the company or the persons in charge respectively but downright obvious.

In the case of tax evasion or tax fraud, penalties may be imposed for all taxes involved. For instance, a transfer price-induced adjustment by the tax administration concerning corporate income tax may trigger respective consequences regarding withholding tax or VAT. Hence, in practice it seems advisable to seek an amicable solution with the tax administration as the tax administration would then refrain from initiating criminal proceedings. Whether this approach is actually appropriate requires a careful consideration and assessment of the facts and circumstances of the individual case.

Documentation Obligations

Swiss tax laws do not define specific documentation requirements with respect to transfer pricing. However, taxpayers must provide all documents necessary in order to enable the tax administration to conduct a proper assessment of the taxable base. This legal obligation is based on the principle that the taxpayer and the tax administration jointly determine the relevant facts to ensure a complete and correct assessment as far as corporate income tax is concerned. As a consequence, despite the lack of specific documentation rules, taxpayers are strongly advised to have full and state-of-the-art transfer pricing documentation at hand that can, if requested by the tax administration, be disclosed. This also includes intercompany agreements with respect to the controlled transactions. Such documentation will also be helpful in the defence of potential tax evasion charges. Such documentation should also include sound and updated benchmarking studies.

If no appropriate transfer pricing documentation can be presented and the taxable base subsequently cannot be properly determined, the tax administration might need to estimate the transfer prices. Even though that estimate has to be dutiful and based on experience, such estimates are rarely in favour of the taxpayer. Although such an estimate is not to be considered as a penalty, it still has to be taken into consideration as a potential negative impact. The reason for that is that the courts will reject such an estimate only if the taxpayer can demonstrate that the transfer prices set by the tax administration are obviously flawed or arbitrary.

Penalty Relief

Federal and cantonal Swiss tax laws provide for a one-time voluntary disclosure, which leads to a complete penalty relief if specific statutory conditions are met. Outside the voluntary disclosure procedures, penalties charged are lower

in the case of ordinary negligence and higher in the case of gross negligence. Collaboration with the tax administration in the course of a tax criminal investigation will usually result in a lower penalty. With regard to the question of culpability, the importance of state-of-the-art transfer pricing documentation should be emphasised. If a company does have such documentation, it will be difficult for the tax administrations to substantiate culpability. However, as indicated above, many disputes can be prevented or settled by negotiations with the tax authorities during a tax assessment or tax audit process (by filing formal complaints).

8.2 Taxpayer Obligations under the OECD Transfer Pricing Guidelines

Concerning transfer pricing documentation, Switzerland only adopted the minimum standard. Hence, taxpayers are only required to prepare CbCRs without having the obligation to prepare a master or local file.

However, in view of a potential challenge of the transfer prices by the tax authorities, it is nonetheless advisable to have master and local files at hand.

9. ALIGNMENT WITH OECD TRANSFER PRICING GUIDELINES

9.1 Alignment and Differences

Though the Guidelines are not implemented into domestic law, the administrative practice declared the Guidelines as applicable.

Nonetheless, differences exist regarding the application of thin capitalisation rules and the determination of intra-group interest rates for loan receivables and loan payables both in Swiss francs and in foreign currencies. In this regard, the FTA annually publishes safe haven interest rates that deviate from the at arm's-length principle as defined and agreed upon in the OECD's TPG.

In addition, there is a long tradition in Swiss tax law of applying the formulary apportionment method regarding the profit allocation between the Swiss head office of an enterprise and its foreign permanent establishments. However, the tendency is to apply the OECD authorised approach (AOA).

With regard to the apportionment of profits between a head office and foreign permanent establishments, the FSC has shown sympathy for the application of the AOA in its famous ruling in the matter of Swiss International Airlines, but ultimately left the question open. In this respect, it should be noted that Switzerland has numerous DTAs in force that are still based on the OECD Model Convention, where the application of the formulary apportionment method for the allocation of profits to permanent establishments was considered permissible.

9.2 Arm's-Length Principle

Deviations from the arm's-length principle can be seen in the implementation of the patent box and the notional interest deduction, which were introduced in connection with the corporate tax reform that came into force on 1 January 2020.

In line with BEPS Action 5, cantons are allowed to exempt income from patents and similar rights from taxation up to 90%. The top-down approach is used to determine qualifying income. Thereby, income from routine activities and trade marks is to be excluded. These are subject to ordinary taxation. According to the FTHA, it is not necessary to determine the income for routine activities and brand use by means of transfer pricing studies. Instead, for reasons of practicability, the law provides for fixed margins. With regard to the income of routine functions, a mark-up

of cost plus 6% is defined, and concerning the income of trade marks, as a rule of thumb, 1% of the turnover of the patent box is regarded as appropriate. However, the right to prove higher or lower income from trade marks based on the arm's-length principle is reserved.

The law also provides for simplifications in connection with the notional interest deduction. The special feature of the Swiss notional interest deduction is that it is only possible on the so-called security equity. For this purpose, core and security equity must be determined in a first step. The law does not require the preparation of a transfer pricing study for this purpose.

For reasons of practicability, the regulation rather provides for equity backing rates for the individual assets, following the circular on thin capitalisation and its inversed maximum safe haven debt capacity rates (for example, for intercompany loans, a minimum equity rate of 15% is required). If these rates are exceeded, there is security capital on which an imputed equity interest deduction can be claimed. In general, this interest is also not determined on the basis of the arm's-length principle. Rather, the law provides for the interest rate for ten-year federal bonds. However, to the extent the security capital is attributable to receivables from related parties, an interest rate corresponding to the arm's-length principle may be applied.

