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Tax Controversy

Switzerland: Trends & Developments

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Trends and Developments

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Introduction

The Base Erosion and Profit Shifting (BEPS) project, which the OECD/G20 Inclusive Framework on BEPS is relentlessly pushing forward, has led to major upheavals in Swiss tax law.

In this context, the exchange of information with foreign tax authorities has been massively expanded in recent years. Switzerland now has a dense network of countries with which bank account information and country-by-country reports are automatically exchanged. In addition, there is the spontaneous exchange of information regarding tax rulings that relate to cross-border situations, as well as administrative assistance on request, which foreign tax authorities make frequent use of, particularly in the context of so-called group and bulk requests. Switzerland has thus implemented all the standards required by the OECD/G20 to increase transparency in tax matters.

In addition, further milestones in international tax policy have been reached in recent months: first of all, The Federal Act on Tax Reform and Pension Fund Financing and the associated enforcement ordinances came into force on 1 January 2020. This marked the successful conclusion of a legislative project that had lasted for more than a decade and Switzerland succeeding in implementing the minimum standard against harmful tax competition set by the OECD/G20 under Action Point 5, into national corporate tax law. As a result, the EU removed Switzerland from the list of non-co-operative states in the area of taxation on 17 October 2019. Secondly, on 1 December 2019, the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (MLI) entered into force in Switzerland. Last but not least, and following a more than ten year blockade by the US senate, the protocol amending the existing Double Taxation Agreement (DTA) between Switzerland and the USA came into force on 20 September 2019. As a result of these important legislative developments, various trends which multinational enterprises (MNE) and high net worth individuals (HNWI) must keep in mind, and as outlined below, will emerge over the coming years in the area of tax controversy.

Prevention of Treaty Abuse

Over the last few years, Switzerland's Federal Tax Administration (FTA) has won several disputes in connection with the improper use of double taxation agreements. The cases concerned financial derivative transactions for which foreign financial institutions acquired shares in listed Swiss companies in order to minimise or avoid the risks resulting from these agreements, "cum-ex" transactions, the asset management structures of HNWIs, and group structures with intermediate companies that did not have sufficient substance.

The subject of the lawsuits in each case was the refund of the Swiss withholding tax of 35%, which is levied on dividends from Swiss companies. According to the relevant double taxation agreements, the refund requires that the person receiving the dividend is the beneficial owner which means that they are actually entitled to use it. Within the framework of the refund procedure, the person who submits the refund application must provide the FTA with all the information necessary to verify their eligibility for the agreement.

In the respective cases, the complainants were not able to prove that they were the beneficial owners. There are still numerous proceedings concerning the application of the concept of beneficial ownership. These concern, in particular, private equity funds with Luxembourg intermediate companies and other foreign Collective Investment Funds. In view of the case law decided thus far, a successful assertion of the claim for reimbursement, will be contingent upon the complainant's ability to demonstrate, in a precise and comprehensible manner, what risks they have assumed regarding the financial transactions entered into, or what personnel resources they actually had for the management of these risks.

The issue of treaty abuse will become even more important in subsequent years because Switzerland has introduced the principal purpose test (PPT) as part of the conclusion of the MLI and the revision of many double taxation treaties. According to the PPT, a treaty advantage must be denied where obtaining it was one of the main reasons for the chosen arrangement or transaction. In such cases, the DTA can only be invoked if it can be shown that the granting of the contractual advantage is in accordance with the meaning and purpose of the corresponding provision of the double tax agreement.

It is currently difficult to assess, to what extent the PPT will further tighten the already strict practice of the FTA, with regard to the granting of agreement benefits. Indeed, it is true that the FTA has indicated on various occasions that the introduction of the PPT will not bring about any significant changes to current practice. However, it should be noted that the PPT is part of the BEPS minimum standard, the implementation of which will be subject to peer review by the Inclusive Framework. This could

increase the pressure on the FTA and other state authorities to apply the PPT more strictly, which could, in turn, trigger new tax proceedings. Hence, legal uncertainty remains with regard to tax treaty entitlement. As a consequence, companies are recommended to provide sufficient substance to their respective intermediate companies in compliance with the transfer pricing guidelines, and to document them accordingly, so that they are prepared for challenges by the tax authorities in the form of tax audits.

