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Tax Controversy

Switzerland: Trends & Developments

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Trends and Developments

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Introduction

As a location of numerous multinational companies and a leading financial centre, Switzerland is particularly affected by international developments at the level of the OECD and the Inclusive Framework on BEPS.

On the one hand, the Swiss companies of multinational enterprises (MNEs) are exposed comparatively often to foreign unilateral, bilateral or multilateral tax audits. In order to strengthen legal certainty, Swiss taxpayers therefore have a particular interest in concluding advance pricing agreements (APAs) or conducting mutual agreement procedures (MAPs). The Tax Treaty Implementation Bill, which is currently being discussed in the Federal Parliament and is expected to be passed this year, contains important new procedural provisions for the initiation, implementation and enforcement of MAPs, which are likely to be applied analogously to APAs. The following article therefore takes a look at these new procedural provisions, which are expected to enter into force on 1 January 2022.

On the other hand, the Swiss tax authorities are also under pressure to take measures to protect the Swiss tax base. In this context, the focus is particularly on combating treaty abuse and profit shifting with the use of low -tax companies. Important developments have also occurred in this regard, which are explained below.

Bill on the Implementation of International Tax Agreements

Given the importance of APAs and MAPs for MNEs conducting business activities in Switzerland, it is surprising that important domestic procedural issues are still not statutorily regulated in Switzerland. The Bill on the Implementation of International Tax Agreements aims to remedy this situation and thus also increase legal certainty. It will regulate the application and the conduct of MAPs as well as the implementation of mutual agreements into domestic law. The law is also to apply, mutatis mutandis, to APAs.

The MAP is, essentially, a procedure between the competent authorities of two or more states. Formally speaking, the taxpayers affected by the MAP are not parties to the proceedings. Accordingly, they have no procedural rights, which is criticised in the international discussion around them. This also applies to MAPs in which Switzerland is involved due to the framework of the treaty law. As a consequence, the taxpayers have no right to inspect the files of the proceedings. According to the current state of discussions, however, the taxpayers concerned should be granted the right to be heard as far as possible. In concrete terms, this means that the State Secretariat for International Financial Matters (SIF), ie, the Swiss authority responsible for conducting the mutual agreement procedure, must provide the taxpayer applying for a MAP with information on the status of the procedure. However, the right to be heard also gives the applicant the opportunity to comment on the position papers of the states involved in the procedure. In this way, the applicant can indirectly influence the technical argumentation of the SIF. In principle, Switzerland does not participate in joint audits. In the context of a MAP or an APA, SIF is, however, authorised, with the consent of the person making the request, to conduct an inspection together with the competent authority of the other state if this serves to establish the facts.

The implementation of mutual agreements sometimes leads to difficulties in practice. Various states require the payment of compensation in the framework of a secondary adjustment when a profit adjustment is made (primary adjustment). According to the practice of the Federal Supreme Court, such a payment is generally regarded as a constructive dividend on which a withholding tax of 35% must be paid according to the domestic withholding tax law if it is made to a foreign parent or sister company. However, the practice has now been relaxed for those cases in which the refund was made on the basis of a mutual agreement. However, there are situations, in practice, where no mutual agreement is reached and, as a consequence, the 35% withholding tax becomes due if a compensatory payment needs to be paid. This is the case when the competent authorities cannot agree on a mutual agreement. There are also situations in which a foreign tax audit is concluded by a unilateral mutual agreement, in which the taxpayer undertakes to forego a subsequent mutual agreement procedure.

The planned Tax Convention Implementation Act now brings some relief: already, under current practice, double taxation that has arisen due to a primary adjustment made abroad can be eliminated by a unilateral agreement concluded between SIF and the canton responsible for the assessment. The planned law now explicitly states that a compensation payment made on the basis of such a unilateral agreement is also exempt from withholding tax. However, a corresponding adjustment granted autonomously by the cantonal tax authority without involving the SIF will not protect the taxpayer from withholding tax in the future if the foreign state demands a compensation payment. The same applies with regard to subsequent taxes owed by a foreign company if these are charged to a Swiss subsidiary or sister company.