9.3 Impact of BEPS

In general, it can be noted that the BEPS project had a major impact on the Swiss tax law landscape. Based on BEPS Action 5, Switzerland agreed to spontaneously exchange certain tax rulings and based on BEPS Action 13, the exchange of country-by-country reports (see **6.1 Sharing Taxpayer Information**).

Moreover, Switzerland abolished the administrative practices on Swiss finance branches and principal companies (see **1.2 Current Regime and Recent Changes**). The BEPS project considerably raised the awareness of transfer pricing, prompting the tax administrations – at cantonal and federal level – to address this issue more frequently and persistently (see **1.2 Current Regime and Recent Changes**).

9.4 Entities Bearing the Risk of Another Entity's Operations

From a contract and commercial law perspective, a group can freely allocate risks and functions to be assumed between its entities. With a view to the acceptance of such an allocation, the FSC held, in favour of the taxpayers, that the tax administration must recognise the contractual distribution of functions and risks undertaken by group entities, if these were not merely sham structures.

However, as the tax administrations are also following a substance-over-form approach in the area of transfer pricing, the splitting up of the assumption of risks and functions is increasingly questioned by the tax authorities. In particular, the tax administrations will evaluate whether the personnel of a risk-bearing entity was effectively able to manage and control the assumed risks.

10. RELEVANCE OF THE UNITED NATIONS PRACTICAL MANUAL ON TRANSFER PRICING

10.1 Impact of UN Practical Manual on Transfer Pricing

The UN Practical Manual on Transfer Pricing is of only minor importance in Swiss transfer pricing practice.

11. SAFE HARBOURS OR OTHER UNIQUE RULES

11.1 Transfer Pricing Safe Harbours

There are safe harbour rules that apply on thin capitalisation and on interest rates that are regularly used by corporate tax payers (see **9.1 Alignment and Differences**).

Thin Capitalisation

The FTA published thin capitalisation rules in its Circular Letter No 6 (6 June 1997). In this circular, the maximum debt is determined according to maximum debt capacity ratios that apply for each asset category. No interest expense can be made on debt that surpasses this maximum debt calculated (to be considered as constructive dividend distribution). Special safe haven rules might apply on the level of the Swiss cantons (eg, a maximum debt ratio of 6/7 in the canton of Zug).

Interest Rates

Furthermore, the FTA annually publishes circular letters providing inbound and outbound safe harbour interest rates.

The FTA, in principle, allows taxpayers to deviate from the conditions set out in the abovementioned circular letters if the taxpayer can prove that the applied interest rate is at arm's length. The tax payer has the burden of proof to establish that the applied interest rate is at arm's length. the tax payer preferably does that through performing a detailed transfer pricing analysis.

11.2 Rules on Savings Arising from Operating in the Jurisdiction

Switzerland does not have any specific rules relating to location savings and relies on the OECD's TPG on this issue. It is to be noted, though, that Switzerland does not provide notable location savings in the sense of the OECD's TPG as production and labour costs are comparatively high.

11.3 Unique Transfer Pricing Rules or Practices

Switzerland does not have unique transfer pricing rules and, in principle, adheres to the OECD's TPG.

12. CO-ORDINATION WITH CUSTOMS VALUATION

12.1 Co-ordination Requirements between Transfer Pricing and Customs Valuation

Switzerland levies VAT on imported goods (import tax) of currently 7.7%, where the tax is assessed on the respective consideration. The import tax is levied by the Federal Customs Administration, which acts, like the FTA, as an independent administrative body of the federal government.

Despite the fact that the FTA and the Federal Customs Administration act independently, the administrations are entitled and encouraged to exchange relevant information between themselves and with other interested administrative branches. Accordingly, it can be observed that said information exchange has massively increased within the past couple of years, which is mostly due to improved electronic systems allowing a comprehensive and steady data flow. Hence, transfer pricing adjustments should always be considered for import tax purposes, as well. With regard to customs duty purposes, it can be noted that generally no adjustment is required as the customs duty itself is based on weight and not on monetary value.

13. CONTROVERSY PROCESS

13.1 Options and Requirements in Transfer Pricing Controversies

General

Transfer pricing issues can generally be raised by the tax administration in the course of the ordinary tax assessments or in the course of audits. With regard to the transfer pricing controversy process, it has to be differentiated whether a cantonal tax administration or the FTA raised the issue of transfer pricing. While the cantonal tax administrations raise this issue in the context of corporate income tax, the FTA may challenge transfer pricing also with regard to withholding tax, stamp duty or VAT.

As will be shown, taxpayers may challenge the results of a tax assessment or from an audit firstly in an administrative objection proceeding before bringing the case to court. As regards the selection of the courts, the taxpayer does not have options since the competent courts are determined by law.

Corporate Income Tax

Since the cantonal tax administrations are the competent authorities to assess and levy corporate income tax at cantonal and federal level, transfer pricing adjustments affecting corporate income tax have to be discussed with these cantonal tax administrations. If the tax administration has already issued an assessment or a decision, an objection can be lodged with the tax administration itself within 30 days. The tax administration will then have to evaluate the material objections and render a new decision.

The tax administration's second decisions can be appealed before court, again within a 30-day deadline. Generally, each canton provides two judicial instances, whereas, typically, smaller cantons only established one judicial instance. Once the highest cantonal court has rendered its decision, an appeal with the FSC can be lodged, also within 30 days. In contrast to the cantonal instances, the FSC will only deal with questions concerning the correct application of the law, which includes the application of the OECD's TPG. Issues concerning the facts will only be dealt with if the facts were arbitrarily established.