Transfer Pricing

Due to the comparatively moderate corporate rates in Switzerland, the transfer prices of multinational companies have not been the focus of Swiss tax authorities in the past. However, there are various indications that the previous reluctance of the Swiss tax authorities to review transfer prices, will change.

In 2019 the FTA established the Transfer Pricing Competence Centre, which is affiliated to the External Tax Audits Department. According to the FTA, the aim of this new organisational unit, comprising a pool of transfer pricing experts, is to optimise the pricing environment of transfer pricing in the FTA and become the number one contact in the field of transfer pricing. In the meantime, the Cantonal Tax Administration of the Canton of Zurich has also significantly strengthened its activities in the area of transfer pricing. Current experience shows that the tax authorities are focusing on intangible properties (IP), asset management services and financial transactions when conducting a transfer pricing audit. In addition, the appropriate compensation of foreign distribution companies, such as limited risk distributors and full risk distributors, is also under scrutiny.

From a technical point of view, the following points are of particular interest. The tax authorities follow the substance-over-form approach in the area of transfer pricing. The splitting of risks and functions, which has been accepted by various tax authorities in the past, is increasingly being questioned by the Swiss tax authorities, and critically so, with regard to the revision of the transfer pricing guidelines. Compensation for the assumption of risks that the compensated group company does not manage with its own personnel, is being challenged.

The concept of development, enhancement, maintenance, protection and exploitation of intangibles (DEMPE) – developed by the OECD in the course of the BEPS project and included in the Transfer Pricing Guidelines 2017 – is also used at times by the Swiss tax authorities for IP transactions that were settled before 2017. It remains to be seen, whether the Swiss courts will support this view. In a recent ruling, the highest court apodictically stated that the version of the OECD Transfer Pricing Guidelines to be applied is the one that existed at the time the transaction under review was settled. In other judgments, however, a dynamic approach has been chosen – notably without in-depth discussion – and the current version of the OECD Guidelines has been applied to transactions that were executed at a time when the current version had not yet been published.

In another important ruling, the Swiss Federal Supreme Court held, in favour of the taxpayers, that the tax authorities must recognise the contractual distribution of functions and risks undertaken by group companies, if these were not merely sham structures.

On 11 February 2020, the OECD published their Transfer Pricing Guidance on Financial Transactions, which will undoubtedly influence the audit practice of the Swiss tax authorities. The new guidance covers the transfer pricing aspects of various intercompany financial transactions such as loans, financial guarantees, cash-pooling, hedging and captive insurance companies. This more detailed guidance will support taxpayers as well as tax authorities in analysing these financial transactions and in determining arm's length prices.

In Switzerland, the Federal Tax Administration's Circular Letter No 6 (6 June 1997) regarding hidden equity serves as a safe harbour rule, according to which, hidden equity is assumed if a Swiss entity's intercompany debt exceeds a certain percentage of the market values of the entity's balance sheet assets. In addition, the Federal Tax Administration publishes annual circular letters providing inbound and outbound safe harbour interest rates. However, these rates often deviate from realistic interest rates, particularly when the debt instrument is subject to a higher risk. The circular letters specify that the interest rate may deviate from a safe harbour interest rate, but the onus is on the taxpayer to prove that the interest rate applied is at arm's length. Swiss taxpayers who do not wish to apply the Swiss safe harbour interest rate rules will now be in a better position to support the arm's length interest rate, by referring to the outcome of an OECD conform transfer pricing analysis (performed contemporaneously).

Prevention of Double Non-taxation

The containment of international double non-taxation is part of the BEPS minimum standard. To this end, and as already mentioned, the MLI which came into force for Switzerland on 1 December 2019, provides for the amendment of the preamble of a double tax agreement. Henceforth, the avoidance of double non-taxation, or reduced taxation through tax evasion, or tax avoidance, will be explicitly included in the preamble of a double tax agreement.

