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The taxation of foreign passive income for groups of companies

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Summary and conclusions

For decades, Switzerland has itself tried to offer a beneficial economic environment with low tax rates. This is an important factor in attracting multinational groups establishing operations to Switzerland and retaining domestic businesses. As a result, Swiss companies are themselves often regarded as low-taxed companies from a foreign tax perspective, as the maximum tax rate for ordinary taxed companies currently ranges between 12 per cent and 24 per cent (depending on the canton and community), which can be further reduced to as low as 5 per cent by the application of privileged tax regimes.

Switzerland certainly aims to remain a competitive tax environment. That said, in view of the changes of the global tax environment and the increased international tax competition, the country now faces the reality that profits are allocated to even lower or non-tax foreign jurisdictions and, as a consequence, the Swiss tax authorities are reviewing cross-border structures more closely, mainly to find tax income allocated to offshore locations without sound economic reasons.

According to Swiss tax legislation neither a general definition of a "group of companies" nor one of passive income exists. Since Switzerland has no written controlled foreign company (CFC) rules either, and since there is no official published policy on the taxation of foreign passive income, the Federal Tax Authority approaches, generally in collaboration with the tax authorities of the cantons, cross-border structures mainly based on the precedent set by the Swiss Federal High Court. In relation to foreign passive income, different methods are applied by the tax authorities in order to tax such income in a cross-border situation in Switzerland: by a (broad) interpretation of the legal terms "effective management" and "permanent establishment", the assumption of a mandate relationship or based on the general abuse of tax law doctrine. This approach displays a rather strict treatment of (passive) foreign income.

Predominantly offshore structures are subject to increased scrutiny and, once detected by the (federal) tax authorities, rejected for tax purposes. It still remains to be seen whether the objections of the tax authorities will in practice be limited to

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specific (anti-abuse) cases, mainly aiming at non-tax treaty countries. Structures with real functions and substance should still remain acceptable; however, the requirements have increased over the past decades. This is also a reason why activities in Switzerland with "real" business functions, with qualified personnel and business substance are rather robust from a foreign CFC perspective.

The fact that Switzerland has no CFC legislation and no intention of implementing such legislation is an important advantage in the international tax environment. Thus, the tax authorities should continue to apply the anti-avoidance rules very carefully in order to preserve the attractiveness of Switzerland as a business location for multinational groups and domestic businesses.

1. Introduction

As a starting point of the analysis of the Swiss provisions about the taxation of foreign passive income for groups of companies, an introduction to the Swiss corporate tax system, the applied practice of the tax authorities on cross-border structures and the definition of passive income is presented.

1.1. General information about the corporate tax system

Income taxes are applied at the federal, cantonal and communal level in Switzerland. Swiss resident corporations are generally subject to unlimited taxation on their annual worldwide income, if they have their registered seat or their effective management in Switzerland (article 50 Federal Income Tax Act, article 20(1) Tax Harmonization Act[1] for cantonal/communal tax purposes). However, income attributable to foreign permanent establishments and foreign landed property is exempt from Swiss taxation according to domestic provisions and only considered when determining the tax rate. Non-resident companies are subject to income taxation in Switzerland if they derive income attributable to a permanent establishment or in connection with landed property in Switzerland (article 51 Federal Income Tax Act).

There is no group taxation for income tax purposes in Switzerland; each legal entity is taxed on a stand-alone basis. Therefore, no general definition of a "group of companies" exists. However, for tax-neutral reorganizations within a group, article 61(3) Federal Income Tax Act requires a majority of voting rights or common control by a corporation. This may also serve as an indication for the qualification as a group of companies in cross-border scenarios.

The statutory accounts (Swiss GAAP) of a Swiss company, or the branch accounts in case of a foreign company, serve as basis for the determination of the taxable income. Generally, there are only minor differences between statutory and taxable profit apart from some specific cases (e.g. tax loss carryforwards or thin capitalization).

1 In what follows we will only refer to the Federal Income Tax Act as the provisions of the Tax Harmonization Act contain generally similar rules.

Income, e.g. dividends from qualifying domestic or foreign participations,[2] is subject to a participation deduction scheme. The income tax is reduced in proportion to the net qualifying participation income as a percentage of total taxable income. The level of taxation of the subsidiary is not relevant for the application of the participation deduction; however, income which qualifies as commercially justified expenses at the level of the subsidiary does not benefit from the participation deduction ("anti-hybrid-provisions"; see below section 3.2). A similar participation deduction applies for capital gains[3] arising from the sale of qualifying participations.

The tax loss carryforward period is seven years. No loss carryback provisions exist.

Switzerland has no written CFC rules to attack the taxation of passive income of group companies in low-taxed jurisdictions. Swiss companies themselves, however, are often regarded as low-taxed companies from a foreign tax perspective, as the maximum tax rate for ordinary taxed companies currently ranges between 12 per cent and 24 per cent (depending on the canton and community) and privileged taxed companies can benefit from corporate income tax rates between 7.8 per cent (holding company) and about 12 per cent (mixed company) or even 5 per cent (principal companies; see below section 3.4). The application of the privileged tax status is usually confirmed by the tax authorities in an advance ruling. Such a ruling granted by the canton is binding for cantonal and, generally, federal tax purposes and is usually not limited to a certain period of time. Further, full or partial tax holidays of up to ten years on cantonal and – in certain regions – federal tax level can be granted by the relevant government to substantial investment projects which result in even lower tax rates.