The disputed tax needs to be paid irrespective of the fact of appealing a decision or moving the case forward into court. If the appeal/objection is successful, the tax already paid will be paid back. However, in ruling 5A_41/2018, the Supreme Court clarified that the tax administration is nevertheless not entitled to enforce the disputed tax amount as long as the controversy has not been decided with legal effect. Nevertheless, the tax authority may request a freezing order at any time, even before the tax amount has been legally determined, if the taxpayer is not domiciled in Switzerland or payment of the tax owed by him or her appears to be at risk. The freezing order is immediately enforceable and has the same effects in the debt collection proceedings as an enforceable court judgment.

Withholding Tax, Stamp Duty, VAT

In contrast to the cantonal tax administrations, the FTA can also raise transfer pricing issues in connection with withholding tax, stamp duty and VAT. As at the cantonal level, the taxpayer can object against a negative decision of the FTA before appealing to the court.

As such a decision affects taxes being levied at federal level, the appeal has to be lodged with the Swiss Federal Administrative Court within 30 days. This court's decision can then be appealed with the FSC.

The disputed tax needs to be paid irrespective of the fact of appealing a decision or moving the case forward into court. If the appeal/objec-

tion is successful, the tax already paid will be paid back. However, in ruling 5A_41/2018, the Supreme Court clarified that the tax administration is nevertheless not entitled to enforce the disputed tax amount as long as the controversy has not been decided with legal effect. Nevertheless, the tax authority may request a freezing order at any time, even before the tax amount has been legally determined, if the taxpayer is not domiciled in Switzerland or payment of the tax owed by him or her appears to be at risk. The freezing order is immediately enforceable and has the same effects in the debt collection proceedings as an enforceable court judgment.

14. JUDICIAL PRECEDENT

14.1 Judicial Precedent on Transfer Pricing

Due to Switzerland's practice of issuing transfer pricing rulings and its APA programme, disputes on core transfer pricing issues that have to be settled by courts are relatively rare. Nevertheless, the Supreme Court has issued some important decisions that also raise some key issues in the field of transfer pricing. It is already evident that transfer pricing will play an important role in case law in the future.

Important cases have been decided in connection with IP transactions, group financing (in particular, cash pools), contract manufacturers and asset management services. In some cases, the rulings deal with transactions involving companies resident in low-tax jurisdictions. In addition, there are various administrative assistance cases arising from transfer pricing audits abroad.

14.2 Significant Court Rulings

Due to the significant number of rulings in the area of transfer pricing, a selection of the most important transfer pricing cases decided by the FSC in the past four years is presented below.

FSC Decision 2C_11/2018 of 10 December 2018

This decision marks a tipping point concerning the case law of the FSC. The subject of the case was a penalty that was imposed for unlawful tax evasion due to blatantly disregarding the principle of dealing at arm's length. Second, it has to be pointed out that this decision concerns payments to the Netherlands, whereas other cases usually concerned offshore tax havens.

The case at hand dealt with a Swiss company that is involved in the manufacturing and distribution of pharmaceutical and chemical products. The Swiss company was held by a Dutch parent that held another company in France. The R&D activities were delegated by the Dutch parent to its French subsidiary and compensated with cost plus 15%. In turn, the Swiss company had to pay a royalty to its Dutch parent of 2.5% of its turnover for using the R&D results.

The FSC ruled that the Dutch parent was a mere shell company as it had no substance (in 2006 and 2007, no employees were employed, and in 2010 and 2011, an average of only three employees were employed). Hence, the royalty agreement was disregarded. Instead, the R&D agreement between the Dutch parent and the French subsidiary was regarded as being directly concluded between the Swiss and French companies. The tax adjustment therefore amounted to the royalty payments minus the cost plus 15% remuneration, which equalled a yearly average adjustment of approximately CHF350,000. Whether the latter was in line with the OECD's TPG was not assessed by the FSC.

With regard to the imposed penalty, the Court ruled that it must have been recognisable to the persons in charge and that a royalty to the shell company that was not entitled to the fruits of the R&D activities could obviously not be considered as a commercially justified expense. Hence,

an unlawful tax evasion was confirmed and 75% of the evaded tax was imposed as a penalty.

FSC Decision 2C_343/2019 of 27 September 2019

This decision concerns a Swiss company that offered administration and other services concerning trusts. For this purpose, it held, inter alia, an international business company in the Seychelles that handled the daily business of the administered trusts. The remuneration of the Seychelles company was defined in a service agreement. In the relevant years (2008–12), the Swiss company mainly reported losses. The tax administration argued that the remuneration for the Seychelles company was not at arm's length and determined the remuneration using the cost plus (5%) method.

According to long-standing case law, the tax administration has to prove that the company rendered a service for which it was not, or not adequately, reimbursed. The taxpayer then has to prove that the remuneration was, in fact, at arm's length. The burden of proof is thus reversed.

In case at hand, the plaintiff was not able to provide proof regarding the payments to its subsidiary being conducted at arm's length. The plaintiff has limited itself to submitting price lists of competitors. However, it was not clear from these lists that the transactions in question were actually free-market transactions to which the intragroup transactions were comparable. Thus, due to the lack of adequate information, the CUP method could not be applied. In turn, the FSC confirmed the ruling of the lower instances that the Seychelles company only executed routine functions and did not assume any risk. The cost plus 5% remuneration was, hence, confirmed. However, in the years 2008 to 2010, only immaterial adjustments were made and consumed by the tax losses carried forward. In 2011 and 2012, adjustments were made in the amounts of approximately CHF125,000.