BEPS Action 14 (Minimum Standard) requires that MAPs be implemented independent of domestic limits. However, Switzerland has made a reservation in this regard. The Bill on the Implementation of International Tax Agreements will oblige the competent cantonal authority to implement a mutual agreement, provided that the request for implementation of the mutual agreement procedure is submitted within ten years of the issuance of the ruling or decision that relates to the matter of the implementation ruling. The legislature rejects the restrictive view of some cantonal tax authorities that the obligation to implement a mutual agreement expires ten years after the ruling or decision that caused the double taxation was issued.

Abusive Tax Treaty or Tax Rule Shopping

Swiss withholding tax also poses a risk in the case of a cross-border sale of shares in a company domiciled in Switzerland. Due to the different bilateral provisions in the double taxation treaties, the withholding tax burden might be lower in the buyer's country of residence than in the seller's country of residence. Under certain circumstances, it may therefore be possible to reduce the withholding tax burden by means of a cross-border sale of participations. The FTA has therefore developed various practices to prevent sales and restructurings motivated solely by the reduction of the residual withholding tax burden. As a consequence, the FTA regularly checks whether a transfer of shares could result in the loss of Swiss withholding tax base. Due to this tax audit focus of the FTA, the sale of a Swiss company by means of a share deal must always be examined with regard to its retained earnings which are subject to deferred withholding taxes. This examination is an important component of every tax due diligence.

Probably the most prominent doctrine in this regard is the so-called "old reserves practice" applied by the FTA. This aims to deny the appli-

cation of the lower withholding tax rate of the country where the buyer is resident on a dividend distribution subsequent to the acquisition of a company. The sale of an equity interest can take place either between related group companies or independent third parties. It is irrelevant whether the target company is sold to a Swiss or a foreign company. The only decisive criterion according to the FTA is the improvement of the buyer's refund position under the applicable tax treaty or the domestix withholding tax code as a result of the sale.

International transposition and proxy liquidation

Doctrines related to the old reserves practice are, amongst others, the so-called "international transposition" and the "proxy liquidation", as they also counter the abusive refund of withholding tax in international corporate acquisitions.

International transposition involves an intra-group sale (excluding sales to independent third parties) to a Swiss buyer, whereby the purchase price is left standing by means of a loan to the previous participation holder and is amortised over time, free of withholding tax, through loan interest payments. The interest on the loan is financed from the dividend distributions of the target company.

In the case of a proxy liquidation, the refund of withholding tax is denied if the economic objective of the transaction was not a share deal but an asset deal. The decisive factor here is that the intention of the seller – to bring the company or its assets into a liquid form after the sale or to absorb the company in its entirety – was already clear at the time of the sale. The existence of a proxy liquidation can only be established by means of indications such as a prompt liquidation after the transaction and the absence of economic reasons for the share deal.

In practice, the withholding tax issues concerning the retained earnings of a Swiss target company quite often lead to controversies with the FTA and must be clarified in a ruling before the transaction is carried out for reasons of legal and planning certainty. As a result, cases are very rarely the subject of court proceedings. An important point of discussion with the FTA is often whether the intended share deal leads to an abuse of treaty or tax avoidance. In this regard, there were two cases concerning the old reserve practice before Swiss court authorities last year.

Recent old reserve practice cases

The Federal Supreme Court decision of 20 April 2020, 2C_354/2018, deals with the Irish A Co, which is a group company of the world's largest manufacturer of coffee machines. In 2005, it acquired shares in the Swiss F Co from its Dutch sister company E Co. F Co distributed various dividends in the years 1999 to 2003, for which E Co requested a full refund of the withholding tax based on the Swiss-Dutch Double Tax Treaty. However, the FTA refused to refund 15% of the withholding tax. It took the view that the Swiss participation was acquired without any economically motivated reason from a company resident in the Netherlands Antilles that was not entitled to any treaty relief.

Two years after F Co was sold to A Co, the former distributed a dividend to A Co in the amount of CHF14 million. Based on Article 15 paragraph 1 of the Savings Tax Agreement (now Article 9 paragraph 1 of the Agreement on the Automatic Exchange of Information with the EU), A Co applied for a full refund of the withholding tax. This was refused by the FTA.