1.2. Policy on the taxation of foreign passive income

There is no official published policy on the taxation of foreign passive income. However, the Federal Tax Authority approaches, in collaboration with the tax authorities of the cantons, cross-border structures mainly based on the interpretation of precedent set by the Swiss Federal High Court. The following comments in relation to federal income tax and withholding tax are based on the application of this interpretation, as far as the information is available to the reporters according to experience and case law. The current approach, in particular of the Federal Tax Authority, shows a rather strict treatment of passive foreign income. Despite the lack of formal CFC legislation, offshore structures[4] are subject to increased scrutiny and, once detected by the (federal) tax authorities, rejected for tax purposes.

2 Qualifying participations require a minimum 10 per cent participation in the capital or profit of the company or a fair market value of the participation of at least CHF 1 million (art. 69 Federal Income Tax Act).

3 For capital gains, at least 10 per cent of the shareholdings which are held for at least one year need to be sold in order to qualify for the participation deduction (art. 70(4) Federal Income Tax Act).

4 In particular structures with entities in no-tax jurisdictions, e.g. non-treaty countries like the Cayman Islands, Bermuda, the British Virgin Islands, the Channel Islands, with limited substance are subject to objections. The approach of the tax authorities, however, goes beyond this and does not limit the application of the legislation to such countries.

1.3. Passive income vs. active income

The Swiss corporate income tax law does not contain a general definition of passive income. However, the unilateral exemption of foreign permanent establishment income (as well as income from foreign landed property) can serve as an indication that such income is seen as active.[5] A permanent establishment requires, pursuant to article 51(2) Federal Income Tax Act, a fixed place of business in which a business activity is partly or fully exercised.[6] In addition, provisions with regard to tax-neutral reorganizations or unilateral anti-abuse rules also give some examples of when a Swiss company can be regarded as an active company (see below section 1.3.1).[7] Thus, the determination of passive income under Swiss income tax law is better approached by considering non-active income as opposed to active income.

1.3.1. Active income

1.3.1.1. The business term

Different terms can be taken as a basis for the definition of active business income, e.g.:

- the participation in a business (*Geschäftsbetrieb*) for foreign residents (article 51(1(a)) Federal Income Tax Act);
- the permanent establishment (article 51(2) Federal Income Tax Act);
- the business or business unit for tax-neutral reorganizations (article 19, article 61 Federal Income Tax Act); and
- the self-employed activity of individuals (article 18 Federal Income Tax Act) compared to other income.

First, participation in a business (*Geschäftsbetrieb*) in Switzerland by a foreign resident could be used as an indication for the definition of an active business. While "business" is not a legal definition but an economic fact, it can be seen as an active participation in the economy using financial and/or human capital.[8]

5 Christoph Niederer, *Key practical issues to eliminate double taxation of business income*, *Cahiers de droit fiscal international* 2011, Vol. 97a, pp. 645 *et seq.*

6 For further details, see Peter Brülisauer, *The attribution of profits to permanent establishments*, *Cahiers de droit fiscal international* 2006, Vol. 91b, pp. 642 *et seq.*; Stefan Widmer, *Is there a permanent establishment?*, *Cahiers de droit fiscal international* 2009, vol. 94a, pp. 631 *et seq.*

7 For further details, see Georg Lutz, "Abkommensmissbrauch – Massnahmen zur Bekämpfung des Missbrauchs von Doppelbesteuerungsabkommen", *Schriften zum Steuerrecht* 2005, Band 15, pp. 72 *et seq.*; Circular letter of the Federal Tax Administration, *Massnahmen gegen die ungerechtfertigte Inanspruchnahme von Doppelbesteuerungsabkommen des Bundes (BRB 1962/KS 1999)* of 17 December 1998; *Anpassung der Praxis der Eidgenössischen Steuerverwaltung (ESTV)* and *Häufig gestellte Fragen (FAQ) zum Kreisschreiben 1999 (KS 1999),* from http://www.sif.admin.ch/ themen/00502/00742/index.html?lang=de.

8 Peter Athanas and Guiseppe Giglio, in Martin Zweifel, Peter Athanas (eds.), *Kommentar zum schweizerischen Steuerrecht*, Band I/2a – *Bundesgesetz über die direkte Bundessteuer (DBG)*, 2nd edn, Basle 2008, art. 51 no. 8. This definition is of less practical relevance than that of a permanent establishment.

With regard to the second term, a fixed place of business in which a business activity (*Geschäftstätigkeit*) is partly or fully exercised is required for a permanent establishment based on the domestic definition. The term "business activity" is rather broad and, in particular, broader than the term "business of an enterprise" according to article 5(1) OECD model convention with respect to taxes on income and capital.[9] The tax authorities seem to refer to the definition of a business (*Betrieb*), which is not exactly in line with the legal definition of a permanent establishment. A "business" is defined as an organizational-technical complex of assets which is a relatively independent organic unit for the rendering of services and goods (*Leistungserstellung*). This is a definition taken from the circular on reorganizations[10] which determines the availability of a business or business unit which can be transferred within Switzerland, under certain requirements, without income tax consequences. In the view of the tax authorities, the definition of a business is narrower for the periodical income taxation than for reorganizations, which only happen once in a while. Whereas the circular on reorganizations accepts a "holding business", "asset management business (finance or intellectual property business)" and "landed property business" for tax neutral restructurings,[11] these requirements seem insufficient to justify a business for the definition of a permanent establishment from the tax authorities' perspective. In the reporters' opinion, such different requirements for the same income tax term "business" are not justifiable, in particular as the tax authorities take the opposite position for the self-employed activity of individuals: even if they clearly have a business (business assets) according to article 18 Federal Income Tax Act for periodical income taxation, they do not always fulfil the requirements for a tax neutral transfer of such business in a reorganization.[12]