This case demonstrates that in the absence of transfer pricing analysis documenting the correct delineation and pricing of the intra-group transaction (as outlined in the OECD's TPG), the taxpayer is not in a strong position when facing the tax authorities.

FSC Decision 2C_1073/2018 of 20 December 2019

Contrary to the above-mentioned cases, this case dealt with an insufficient remuneration of the Swiss company, a bank. Said bank had a subsidiary in Guernsey that administered a number of umbrella funds and received a management fee of 1.5% of the net value of the assets under management and a performance fee of 10–20% of the funds' performance. Even though the Guernsey company was contractually obliged to administer the funds, these activities were delegated to third parties and to the Swiss parent. Whereas the third parties as well as the Swiss parent received an equal management fee (0.75%), only third parties were also entitled to a performance fee. The Swiss parent company did not receive any retrocessions relating to the performance fees.

The tax administration claimed that 70% of the performance fees and a remuneration for other activities (eg, marketing and distribution) should have been awarded to the Swiss parent. In addition, the tax administration imposed a fine of 75% of the unlawfully evaded tax concerning the already definitive tax assessments (2001–07) and 50% concerning the open ones (2008–10). Unfortunately, the effective amounts were redacted by the competent courts.

The FSC confirmed the decision of the last cantonal court in the present matter and took into consideration that the Guernsey company

received management and performance fees concerning the funds, the management of which it has delegated to third parties and its parent. Hence, it could have been assumed that the contractual conditions concerning the third-party services were, in fact, at arm's length, which, according to the FSC, should also have been applied in relation to the Swiss parent company.

15. FOREIGN PAYMENT RESTRICTIONS

15.1 Restrictions on Outbound Payments Relating to Uncontrolled Transactions

With regard to uncontrolled outbound transactions, Switzerland does not have any specific rules or even restrictions.

15.2 Restrictions on Outbound Payments Relating to Controlled Transactions

With regard to controlled outbound transactions, Switzerland does not have any specific rules or even restrictions.

However, as for all transactions, the payments have to be commercially justified in order to be effectively deductible for corporate income tax purposes. Furthermore, according to the FSC, a "particularly qualified" duty to co-operate with the tax authorities in the case of cross-border legal relationships has to be taken into account. This increased duty especially applies to outbound payments to a non-DTA foreign country or to a DTA foreign country to the extent that the DTA does not yet meet the current OECD standard on information exchange. The reasoning is that the circumstances of the foreign recipient are beyond the control of the domestic tax authorities.

15.3 Effects of Other Countries' Legal Restrictions

Switzerland does not have specific rules with regard to the effects of other countries' legal restrictions. In the event that a foreign entity is affected by an adjustment of a payment to a Swiss entity due to such restrictions, a double taxation is most likely to incur.

However, depending on the reasons for the adjustments and the status of the assessments, Swiss tax authorities may prevent a double taxation with unilateral measures. If the tax year concerned is already finally assessed, though, the conduct of a MAP would probably have to be requested.

16. TRANSPARENCY AND CONFIDENTIALITY

16.1 Publication of Information on APAs or Transfer Pricing Audit Outcomes

In Switzerland, taxpayer information is kept strictly confidential, apart from cases of administrative assistance with contracting states.

Thus, results from APAs and transfer pricing audits are not published. Data regarding APAs is, however, collected for statistical purposes, with these statistics limited to the number of requested APAs, current APA proceedings and closed APA proceedings.

16.2 Use of "Secret Comparables"

In principle, Switzerland adheres to the OECD's TPG and also follows the principle according to which the tax administration is prohibited to base transfer pricing adjustments on secret comparables.

However, there is not sufficient publicly available information with respect to transactions between unrelated parties in Switzerland, nor is

there a public registry where the financial data of Swiss companies can be consulted. The lack of sufficient publicly available data might, for tax administrations, trigger the need for the use of secret comparables, at least for audit purposes. However, in practice, the tax administrations generally accept the use of pan-European data and, thus, the problem of limited data can effectively be mitigated.

Although pan-European data that generally provides a sound base for benchmarking analysis can be used, it can be observed in practice that tax administrations nevertheless try to stick to secret comparables. If this occurs, the tax administration needs to disclose the comparables to the taxpayer.

17. COVID-19

17.1 Impact of COVID-19 on Transfer Pricing

The authors expect that COVID-19 will have a notable effect on transfer pricing in Switzerland, certainly where principal or trading structures with the main risk-taking entity in Switzerland are faced with a substantial fall in their taxable profits in Switzerland. It is expected that the tax administrations will monitor transfer prices very closely, since the COVID-19 measures heavily rely on the state's finances, as, probably, in all countries around the world.

The safe haven interest rates and thin capitalisation rules have not been adapted in spite of the extraordinary financial effects of the COVID-19 crisis.

17.2 Government Response

Regarding the Swiss economy, a large-scale financing programme has been rolled out in order to support the liquidity needs of companies short of funds. As regards taxpayers, the response regarding the implications of the COVID-19 pandemic focused on securing the taxpayers' liquidity as far as possible.

Financing Programme

In record time, the Swiss government and the Swiss banks have rolled out an emergency programme to provide bridge loans to companies against the risk of illiquidity due to the COVID-19 measures. Affected companies can apply to their banks for bridging credit facilities representing a maximum of 10% of their annual turnover and no more than CHF20 million. In essence, the applicants fill out a one-page form with readily available information and identification.