In this context, reference should be made to the ruling of the Federal Supreme Court given on 16 December 2019, in the case of the national airline, Swiss International Airlines Ltd. (Swiss

Ltd) In general, Swiss companies are not subject to taxation for their profits generated in foreign permanent establishments. Based on this and applying the formulary apportionment method – as is customary for the purposes of inter-cantonal allocation – Swiss Ltd allocated approximately 30% of its profits to its foreign permanent establishments.

The Federal Supreme Court, despite clear statutory wording, which explicitly refers to the rules of inter-cantonal tax law regarding international allocation of profits, ruled that profits must be allocated internationally using the authorised OECD approach (AOA).

In a first step, the Federal Supreme Court argued that the application of the formulary apportionment method used in inter-cantonal tax law could result in double non-taxation.

In a second step, the court went even further: Swiss Ltd was denied the opportunity to detail the amount of profit it could allocate abroad if the AOA were applied. The Federal Supreme Court argued that, under the income allocation rules of most of the double tax agreements, all profits can be taxed where the airline company is resident.

If Swiss Ltd were allowed to shift part of the profit abroad under domestic law, this would result in double non-taxation. The judgment is not convincing from a purely legal perspective. However, it supports the Swiss tax authorities in their efforts to combat tax planning structures that lead to double non-taxation, by means of a dynamic interpretation of the existing tax laws.

Mutual Agreement Procedure and International Arbitration

The implementation of the BEPS measures is likely to increase disputes between taxpayers and tax authorities and the risk of double taxation. In order to counteract the threat of tax obstacles in cross-border economic transactions and to provide taxpayers with legal certainty, the OECD advocates improving dispute resolution mechanisms.

Within the framework of the MLI, Switzerland has committed to adopting the provisions regarding the mutual agreement procedure (MAP) and incorporating them accordingly into its DTAs. This includes, in particular, the obligation to grant corresponding adjustments if an adjustment is made in a contracting state on the basis of a mutual agreement procedure.

In line with the domestic revision procedure applicable to assessments which had already entered into force, Switzerland considers that the initiation of a MAP requires that the request be submitted within a period of ten years from the date on which the assessment to be revised becomes legally binding. Switzerland therefore made a corresponding reservation to Article 16, paragraph 2 of the MLI. In return, it must now be prepared to accept reciprocal provisions within the framework of DTA negotiations, which restrict the time limit for adjustments in the case of affiliated companies or permanent establishments.

The number of MAPs has increased significantly in recent years and the financial impact of these procedures is considerable. Currently, there are more than 320 procedures pending. In more than 10% of cases, an adjustment of the tax base of more than CHF100 million is in dispute. The Federal Council therefore plans to regulate the procedural rules applicable to MAPs in a new federal law, a preliminary draft of which is currently in consultation. In particular, the new law will also regulate the enforcement of mutual agreements by the cantons. In the past, there have been cases in which cantons refused to make a corresponding adjustment based on a mutual agreement, if it was considered that the company subject to tax had acted against good faith. The planned law is intended to establish a general obligation on the cantons to grant corresponding adjustments if a mutual agreement was reached between Switzerland and the contracting state in the framework of a MAP. This will enhance legal certainty and grant the taxpayer better protection from double taxation.

In its international tax policy, Switzerland advocates the inclusion of arbitration clauses, whereby it prefers the "final offer arbitration" method (also known as last best offer or baseball arbitration). Under this method, the competent authority of each member state must submit a proposal for a decision to the arbitration board. In the course of its decision-making process, the arbitration board has to decide in favour of one of the two submitted proposals. In other words, it cannot make a decision that differs from the proposals submitted.

Switzerland has already gained experience with arbitration proceedings in relation to Germany, and it is expected that the trend towards MAP and arbitration will continue in the coming years. In this context, reference should be made to the Protocol of Amendment to the Double Taxation Agreement with the USA, which entered into force on 20 September 2019 and contains a revised arbitration clause. The relevant procedural provisions for the conduct of arbitration proceedings were laid down in an exchange of letters.