The strict requirements for the qualification as business stipulated by the tax authorities are based on the intention of limiting the tax exemption of foreign business activities in outbound scenarios: the Swiss unilateral rule to exempt income from foreign permanent establishments applies irrespective of a double tax treaty, also with respect to foreign "tax haven" jurisdictions and can serve to achieve "non-taxed" income. However, in inbound cases, the assumption of a Swiss permanent establishment usually does not need to meet such strict criteria, as e.g. a Swiss finance branch does not need to show – from a Swiss perspective – a business activity to be taxed in Switzerland. A different qualification of a business or permanent establishment for outbound and inbound cases – based on fiscal intention – is not in line with the Swiss tax law and hence, the same broad criteria as for inbound cases should also be applicable for outbound cases. This means that if an activity would justify a Swiss permanent establishment if pursued in Switzerland, the same activity should qualify as a foreign permanent establishment if performed abroad. As mentioned, the tax authorities take a partially different view on this question.

9 *Ibid.*, No. 37.
10 Circular letter of the Federal Tax Administration, *Umstrukturierungen* of 1 June 2004, No. 5.
11 *Ibid.*, para. 4.3.2.6–4.3.2.8.
12 See discussion of Hans-Jürg Neuhaus and Markus Reich, "Fall 1: Sacheinlagegründung durch Liegenschaftenhändler", *in Aktuelle Probleme im schweizerischen Unternehmenssteuerrecht – Ausgewählte Probleme bei Unternehmensumstrukturierungen*, ISIS Seminar of 7/8 June 2010.

1.3.1.2. Treaty perspective and anti-abuse rules

From a treaty perspective, Switzerland applies unilateral anti-abuse rules to protect foreign withholding tax claims (Swiss anti-abuse decree of 1962).[13] Certain business activities qualify as active and impose fewer restrictions on the Swiss company in order to benefit from a foreign withholding tax relief. Active in this sense is an independent entrepreneurial activity with the intention to realize profits, which includes the production or the distribution of goods or the rendering of services with own personnel in a business set up (*eingerichteter Geschäftsbetrieb*). Based on a clarification in 2010,[14] active business is defined in contrast to a mere passive, administrative and executive function. The activity needs to support economic value creation. Services to group companies can be active, if a real added value is created which would justify a (at least theoretically) viable unit outside the group. This requires a certain degree of independence, e.g. regarding decisions, direction and control. On this basis, certain financing functions as well as certain licence activities can be seen as active. Although these rules apply to Swiss resident companies only, they can serve as a general indication of an active business, in particular to assess which criteria certain rather passive activities (financing, licensing, etc.) need to fulfil to qualify as active. The intention of these rules, i.e. the protection of foreign withholding tax claims, is, however, different from the intention of taxation of foreign passive income which aims to increase the domestic tax basis. Whereas the practice for the anti-abuse decree has been relaxed in 2010, the taxation of foreign activities has been tightened in the past years by the Swiss tax authorities.

1.3.2. Passive income

1.3.2.1. Companies with passive purpose

A clear distinction between business activities and mere asset management activities as criteria for active and passive activities is usually not drawn under Swiss tax law. The functions are, however, relevant for profit allocation, as the mere administrative activities of a foreign partnership generally only justify an allocation of the income which arises from those administrative activities. The Swiss tax authorities recently established the new term "companies with passive purpose", in order to determine the place of effective management (and Swiss tax residency) of such companies. For such companies, the place where the tactical decisions are taken (generally by the controlling individual, the group management) should be decisive (see below section 2.1.1). Examples of such companies with passive purpose are:

- corporations with foreign registered seats which are controlled by individuals and which have the sole purpose of managing their own assets;

13 Circular letter of the Federal Tax Administration, *Massnahmen gegen die ungerechtfertigte Inanspruchnahme von Doppelbesteuerungsabkommen des Bundes (BRB1962/KS1999)* of 17 December 1998; *Allgemeine Informationen bezüglich der Missbrauchsvorschriften*, from: http://www.sif.admin.ch/themen/00502/00742/index.html?lang=de.

14 *Anpassung der Praxis der Eidgenössischen Steuerverwaltung (ESTV)* and *Häufig gestellte Fragen (FAQ) zum Kreisschreiben 1999 (KS 1999)*, from: http://www.sif.admin.ch/themen/00502/00742/index.html?lang=de.

- corporations with passive purposes, e.g. the financing of group companies;
- foreign financing companies which serve to issue public bonds.

From a practical perspective, mainly foreign (offshore) companies with financing, asset management (e.g. trading of securities) and licensing functions have been the focus of the tax authorities. One example is the so-called converter structure, where taxable interest income is converted into tax exempt dividend income by the use of an offshore financing subsidiary, as shown in Figure 1.