The applicants must meet certain minimum criteria. In particular, the company must declare that it is suffering substantial reductions in turnover because of the COVID-19 pandemic. For credit up to CHF500,000, 0% interest is charged. The interest rate on credit exceeding CHF500,000 is 0.5% per annum on the loan secured by the Confederation.

Taxpayers' Payment Obligations

Temporary waivers concerning federal and, in most cases, cantonal taxes were granted and payment deadlines were extended. Furthermore, with regard to VAT credits, quicker refunds were made. These measures correspond with the measures recommended by the OECD but were only in effect until 31 December 2020. Furthermore, and also in line with the OECD's recommendations, the deadlines for the filing of tax returns were temporarily extended.

COVID-19 Provision

Four cantons allowed for the booking of a COVID-19 provision regarding the fiscal year 2019. However, the FTA made it clear that these provisions will not be accepted regarding the federal corporate income tax. The reasoning of the FTA is that in Europe in general and in Switzerland in

particular, the extent of the COVID-19 pandemic only became apparent in early 2020 and, thus, after the balance sheet date concerning 2019.

17.3 Progress of Audits

Though the tax administrations were at times urged to reduce the physical presence of personnel in their offices and partially work from home, audits have not stalled but notably slowed down. Such audits have been performed electronically (desk reviews).

As practice has shown thus far, tax audits have not been conducted in a harsher fashion than before the COVID-19 pandemic. On the contrary, tax administrations have demonstrated a higher willingness to reach amicable solutions at times.

Tax Partner AG is focused on Swiss and international tax law and is recognised as a leading independent tax boutique. With currently 15 partners and counsels and a total of approximately 50 tax experts consisting of attorneys, legal experts and economists, the firm advises multinational and national corporate clients as well as individuals in all tax areas. A central focus lies on tax controversy and dispute resolution, including transfer pricing issues. Tax Partner AG also provides support regarding transfer pricing studies and the preparation of transfer pricing documentation. Other key areas include M&A, restructuring, real estate transactions, financial products, VAT and customs. Tax Partner AG is independent and collaborates with various leading tax law firms globally. In 2005 the firm was a co-founder of Taxand, the world's largest independent organisation of highly qualified tax experts.

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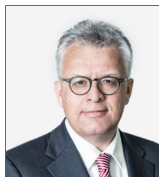

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Trends and Developments

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Introduction

One of the central motivations behind the OECD's work on the base erosion and profit shifting (BEPS) project is the desire to align a multinational company's (MNC's) profit with value-creating activities. The project brought about significant changes to the OECD Transfer Pricing Guidelines (OECD TPG). Its transfer pricing analysis framework explicitly recognises that the role of the significant people functions, the critical business decisions they are making and the operational risks they are controlling are leading when deciding how transactional results should be allocated over entities/jurisdictions.

Updates of the OECD TPG have been ongoing since 2017, covering, amongst others, specific guidance on transactions involving intangibles (introducing the concept of DEMPE, or development, enhancement, maintenance, protection and exploitation), business restructurings and financial transactions. Most recently, guidance on the impact of COVID-19 was issued.

In addition, there is significantly expanded co-operation in the field of tax law. The exchange of information has been considerably expanded with the BEPS project. Not only country-by-country reporting, but also the spontaneous exchange of information, EU Council Directive 2018/822 of 25 May 2018 amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation in relation to reportable cross-border arrangements (also known under the acronym DAC 6) and, last but not least, the exchange of information upon request need to be mentioned in this regard. Together with simultaneous, bilateral and multilateral joint audits, the states have new information channels in their hands, which have not only led to increased audit activity in the area of transfer pricing, but also to the definition of transfer pricing audit priorities.

All these developments have a substantial impact on how intercompany transactions are analysed by MNCs as well as tax authorities. MNCs based in Switzerland are affected differently by these developments.

The liberal economic system, in particular the liberal labour law, good infrastructure, the first-class education system as well as the comparatively moderate corporate tax burden are reasons why Switzerland is a popular location for group headquarters and entrepreneurial activities that yield high residual profits, despite internationally rather high labour costs. Given this situation, it is not surprising that foreign tax authorities are particularly interested in intra-group transactions with Swiss companies. But the Swiss tax authorities are also increasingly auditing transfer prices. The experience of recent years and case law show that the Swiss tax authorities make increasing use of the OECD TPG as updated in 2017 to review intra-group transactions. Intra-group transactions with companies that are domiciled in tax havens or in countries with attractive tax regimes are particularly scrutinised.

Current transfer pricing issues also arise in connection with financial transactions and transfer pricing adjustments that were made due to the COVID-19 pandemic.

The increased relevance of transfer pricing issues in Switzerland has finally led to new legislative developments in the field of dispute resolution.

Impact of the 2017 Update of the OECD TPG on Swiss Practice

The allocation of returns between related parties was previously often based on the premise that risks and, hence, high-return rewards could be contractually allocated to a party in a (low-tax) jurisdiction even though that party had no significant people functions located in that jurisdiction. The 2017 update of the OECD TPG, following Actions 8–10 of the BEPS project, now stipulates that MNCs will have to identify all economically significant risks per transaction and to determine which party of each transaction controls the risks (ie, which party makes the decisions to take on, lay off and mitigate such risks) when defining the transfer pricing methodology. The contractual arrangement is still the starting point of a transfer pricing analysis, but when not aligned with actual allocation of the functional control of risks, the latter will lead in deciding on the transfer pricing outcome.