Also, according to the DTA with the USA, the arbitration board will take its decision on the basis of the final offer arbitration method. The inclusion of this kind of arbitration procedure in Switzerland's DTAs with Germany and the USA can be seen as a significant improvement. The procedure is not only more efficient but advantageous insofar that competent authorities

will likely take reasonable positions when establishing their last and 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 authorities to reach a mutual agreement, even before the arbitration procedure is initiated.

Exchange of Information

In 2019 alone, around 5,000 foreign requests for administrative assistance were addressed to Switzerland, with the number of requests expected to increase in years to come.

The distinguishing feature of Switzerland's international administrative assistance in tax matters is that persons who are affected by foreign administrative assistance proceedings can have a judicial review carried out in Switzerland, to determine whether the conditions for granting administrative assistance under the applicable double taxation agreement are fulfilled. As a result, a comprehensive case law on international administrative assistance has developed in Switzerland. Requests for administrative assistance usually originate by way of a tax audit conducted by a foreign tax authority. In addition to HNWIs, MNEs are particularly affected by information exchanges upon request.

Foreign tax authorities frequently request information on the residency of a HNWI with tax nexuses to several countries. If the person is subject to unlimited tax liability in Switzerland, the foreign tax authorities must state in their request that they have reason to believe that the person is also subject to unlimited tax liability in their own country.

Additionally, tax audits relating to both the place of effective management and transfer prices frequently lead to requests for administrative assistance. In practice, we often find that the requesting tax authorities do not sufficiently explain why the requested information is likely to be relevant to the tax assessment. Many procedures also revolve around the question of the conditions under which information on third parties (such as, employees, external consultants, family members and customers) can be exchanged within the context of administrative assistance. Domestic law offers subtle rules in this respect, which must be observed.

As the Federal Administrative Court decided in a recent ruling, requests made to Switzerland by foreign tax authorities compelling a Swiss group parent company to disclose information on legal transactions within the group, in which only foreign group companies are involved, are illegal.

Proceedings are currently pending before the Federal Administrative Court concerning the application of the Ordre Public, if the information can be used by the other state in criminal tax proceedings, which violate the presumption of innocence, enshrined in the European Convention on Human Rights. Similarly, the Federal Administrative Court is currently examining the question of whether a request for administrative assistance lapses if the person affected by the request for administrative assistance has been able to settle the tax dispute amicably with the assessment authorities of the requesting state. This question is relevant, because in most states the requesting authority is not identical to the assessment authority.

The Protocol of Amendment to the Double Taxation Agreement with the USA, which came into force on 20 September 2019, will bring the exchange of information between Switzerland and the USA in line with the OECD standard. The previous restriction on administrative assistance in cases where "tax fraud or the like" was suspected, will now be abolished for both individual and group requests.

Notably, wide-ranging administrative assistance will apply to cases from 23 September 2009 onwards. Group requests within the framework of the Foreign Account Tax Compliance Act (FATCA) agreement will be admissible for matters from 30 June 2014 onwards. Based on the FATCA agreement, the competent US authority may request all information relating to US accounts that the reporting Swiss financial institution would have had to report under a Foreign Financial Institutions Agreement, if it had received a corresponding declaration of consent to do so from the account holder. It is to be expected that on this new basis, Swiss financial institutions will again have to report a large amount of financial information to the USA in the future.

Final Remarks

The considerable legislative changes that Switzerland has had to make in the field of tax law as a result of the BEPS project raise various new legal questions. It is therefore to be expected that tax controversy will become even more important in practice in the coming years. Taxpayers will be challenged: due to their legal obligation to participate in the establishment of the tax-relevant facts and circumstances, they must efficiently process and document the elements of the facts that speak in their favour. In complex cases, it will also be of decisive importance to analyse the legal questions that arise in detail and from different angles, in order to be able to present them in a structured, comprehensible and convincing manner to the competent tax authority or court.

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 multi-national enterprises and high net wealth 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.

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