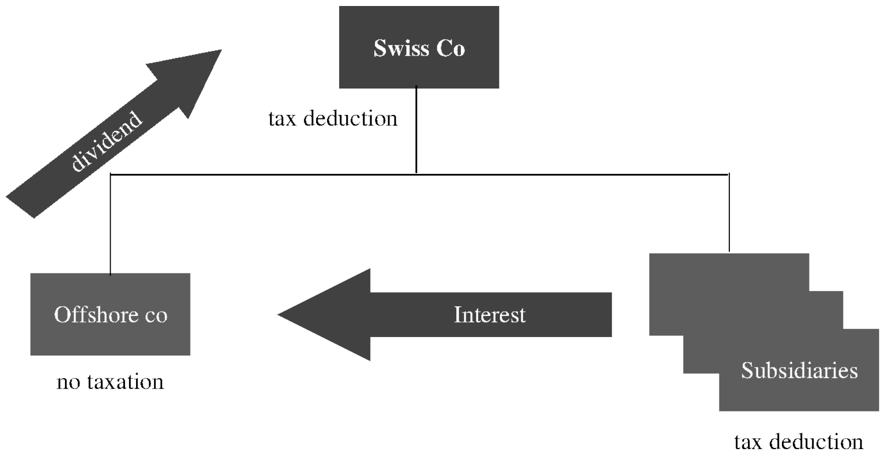

Figure 1. Converter structure

Whether this focus is due to the "passive" nature of the income or the limited required substance to obtain such income is not entirely clear. Depending on the level of local substance (qualified personnel, offices, financial means to fulfil the business purpose, etc.), the structures may be accepted for Swiss tax purposes.

1.3.2.2. Non-business activity of Swiss privileged taxed companies

In order to qualify for beneficial taxation under the Swiss holding regime with a cantonal and communal income tax exemption, no business activity is permitted to be performed in Switzerland. However, certain activities are permitted as ancillary activities (e.g. group services, financing, administration of intellectual property (IP))[15] and could be viewed as non-business activity, thus passive (non-active) income. With this argument, significant activities could be denied as "active business" activities. The intention of attracting companies to Switzerland with a privileged taxation (despite certain limited activities in Switzerland) is, however, contrary to the intention to tax foreign group companies with passive income and thus, such permitted activities should in the reporters' view not be an indication of passive income.

15 For further details, see the directive of the Zurich Tax Administration, *Weisung der Finanzdirektion über die Besteuerung von Beteiligungs-, Holding-, Domizil- und gemischten Gesellschaften* of 12 November 2011, para. C.

As so-called domiciliary companies with no activities and personnel in Switzerland are still privileged taxed on a cantonal/communal basis (regarding the dispute with the European Commission, see below section 6), the denial of certain foreign structures with comparable limited substance by the Swiss tax authorities seems rather contradictory. However, in view of the changes of the global tax environment and the global tax competition, Switzerland faces the fact that profits are being allocated to even lower or non-tax foreign jurisdictions and, as a consequence, the tax authorities have tightened their approach in practice to deal with such cross-border structures.

1.3.2.3. Avoidance of double taxation

A different approach to defining passive income can be seen in Switzerland's system on the avoidance of double taxation. Whereas income from foreign permanent establishments is exempt (based on domestic law), dividends, royalties and interest are subject to the credit method according to the Swiss income tax treaties,[16] which could serve as an indication for qualifying the latter as passive income. However, this distinction is in the reporters' view of limited value for the determination of foreign passive income since it would be much too broad an interpretation to treat dividend, interest and royalties as passive.

2. General anti-avoidance rules (GAARs)

Switzerland has no written GAAR in its tax laws. Certain laws[17] refer to abuse of tax law (*Steuerumgehung*), however, without further definition.[18]

2.1. Basis for taxation of foreign passive income

In relation to foreign passive income, the following approaches can generally be used to attack foreign structures in order to tax the income in Switzerland.[19] It is not quite clear whether they only apply to groups of companies, i.e. whether a majority of voting rights or predominant influence is required. In practice, this criterion will in most cases be fulfilled; however, due to the lack of written CFC rules or guidelines, it cannot be excluded that taxation is also applied in "non-group" cases, e.g. a minority shareholding.

16 Christoph Niederer, *Key practical issues to eliminate double taxation of business income*, *Cahiers de droit fiscal international* 2011, Vol. 97a, pp. 645 *et seq.*

17 E.g. art. 70(5) Federal Income Tax Act which covers the application of the participation deduction in transactions which result in unjustifiable tax savings or art. 21(2) Withholding Tax Act.

18 For further details, see Maja Bauer-Balmelli, in Martin Zweifel, Peter Athanas and Maja Bauer-Balmelli (eds.), *Kommentar zum schweizerischen Steuerrecht,* Band II/2 – *Bundesgesetz über die Verrechnungssteuer (VStG)*, Basle 2005, art. 21 para. 2.

19 See Robert Waldburger, *Möglichkeiten und Grenzen des Zugriffs des schweizerischen Fiskus auf ausländische Konzerngesellschaften*, IFF Seminar of 17/18 March 2008.

2.1.1. Place of effective management

A foreign resident subsidiary is subject to unlimited taxation in Switzerland (with the exception of income from foreign permanent establishments and landed property), if the place of effective management (*tatsächliche Verwaltung*) is deemed to be in Switzerland (article 50 Federal Income Tax Act). The effective management is determined by the day-to-day business from a Swiss perspective; neither the mere strategic decisions (e.g. shareholder meetings) nor the mere administrative actions are decisive.[20] The place where the important operational business decisions are taken depends on the specific activities of the company. Based on case law and the interpretation of the tax authorities, the following indications should be considered for the determination of the place of effective management, based on where the majority of the business activity happens:

- the negotiation and signing of contracts;
- the governing law for such contracts;
- the execution and control of the contracts;
- the fulfilment of tasks which exceed the mere administration and financing of the business activity;
- qualified and entrusted personnel for operational decision taking;
- infrastructure for business activity;
- the postal address and bank accounts of the company;
- the location of persons entitled to sign and make use of the bank accounts.