The 2017 update of the OECD TPG also introduced the DEMPE analysis as a new way of dealing with transactions involving intangibles. The DEMPE analysis, also stemming from the same effort of creating a clear link between economic substance and profit recognised in a jurisdiction, required responses to the questions regarding who within the MNC undertakes and, more importantly, who controls the DEMPE functions of the intangibles under review, and who bears the relative risks and owns the associated assets. The MNC should not only consider what meaning and relative importance can be attributed to the DEMPE functions in its particular industry and company structure but also needs to establish the location of the functions and their relative significance. After having delineated the intangible related transaction, the pricing of these transactions needs to be determined.

Additionally, the OECD TPG updated the sections on business restructurings. The actual transactions, including the accurate delineation of the transactions comprising the business restructuring and the functions, assets and risks before and after the restructuring will need to be determined. If something of value is transferred from one group entity to another in that business restructuring transaction, the pricing needs to be established in line with the arm's-length principle; more specifically, a transfer of something of value will require an assessment under transfer pricing business restructuring provisions and the "options realistically available" to the transferor will need to be considered.

The above-mentioned 2017 updates to the 2010 OECD TPG were generally considered a mere clarification of existing principles rather than a revision of the guidelines and therefore had immediate impact. The authors observed soon after that, in structures involving Swiss entities, the tax authorities started to require the taxpayers in tax audits, litigation, advance pricing agreements (APAs) and mutual agreement procedures (MAPs) to substantiate their position using analytical frameworks as they were explained above and laid down in the 2017 OECD TPG. One important consequence of the BEPS project in general and the 2017 update in particular was that over the past few years, taxpayers have, as part of their transfer pricing risk management and under pressure from the tax authorities, unwound structures lacking the necessary substance and/or adjusted the transfer pricing approaches.

Controlled Transactions with Low-Taxed Companies

The increased awareness of transfer pricing issues is also reflected in the way the Swiss

tax authorities deal with controlled transactions between Swiss companies and low-taxed foreign companies. Whereas in the past the tax authorities examined offshore companies primarily from the perspective of the place of effective management or general anti-avoidance rules, today the focus is more on transfer prices. This is evidenced by a look at recent Federal Supreme Court rulings in which transfer prices in the financial services industry were put to the test.

In its ruling of 27 September 2019 (2C_343/2019), the Supreme Court had to deal with a Geneva-based company, A SA, that belonged to an internationally active private bank and provided activities related to the management and administration of trusts and companies, as well as related advice and services. A SA held 99% of the shares in A Ltd, a company domiciled in the Seychelles. Under a service agreement with A SA, A Ltd was responsible for the registration and management of companies, the representation of companies before local authorities in the Seychelles and co-ordination services. A SA wanted to support the transfer prices it paid by the application of a comparable uncontrolled price (CUP) method. For this purpose, it submitted excerpts from websites showing the prices charged by competitors.

The tax administration of the Canton of Geneva considered the Seychelles company to be rendering routine functions. Applying the cost plus method, A Ltd was allowed a compensation of 5% of the expenses. A Ltd's profit, reduced by this compensation, was therefore allocated to A SA. In addition, a fine was imposed on A SA, which amounted to three quarters of the unlawfully avoided taxes. The Federal Supreme Court confirmed the decision of the tax administration. In its ruling, it highlighted several important points to be considered in the administrative and judicial review of transfer pricing.

According to the Federal Supreme Court, the OECD TPG are also applicable to transactions with offshore companies that are not resident in a double taxation agreement country. The version applicable should be the one that was current at the time of the taxation periods. Pursuant to the Federal Supreme Court, this was the version published in 2010, although the audit conducted by the administration also concerned the tax periods 2008 to 2009.

The Federal Supreme Court reiterated that the tax authority has to prove that the remuneration paid by A SA was not proportionate to the services provided by A Ltd. However, if the tax authority provides sufficient evidence that such a mismatch exists, it is then up to the taxpayer to prove the validity of its own standpoint.

The Federal Supreme Court concluded that – taking into account the functional and risk analysis, which showed that the subsidiary only provided services with little added value and that the risks in relation to the clients were borne by A SA, and the fact that A SA nevertheless repeatedly incurred losses – the lower court was entitled to reverse the burden of proof. The comparable prices presented by A SA were not sufficient to prove to the court their alignment with the CUP method. According to the Federal Supreme Court, A SA would have had to prove on the basis of a comparability analysis – in which, according to the OECD, five comparability factors have to be taken into account – that the transactions used were, in fact, uncontrolled transactions to which the intra-group transactions were comparable.

The case reveals two important findings that are also relevant for other transfer pricing audits in Switzerland: the functional analysis, together with the comparison of the profit margins achieved by the companies involved in the transaction can be used by the tax authorities as

an indication that the agreed transfer prices do not stand up to the arm's-length comparison. If the company examined by the transfer pricing audit now wants to prove that the transfer prices are nevertheless at arm's length, it must use a properly documented comparability analysis to show that the transactions used in the benchmark analysis are actually comparable, otherwise they will not be accepted as evidence by the tax authorities.

In another ruling, issued on 20 December 2019 (2C_1073/2018, 2C_1089/2018), the Federal Supreme Court had to decide on the arm's-length conformity of asset management services provided by the Geneva-based asset management company A SA to C Ltd, a Guernsey-based subsidiary. The latter acted as manager of various investment funds and was responsible, inter alia, for determining the investment strategies, distributing the fund interests or managing the fund assets on behalf of the investors. For its activities, C Ltd received a fixed fee based on the net asset value of the assets under management and a performance fee. The management activities, however, were partially delegated to third parties and to A SA itself.