The Federal Supreme Court supported the FTA. In its analysis, it referred, on the one hand, to the Denmark cases decided by the ECJ (C-116/16 and C-117/16) and, on the other hand, to the

current OECD commentary on the principal purpose test (PPT). According to this, there is abuse if obtaining a more favourable tax position was one of the main purposes of the transaction or arrangement concerned and granting the treaty benefit would run counter to the object and purpose of the relevant treaty provisions. The Supreme Court explained that it has already previously followed the treaty abuse standard as expressed in the PPT in its case law on the unwritten prohibition of abuse. Taking the Federal Supreme Court at its word, the PPT brings nothing new to Swiss practice. In particular, it applies regardless of whether it is contained in a double tax treaty. Thus, Switzerland has already de facto implemented the minimum standard according to BEPS Action 6 on treaty abuse, even though not all DTTs have been revised in this regard yet. The question now is which criteria are to be applied for the existence of treaty abuse to be manifest, and what legal consequences result from this.

The Federal Supreme Court ruled that the transfer of the shareholding in the Swiss company was not motivated by economic reasons. It found evidence of this in the fact that A Co employed neither staff nor had business facilities in Ireland. In addition, A Co had to borrow heavily from its parent company in order to acquire B Co, especially as it did not have any liquid assets. According to the Federal Supreme Court, it would have been simpler and would have led to the same economic result if B Co had distributed its retained earnings to its then parent company in the Netherlands before the transfer and A Co's sister company had thus received the retained earnings through dividends instead of through a purchase price payment.

Based on this consideration, the company was completely denied the refund of the withholding tax. According to previous practice, which is also covered by the case law of the Federal Supreme Court (ruling of 16 August 1996, 2A.11/1994), the old reserves practice is actually only aimed at denying the taxpayers the effective tax savings that they tried to obtain through the transaction. Based on the Federal Supreme Court ruling, this practice should still apply despite the latest court ruling. However, as a consequence of the new court ruling, the recipient of a dividend charged with withholding tax should base the refund claim on the relevant bilateral DTT rather than on the agreement on the automatic exchange of information between Switzerland and the EU.

The second case, A1795/2017 of 1 December 2020, is currently pending before the Federal Supreme Court and was first heard by the Federal Administrative Court, the second-last instance in Switzerland. The case concerned a Swiss operating company active in the fiduciary sector, which was sold by its parent company resident in a non-Swiss DTT state to a Swiss company. The sale took place between independent third parties on 31 December 2004. At the time of the sale, B Co had distributable retained earnings of CHF636,174.

When, five years later, B Co distributed a dividend of CHF820,300 to its parent company A Co in 2010, the FTA refused to refund the withholding tax to the extent of the old reserves (thus to the extent of CHF636,174) on the grounds that there was tax avoidance and that the distributable, nonoperating substance should have been distributed before the sale (thus an application of the old reserves practice).

The Federal Administrative Court did not back the FTA's argumentation and the appeal of A Co was upheld. The Federal Administrative Court could certainly recognise an economic interest in the purchase of B Co. Particularly as A Co had already acquired and developed operationally active companies in the fiduciary sector in the

past, it did not seem outlandish that the liquidity and retained earnings of B Co were of additional interest. Moreover, when acquiring B Co, A Co had undertaken to continue its business at least until the end of the year of acquisition and, due to profitable business activities, had even continued its operations until 2008. In addition, the time span of more than five years between purchase and distribution argued against the abusive nature of the transaction. Also, no unusual financing of the purchase price had taken place by the seller company.

The fact that tax avoidance was denied in this case shows that case law requires a differentiated practice regarding old reserves. Contrary to the opinion of the FTA, it is not sufficient for the existence of tax avoidance that the transferred company has distributable retained earnings. The ruling was appealed by the FTA at the Federal Supreme Court and the highest court ruling is still pending. The signal effect of a Federal Supreme Court ruling confirming the lower court's considerations would be very significant for taxpayers, especially since the tax authorities would therefore be instructed to examine the economic motives in M&A transactions more closely before concluding that there has been an abuse of rights.

Controlled Transactions with Low-Tax Companies

The Swiss tax authorities and courts have always critically examined transactions with low-tax 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. Various important findings have emerged from the Federal Court rulings handed down in the last two years.