For companies with passive purpose (see above section 1.3.2.1), the location where the decisions for the investment of assets or the group financing (refinancing, grant of loans, terms of the loans) are taken is decisive.

Thus, foreign subsidiaries with decision takers for the daily business being physically located in Switzerland (when taking these decisions), may be deemed Swiss residents for income tax purposes. The same may apply if decisions, even without formal power to represent the company, are in fact taken in Switzerland and only formally executed ("rubber stamped") abroad by the local representative. The mere compliance with group guidelines, e.g. board approvals granted in Switzerland for certain important transactions, should *per se* not be detrimental, as long as a certain operational decision power remains at the level of the foreign subsidiary.

The qualification as Swiss tax resident gives generally rise to an unlimited tax liability (see above section 1.1). However, even if the place of effective management is deemed in Switzerland, certain foreign activities can then constitute a foreign permanent establishment and limit the Swiss income taxation right.

From a withholding tax perspective, it is important to note that a foreign registered corporation which is managed in Switzerland and has an actual activity[21] in Switzerland becomes subject to Swiss withholding tax (mainly on dividends) (article 9(1) sentence 2 Withholding Tax Act).

20 Stefan G. Widmer and Andrea Moser, *Schweizer Aussensteuerrecht BGE vom 4. Dezember 2003 – Verschärfung der Rechtsprechung zur Einschaltung niedrig besteuerter Zwischengesellschaften*, *Der Schweizer Treuhänder* 2005, p. 497.

21 A holding activity or limited activity in Switzerland may suffice, see Zweifel, Athanas and Bauer-Balmelli (eds.), *op. cit.,* art. 9 no. 35.

2.1.2. Permanent establishment in Switzerland

The activities of a foreign subsidiary may give rise to a limited taxation in Switzerland, if it constitutes a permanent establishment. In the case of a foreign resident company with mixed activities, this can be the case if certain activities (e.g. financing, local treasury functions) are clearly performed abroad, whereas other functions (e.g. asset management, holding activities, management of own subsidiaries or development of IP) are performed in a fixed place of business in Switzerland. This approach might clearly be an argument for the Swiss tax authorities where certain substance and qualified personnel are actually available abroad, but certain activities on behalf of the foreign subsidiary are still performed in Switzerland. In particular in the case of business with third parties, this may serve as an argument for a taxation right in Switzerland; in the case of intercompany relationships with a foreign subsidiary, it may be easier for the tax authorities to object to the applied transfer prices in view of the functions performed (as well as risks taken and assets available; see below section 3.1).

2.1.3. Mandate (Auftragsverhältnis)

The Federal High Court[22] has considered the existence of a mandate relationship (i.e. instruction by the Swiss parent company) in a scenario where the foreign subsidiary was effectively managed abroad, but not equipped with the necessary financial means to perform a certain transaction on its own. This decision has been heavily criticized in the Swiss tax literature[23] and no further court case has been decided in line with this argument. However, this still remains a possible approach to tax income from foreign subsidiaries in Switzerland and the Federal Tax Authorities have mentioned applying this court decision in similar cases. It is not clear whether this approach would be limited to a direct parent–subsidiary relationship, or could potentially also apply in comparable group structures. The advantage of this approach is that the tax liability is – unlike in the cases explained above – with the instructor, here the Swiss parent, not the foreign subsidiary. From an administrative perspective, the tax can be assessed at the level of the Swiss parent, i.e. a local taxpayer. The concept of an order or mandate results in the fact that the proceeds from the order as well as the expenses are allocated to the instructing party. In the mentioned court case, the proceeds derived from a sale of a qualifying participation which – if directly generated by the Swiss parent – would have benefited from the participation deduction, whereas proceeds from an order are ordinarily (fully) taxable.

2.1.4. Abuse of tax law

The fourth way to tax foreign (passive) income is by the *fraus legis* approach. *Steuerumgehung*, i.e. abuse of tax law or *fraus legis*, has been developed by case law over many years and requires the following: (a) that a transaction is economi-

[22] See Federal High Court Decision of 9 May 1995, ASA 65, pp. 51 *et seq.*

[23] See Robert Waldburger, *Möglichkeiten und Grenzen des Zugriffs des schweizerischen Fiskus auf ausländische Konzerngesellschaften*, IFF Seminar of 17/18 March 2008.

cally unusual or inappropriate, (b) results in a tax saving if not challenged by the tax authorities and (c) the tax saving is the sole purpose of the taxpayer. If these requirements are all met, the tax authorities can apply the tax rules as if an appropriate economic transaction has happened.[24] This generally results in the fact that the foreign legal entity is disregarded as a separate entity and therefore combined with the Swiss entity. According to the interpretation of the tax authorities, the establishment of a legal entity abroad which is controlled by a Swiss person is not accepted in case of an abuse of tax law, e.g. if a business is transferred to a foreign entity which does not have the entitled and qualified personnel to perform the business and thus, no daily business is performed abroad. As a result, the set-up is qualified as economically unusual or inappropriate. The lack of daily business abroad could also be construed to mean that the daily business (place of effective management) is being performed in Switzerland (see above section 2.1.1). With the same arguments the set-up of two separate legal entities can be qualified as unusual if there is insufficient economic independence and the set-up results in a combination/mixture of functions and corresponding substance of the two entities.[25] Such "consolidation" of the business and income at the level of the Swiss (parent) entity facilitates the enforcement of the tax liability (at the level of the Swiss taxpayer).