In the course of a transfer pricing audit concerning A SA, the following issues arose. First, should A SA have received 70% of the performance fees received by A Ltd for its advisory activities, as was the case with certain third parties to which C Ltd delegated its services? Secondly, should A SA also have received an order placement fee for all funds for which it provided investment advice? Thirdly, should A SA have received remuneration for its sales and marketing activities over the entire period covered by the proceedings and how should this have been determined?

With regard to the issue of the performance fees paid to A SA, the Federal Supreme Court could refer to internal comparables. These transactions with unrelated parties to which C Ltd delegated investment advisory activities demonstrated that these parties received a performance fee of 40 to 70% of the performance fee C Ltd itself received from its clients. Thus, the tax administration was entitled to assume that a deemed dividend existed. The question was now whether the tax authority had the right to base the adjustment on the highest value; ie, 70%. The Federal Supreme Court supported the tax authority's view based on a comparability analysis. The court found that A SA's activities were more extensive than those of the third parties.

Concerning the compensation for the order placement activities, it was disputed whether a remuneration of 0.09% of the net assets under management was due for A SA's advisory activities, especially in connection with funds of funds. The contract between C Ltd and A SA only provided a fee for order placing regarding the management of simple funds. The lower courts disregarded this contractual provision without relying on a comparability analysis or at least providing a coherent explanation. The Federal Supreme Court, however, concluded that the lower courts had not established why A SA – contrary to the contractual agreement – should have received remuneration for order placement activities concerning funds of funds.

With respect to the sales and marketing activities of A SA, the tax audit revealed that A SA was heavily involved in the sales and marketing activities of C Ltd in various respects. In order to measure the compensation for the sales and marketing activities, the tax authority relied on a list of 40 external comparables from 2013 and 2014, although the tax periods examined were 2003 to 2010. Based on the figures in this table, compensation ranged from 26.9% (lower quartile) to 58.92% (upper quartile with a median of 54.96%) of the management fee. To be conserv-

ative and to account for market volatility, the tax authority set the transfer price for sales and marketing activities at 40% of the management fee.

It is now of importance for practice that the Federal Supreme Court did not conclude that the administration acted unlawfully solely due to the fact that the tax authority took comparative values from 2013 and 2014. A SA should have specifically explained why the figures from 2013 and 2014 led to a disproportionate compensation of A SA. However, it failed to do so.

Like in the first case, the Federal Supreme Court affirmed the presence of criminal tax evasion. The Federal Supreme Court confirmed that a tax evasion is generally to be assumed if the reported earnings are the result of a violation of the accounting regulations. Further, the Federal Supreme Court also held that the violation of the arm's-length principle may constitute a tax evasion even if no violation of the accounting regulations occurred. This was the case because A SA was not sufficiently remunerated, which, according to the court, had to be evident to the responsible managers.

The two Federal Court rulings presented are not isolated cases. The practice of recent years shows that the Swiss tax authorities have obviously targeted controlled transactions between Swiss companies and foreign low-taxed companies.

When analysing these cases, it becomes apparent that the Swiss tax authorities and courts are continuously expanding their know-how in the area of transfer pricing. The tax authorities are also not reluctant to conduct criminal tax investigations, especially in connection with offshore companies. In the case of transactions between Swiss companies and those domiciled in low-tax countries, it is therefore also important in Switzerland to clearly regulate transfer prices in contracts and to back them up with OECD-conforming transfer pricing analyses. Due to recent rulings by the Swiss Federal Supreme Court, the Swiss tax authorities are particularly careful to check whether the contractually agreed rights and obligations are actually exercised. If not, there is a risk that the tax authorities will ignore the contracts and challenge the applied transfer pricing approach.

Financial Transactions

Recognising that financial transactions are complex transactions, the OECD published its Transfer Pricing Guidance on Financial Transactions (TPG FT) on 11 February 2020, which is now part of the OECD TPG. The OECD report covered the transfer pricing aspects of various intercompany finance transactions, such as loans, financial guarantees, cash pooling, hedging and captive insurance companies. The OECD now provides detailed guidance supporting taxpayers as well as tax authorities in analysing shareholder loans and in determining arm's-length interest rates. The TPG FT confirms that in the process of determining an arm's-length interest rate, the characteristics of loan instruments – such as credit risks, the term of the loan or the level of seniority – are relevant factors to be considered and the TPG FT provides a detailed analytical framework to accurately delineate and price intercompany loan transactions.

In this context, it is interesting to review the status of the circular letters containing the Swiss inbound and outbound safe harbour interest rates (one for loans denominated in Swiss francs and one for loans denominated in foreign currencies), which the Swiss Federal Tax Administration publishes by circular every year.

These circular letters play an important role in determining interest rates on intra-group loans, reducing the administrative burden of taxpayers resulting from preparing and maintaining transfer

pricing documentation for their intra-group loans. However, the circular letters do not differentiate the interest rate applied based on the characteristics of loan instruments. Therefore, relying on the safe harbour interest rates in cross-border intra-group loan transactions will likely lead to challenges by the other country's tax authorities, claiming that the Swiss safe harbour rates do not correspond with the arm's-length standard. Furthermore, within the setting of the EU, relying on the Swiss safe harbour interest rates may lead to additional DAC 6 reporting requirements.