According to the Federal Supreme Court in 2C_343/2019, the OECD Transfer Pricing Guidelines are also applicable to transactions with offshore companies that are not resident in a DTT country. The version applicable should be the one that was current at the time of the taxation periods in question. The Federal Supreme Court reiterated that the tax authority has to prove that the remuneration paid by the taxpayer was not proportionate to the services provided by the related group company. In addition, the Federal Supreme Court, emphasised the importance of the comparability analysis – in which, according to the OECD, five comparability factors have to be taken into account – to demonstrate that the transactions used for the benchmark analysis were, in fact, uncontrolled transactions to which the intra-group transactions were comparable. However, in its ruling of 20 December 2019 (2C_1073/2018, 2C_189/2018), the Federal Supreme Court did not conclude that the tax administration acted unlawfully due to the fact that it took comparables from 2013 and 2014 although the tax audit concerned the financial years 2003–2010. According to the justices, the taxpayer should have specifically explained why the figures from 2013 and 2014 led to a disproportionate level of compensation. However, it failed to do so. Recent cases also remind taxpayers that the violation of the arm's-length principle may constitute a tax evasion if it also entails a breach of the accounting principles.

The practice of recent years shows that the Swiss tax authorities have obviously targeted controlled transactions between Swiss companies and foreign low-tax companies. There are still other cases in the pipeline which may be brought before the courts. When analysing the recent case law, it becomes apparent that the Swiss tax authorities and courts are continuously expanding their knowledge in the area of transfer pricing. The tax authorities are also not reluctant to conduct criminal tax investiga-

tions. In the case of transactions between Swiss companies and those domiciled in low-tax countries, it is therefore important to clearly regulate the 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.

Outlook

Switzerland has made a major effort in recent years to bring its tax legislation in line with the minimum standards set by the OECD and the Inclusive Framework on BEPS. The regimes for holding companies, mixed companies and domiciliary companies as well as the special profit allocation rules for principal companies developed in practice were abolished as of 31 December 2019. Instead, the legal framework for a patent box and a super-deduction for research and development were introduced. With the tax reform, the statutory average profit tax rates have fallen from around 19.6% to around 14.5%. If a company makes full use of the new tax incentives for research and development, it can even reduce the effective tax burden to below 10%. In an international comparison, Switzerland thus remains an attractive location for multinational companies in terms of taxation. However, a fundamental paradigm shift has taken place. Whereas prior to the corporate tax reform, income from foreign business activities of companies that had little substance in Switzerland was taxed at a privileged rate, today, it is those companies that carry out research and development activities with high added value in Switzerland with their own staff that benefit from preferential tax regimes.

Those who believed that the implementation of the internationally recognised minimum standards would bring legal and planning certainty to Switzerland are now seeing themselves deceived. Until the launch of the two-pillar project, the mantra was that profits should be taxed where the value creation actually takes place. The OECD and the Inclusive Framework on BEPS now intend to fundamentally soften this principle for large multinational corporations in two respects:

- under Pillar 1, a share of the residual profit is to be allocated to the market states, regardless of where the value-creating activities take place; and
- Pillar 2 is intended to grant the states where the group parent companies are based the right to levy a top-up tax on profits generated in other states if these are not otherwise subject to an internationally prescribed minimum taxation.

In addition, the mobility of international employees, which has been increased by the possibility of “remote working”, is likely to arouse new desires and lead to new focal points in tax audits. If one considers the international developments outlined above and takes into account the huge government deficits caused by the COVID-19 pandemic, it can be stated without further ado that the international battle for tax base is about to enter the next round. Needless to say, these developments will also result in an increase in cross-border tax disputes.

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Tax Partner AG is one of the leading independent boutique tax law firms in Switzerland, with tax controversy and dispute resolution being one of its central focuses. Other key areas include M&A, restructuring, transfer pricing, real estate transactions, financial products, VAT and customs. With more than ten partners and counsels, and 40 professionals in total, the firm advises multinational enterprises and high net worth individuals. Tax Partner AG also represents – in complex audits and tax litigation before both tax authorities and the courts – large corporations from a wide range of sectors, including finance and insurance, energy, technology, media, and the hospitality and fashion industries. 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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