By the application of the *fraus legis* doctrine the foreign legal entity is disregarded and all its income and expenses are generally attributed to the Swiss resident entity to which the income and expense would economically be allocated. The tax authorities generally deny the possibility of taxing the income from such a foreign legal entity upon dividend distribution only (by disallowing the participation deduction) if the interposition of a foreign subsidiary was intended to convert taxable income into tax exempt dividend income in Switzerland; thus, the income of the foreign legal entity is taxed at the level of the Swiss entity irrespective of a dividend distribution. As a consequence, this would mean that participation income obtained by the foreign legal entity could qualify as direct participation income of the Swiss parent and could benefit from the participation deduction. Income from non-qualifying participations (e.g. capital gains of portfolio investments) would be fully taxable in Switzerland. Any subsequent dividend

24 Marcel R. Jung, *Tax treaties and tax avoidance: application of anti-avoidance provisions*, *Cahiers de droit fiscal international* 2010, Vol. 95a, pp. 774 *et seq.*; Oliver Untersander, *New tendencies in tax treatment of cross-border interest of corporations, Cahiers de droit fiscal international* 2008, Vol. 93b, pp. 713 *et seq.*; Georg Lutz, *Limits on the use of low-tax regimes by multinational businesses: current measures and emerging trends, Cahiers de droit fiscal international* 2001, Vol. 86b, pp. 843 *et seq.*; Sukumar Mukhopadhyay, "General Anti-Avoidance Rule in Income Tax Law", *Economic and Political Weekly*, Vol. 47, No. 22, 2012, pp. 25 *et seq.*; Federal High Court Decisions: C-632/2007 of 7 April 2008; 2A.660/2006 of 8 June 2007; 2A.470/2002 of 22 October 2003; 2A.135/2000 of 5 November 2001.

25 It should be noted that the establishment of a Caribbean subsidiary for operating, then financing purposes was not deemed as unusual or inappropriate in StE 1988 ZH B 71.2 (Commission of Appeal I Zurich, 4 June 1987). Two arguments were that (a) a limitation of the participation deduction for dividends from such subsidiaries has deliberately not been enacted in Swiss tax law and that (b) holding companies with no business activities are accepted and privileged taxed in Switzerland, i.e. a different approach for such foreign entities would be contradictory. As the tax environment has changed since this verdict, the tax authorities and potentially also the Swiss court would now probably take another position.

from such a foreign subsidiary would have to be disregarded at the level of the Swiss parent, as the profit was already taxed in Switzerland. Due to the lack of explicit guidelines, the avoidance of double taxation is not quite clear in practice. It is therefore recommended to discuss the taxation of such subsequent distribution or liquidation of the foreign subsidiary with the tax authorities at the time when the structure is challenged.

The combination of the two legal entities could jeopardize the tax privileges of the Swiss parent, e.g. if the requirements of a holding company (two-thirds asset or income test) were no longer met. The same could be true for a privileged taxed mixed company, resulting in a (significantly) increased income and capital tax rate. The abuse of tax approach results in taxation according to the economic intent, i.e. how such activity would have been structured without a tax circumvention intention. Thus, the taxation may vary from case to case and the consequences are uncertain for the taxpayer.

2.2. Impact of foreign CFC legislation and holding activities

The above schemes generally aim to tax foreign passive income in low-tax jurisdictions. Due to the fact that such taxation is based on (rare) case law and not on CFC legislation (see below section 4), the requirements for such taxation are unclear. Based on past experience, the focus is generally on non-tax or low-tax jurisdictions, whereas structures with treaty countries (even if favourably taxed, e.g. in Luxembourg) are less scrutinized (see below section 5). The interposition of a treaty country or a country with its own CFC legislation may, hence, avoid the taxation of foreign passive income in Switzerland as income from such a structure would already have been taxed abroad and the structure would probably have non-tax reasons as a basis. However, if the country were only interposed to make use of favourable tax laws which would not be applicable in the case of direct investment (e.g. tax exempt capital gains on portfolio investments), i.e. only to avoid Swiss taxation, the structure may be objected to and taxed under the abuse of tax law doctrine.

Switzerland is famous as a holding location and thus, foreign holding companies are generally accepted for tax purposes as well. The requirements for a foreign holding company qualifying for Swiss tax treaty benefits (reduced Swiss dividend withholding tax rates), for example, usually cover the holding of qualifying participations and an adequate equity amount[26] to perform its holding functions, whereas only limited personnel and office space is required. Based on this understanding, a foreign holding subsidiary should generally be accepted, despite having little activity of its own (see above section 1.3.2.2). A reason for this acceptance could be that a direct investment via a Swiss holding would usually also result in tax exempt income due to the participation exemption scheme (see above section 1.1) and thus, the interposition of a foreign holding (unlike a foreign investment) company would give rise to less scrutiny.

[26] An adequate equity is usually defined in line with the Swiss thin capitalization (minimum equity) rules, e.g. 30 per cent for a holding company.