First Experiences with the COVID-19 Pandemic Guidance

On 18 December 2020, the OECD published the OECD's Guidance on the transfer pricing implications of the COVID-19 pandemic (the "Guidance"). The Guidance focuses on the following four priority issues:

- comparability analysis;
- allocation of losses;
- the allocation of COVID-19-specific costs and government assistance programmes; and
- APAs.

The Guidance was not intended to replace or amend what is already included in the OECD TPG, but rather to illustrate the application of the arm's-length principle in the context of the COVID-19 pandemic.

MNCs with centralised business models have used Switzerland historically as their home for an "entrepreneurial entity" or "risk-bearing entity" that has both the management and the financial capacity to bear risk and should receive the residual profit or bear the residual losses related to the relevant intra-group transactions. These entities conduct transactions with entities that are performing "routine" functions, they are characterised as "limited risk entities" (exposed to less risks) and therefore they earn a more stable return.

The MNCs would typically aim to set the intercompany pricing of the routine entity through the transactional net margin method (TNMM). In applying the TNMM, the net profit of the routine or limited risk entity is expressed as a reasonable profit margin over costs, sales or assets employed. Benchmarking studies are performed using public databases to identify the profit margins of independent companies with a comparable functionality of similar companies based on certain quantitative and qualitative search criteria. A statistical interquartile range (IQR) is applied to the financial results of comparable companies to obtain the arm's-length range of profit margins.

One of the most critical questions on the table of MNCs with Swiss entrepreneurial entities during the COVID-19 pandemic has been: "Can entities operating under limited risk arrangements incur losses?" The prompt input from the OECD on this issue has been highly appreciated from the business community.

At the heart of the OECD response, the concepts of "control over risks" (CoR) coupled with the concept of "options realistically available" (ORA) can be found. The Guidance has made clear that reacting correctly to this issue – ie, deciding whether or not to share losses with the limited risk entity – requires an analytical review following the CoR and ORA concepts, whereby consistency with long-term transfer pricing policies cannot be overlooked.

In the Swiss practice, the authors have experienced that cantonal tax authorities are willing to discuss specific cases; for example, where the Swiss entrepreneurial entity was incurring (substantial) losses as a result of COVID-19. They accepted that position, but required the taxpayer

to explain its business case and – in reference to the Guidance – provide the reasoning why it was in line with the arm's-length principle that the Swiss entrepreneurial entity had been allocated a substantial part of these losses.

Outlook

The trend is clear: transfer pricing issues will keep on gaining importance in Switzerland in the coming years. In order to counteract the threat of double taxation, it is important that dispute resolution mechanisms are strengthened. Switzerland has taken important steps in this regard. In its international tax policy, it advocates the inclusion of arbitration clauses.

After Switzerland had already concluded a consultation agreement with Germany on the implementation of arbitration proceedings in 2016, further agreements with Norway, the United States and Australia were added in 2019 and 2020. These agreements lay down the relevant procedural provisions for the conduct of arbitration proceedings. They are based on the so-called final arbitration method. Under this method, the competent authority of each contracting state must submit a proposal for a decision to the arbitration panel. In the course of its decision-making process, the arbitration panel has to decide in favour of one of the two submitted proposals.

The procedure is efficient in the sense that competent authorities will likely take reasonable positions when establishing their final offer, knowing that a less reasonable offer implies a higher risk of being denied during arbitration. This leads to a convergence of positions and provides an ideal incentive to the competent tax authorities to reach a mutual agreement, even before the arbitration procedure is initiated.

In addition to that, the Swiss legislator is committed to strengthen the rights and obligations of the taxpayer with respect to MAPs. Surprisingly, there is currently no legal basis in this respect. This is about to change: Parliament is discussing the Federal Law on the Implementation of International Agreements, which will regulate the application and the conduct of MAPs as well as the implementation of mutual agreement resolution into domestic law. The law is also to apply mutatis mutandis to APAs.

According to the current state of discussions, the right to be heard in the MAP is to be guaranteed as far as possible. Switzerland thus goes much further than other states: in particular, the persons requesting a MAP or an APA should also be able to comment on so-called position papers drafted by the "competent authorities".

Although Switzerland rejects joint audits, the draft provides that the State Secretariat for Financial Matters may, with the consent of the person making the request, conduct an inspection together with the competent authority if this serves to establish the facts of the case.

Finally, the proposal explicitly stipulates that compensation payments within the scope of "secondary adjustments", which Swiss companies have to pay to foreign group companies as a consequence of foreign profit adjustments, should not be subject to federal withholding tax, provided that such compensation payments are made as a consequence of a mutual agreement or a domestic resolution. Under current practice, the imposition of withholding tax was waived only if a mutual agreement was reached. If the bill becomes law in its current form – which is to be expected – Switzerland will have robust internal regulations for international dispute resolution and dispute prevention, which will further strengthen its position as a business location.

Tax Partner AG is focused on Swiss and international tax law and is recognised as a leading independent tax boutique. With currently 15 partners and counsels and a total of approximately 50 tax experts consisting of attorneys, legal experts and economists, the firm advises multinational and national corporate clients as well as individuals in all tax areas. A central focus lies on tax controversy and dispute resolution, including transfer pricing issues. Tax Partner AG also provides support regarding transfer pricing studies and the preparation of transfer pricing documentation. Other key areas include M&A, restructuring, real estate transactions, financial products, VAT and customs. Tax Partner AG is independent and collaborates with various leading tax law firms globally. In 2005 the firm was a co-founder of Taxand, the world's largest independent organisation of highly qualified tax experts.

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