3. Special anti-avoidance rules (SAARs)

Switzerland has no SAARs concerning the taxation of foreign passive income of group companies. The bases for such taxation are general taxation principles (place of effective management, domestic permanent establishment) or the abuse of tax law doctrine (see above section 2).[27] However, there are certain other specific topics that must be additionally considered in cross-border structures.

3.1. Transfer pricing

Switzerland has no specific transfer pricing legislation and no documentation requirements, but generally follows the OECD transfer pricing guidelines.[28] The remuneration for intercompany relationships is generally based on the functions performed, risks taken and assets used. Thus, consideration for group activities of foreign subsidiaries or branches can be challenged and adjusted for Swiss tax purposes based on transfer pricing rules. This approach to increase the tax basis in Switzerland due to limited activities performed abroad may be easier to pursue from an administrative perspective as the tax authorities can raise their tax claims against the Swiss taxpayer. Moreover, income adjustments (add backs) often not only result in additional income taxes, but also trigger withholding taxes, e.g. in the case of hidden dividend distributions to shareholders or related parties.[29] Such transfer pricing adjustments apply irrespective of the jurisdiction or taxation of the foreign company; however, in practice the scrutiny falls on low-tax countries or jurisdictions with special tax regimes.

3.2. Switch-over clauses/subject to tax clauses

Based on Swiss tax law, income allocated to foreign activities performed in a foreign permanent establishment (if allocation is accepted by the tax authorities) is generally exempt irrespective of a double tax treaty and the level of its foreign taxation. Also deductions for commercially justified expenses are generally accepted irrespective of the taxation in the hands of the recipient. Similarly, the taxation of the profits of a subsidiary is not a condition for the application of the participation deduction on dividend income or capital gains. The participation deduction rules only provide for "anti-hybrid-provisions", e.g. the denial of the participation deduction for dividend income if such a payment has been treated as commercially justified business expense at the level of the subsidiary. Depending on the foreign tax regime, the participation deduction may be denied, e.g. if the dividend payment

27 The mandate doctrine can also be seen as a specific case of abuse of tax law, although different criteria were applied in the court case, in particular the sole intention to save taxes was not decisive.

28 OECD transfer pricing guidelines for multinational enterprises and tax administrations 2010 of 1 September 2010.

29 For withholding tax purposes, Switzerland generally does not apply the triangular approach, but assesses withholding taxes in relation to the direct beneficiary, e.g. a sister company, hence no reduction at source and only a refund to the portfolio withholding tax rate in a double tax treaty apply.

results in tax deductible expenses (or potentially a notional equity deduction)[30] for the foreign subsidiary. Further, the participation deduction does not apply to certain companies which qualify as transparent (not as corporation), in order to avoid double non-taxation.[31] These rules are, however, not specially designed to attack the foreign passive income of low-taxed group companies.

3.3. Thin capitalization/interest deduction limitation

Swiss thin capitalization rules do not set out the minimum equity required, but the maximum debt allowed, i.e. the allowed amount of non-equity positions including provisions, etc. The exact amount of the maximum allowed debt depends on the underlying assets. Per asset category, certain percentages of maximum debt (on the fair market value of the asset) are allowed according to a circular issued by the Federal Tax Authorities.[32] The amount of effective debt (i.e. total of non-equity positions) exceeding the allowed debt (i.e. total of non-equity positions) qualifies as so-called undisclosed (hidden) equity. Undisclosed equity has only negative tax implications if the company shows related party loans (including third party debt with guarantees by related parties) in this amount. The taxation of the recipient of the interest is not relevant for the application of the Swiss thin capitalization rules: the limitation of the interest deduction generally applies to any related party debt exceeding the allowed debt.

In addition to thin capitalization rules, Switzerland has safe haven interest rates for loans to or from related parties (minimum or maximum rates). These rates are annually assessed and vary depending on the function of the Swiss company, the financing of the loan (with equity of debt) and the currency of the debt.[33] However, the taxation of the recipient is not relevant for the application of the safe haven rates. Objections to the interest deduction (or the amount of interest income) despite compliance with the safe haven rates can, hence, only be made in specific cases or on the grounds of transfer pricing arguments or abuse of tax law.

3.4. Limitation of royalty deduction/IP regimes

The current practice of the tax authorities shows a rather strict treatment of passive foreign income. However, the strategy of Switzerland with regard to passive income is not only to attack cross-border structures involving non-tax or low-tax jurisdictions. For decades, Switzerland has itself tried to offer a beneficial economic environment with low tax rates. This is an important factor in attracting

30 See Stefan G. Widmer, "Brasilianische Zinsen auf dem Eigenkapital im schweizerischen Gewinnsteuerrecht", *IFF Forum für Steuerrecht* 2011/4, pp. 287 *et seq.*, with arguments for the grant of the participation deduction in case of formal dividends.

31 Schweizerische Steuerkonferenz, *Praxishinweis zur steuerlichen Behandlung der US-amerikanischen Limited Liability Company bei den direkten Steuern* of 6 September 2011.

32 Circular letter of the Federal Tax Administration, *Verdecktes Eigenkapital (Art. 65 und 75 DBG) bei Kapitalgesellschaften und Genossenschaften* of 6 June 1997, no. 6.

33 Circular of the Federal Tax Administration, *Steuerlich anerkannte Zinssätze 2012 für Vorschüsse oder Darlehen in Schweizer Franken* of 21 February 2012; *Steuerlich anerkannte Zinssätze 2012 für Vorschüsse oder Darlehen in Fremdwährungen* of 22 February 2012.

multinational groups to establish operations in Switzerland and in retaining domestic businesses.

As a result, Swiss companies themselves are often regarded as low-taxed companies from a foreign tax perspective, as the maximum tax rate for ordinary taxed companies currently ranges between 12 per cent and 24 per cent (depending on the canton and community), which can be further reduced by the application of privileged tax regimes. Some "passive income", e.g. interest from a Swiss finance branch, licence income of a Swiss resident company or Swiss permanent establishment (either foreign related income under the mixed company regime or both domestic and foreign sourced income under the newly introduced IP box in the canton of Nidwalden),[34] is beneficially taxed in Switzerland, and often subject to foreign CFC rules.

With regard to IP, Switzerland does not impose withholding tax on royalties and does not provide for specific limitations for the deduction of royalty payments (other than general transfer pricing considerations). A reason for this can be seen in the preferential tax status for IP holding companies in Switzerland, i.e. that Switzerland is rather a location to attract IP and royalty income (potentially "passive" income) than attacking foreign passive income. However, the latter is slowly changing by the current approach of the tax authorities (see above section 1.2).

Generally, several privileged taxation regimes are applicable to such IP companies. The mixed company is a statutory cantonal tax regime. It is a multipurpose vehicle for companies with predominantly international activity. IP companies typically benefit from this status if the IP income or capital gain is predominantly received from foreign counterparties. Generally, also the expenses need to be predominantly foreign sourced (e.g. licence fees or R&D service fees to a non-Swiss entity). The effective statutory tax rate of a mixed company is as low as 8.5 per cent including cantonal and federal income tax (for example the canton of Lucerne). There is no restriction regarding the type of IP held by the Swiss company. In addition to IP income, the reduced tax rates also apply to all other income, e.g. trading income, which is derived from international (foreign) activities.

As of 1 January 2011, the canton of Nidwalden has introduced the "licence box" system. With this currently unique system in Switzerland, IP companies located in Nidwalden benefit from a cantonal tax rate on (domestic or foreign) net licence income reduced by 80 per cent. The effective corporate income tax rate (including federal tax) amounts to 8.8 per cent. The definition of licence income is based on article 12(2) OECD model convention.

A further option is the set up of a principal company which holds the IP in Switzerland. This requires a substantive, and not just contractual, reallocation of functions, risks, IP and income. A foreign branch exemption applies in such a set-up if foreign sales entities are operating under a limited risk buy–sell arrangement. Such structures may result in an effective overall tax rate as low as approximately 5

34 For further details, see Harun Can, "How Nidwalden's competitive licence box regime works", *International Tax Review* February 2012, from http://www.internationaltaxreview.com/Article/2981262/How-Nidwaldens-competitive-licence-box-regime-works.html; Günter Schäuble, Reto Giger, *Lizenzbox in Nidwalden – Ein Steilpass für andere Kantone und den Bund*, *Der Schweizer Treuhänder* 10/10, pp. 711 et seq.

per cent. Due to their reasonable functions, qualified personnel, business substance and activity in Switzerland, such structures make it (if correctly implemented) more difficult for foreign countries to attack them. Switzerland is, in contrast to other typical CFC locations, a location for "real" business functions, with a stable environment, highly qualified workforce, located in the centre of Europe, between the American and Asian time zones and providing significant non-tax reasons for a Swiss establishment. This also results in the creation of jobs and economic growth in Switzerland and is therefore more beneficial than the mere application of CFC rules for taxation purposes (see below section 4). The excellent quality of local suppliers of high-tech products and the Swiss flexible employment market and employment law are also clearly regarded as advantageous. The high degree of security and political stability, as well as the supportive approach taken by the Swiss authorities, further contributes to the attractiveness of the country as a business location.

3.5. Burden of proof

The general rule for the burden of proof in Swiss tax law is as follows: facts giving rise to a tax liability or increasing the tax liability must be evidenced by the tax authorities; facts justifying a reduction in the tax base or excluding a tax liability must be evidenced by the taxpayer.

These general rules also apply for foreign passive income. For the unlimited tax liability of a person the tax authority must present evidence or indications which are appropriate for giving sufficient probability for such tax liability.[35] The taxpayer then must present facts to rebut this probability; general arguments do not suffice.

In case of an abuse of law, the tax authorities generally bear the burden of proof. The distinction between permitted tax planning and abuse of tax law, however, can be difficult. A taxpayer is generally entitled to act economically in such a way that minimal taxes are triggered (permitted tax planning) and the tax consequences are generally based on the chosen legal structure. The latter is, however, not decisive in case of an abuse of law. For an abuse of law, it is generally sufficient for the tax authorities to show that the transaction was unusual or abnormal to achieve the intended economic goal and no other reasons than tax reasons can be seen (conclusive indications). It is then the task of the taxpayer to provide counter-proof for such other reasons or show that the transaction is not unusual.

Similar rules have been stated by the Federal High Court for the burden of proof for hidden dividend distributions, which have to be evidenced by the tax authorities.[36] However, for cross-border payments, stricter rules apply, as the tax-

35 The place of effective management can also be decisive in intercantonal, domestic cases. Other than in the case of an abuse of tax law, the motives (tax reasons) are not relevant, only the actual circumstances of the place of management, cf. StE 1986 ZH A. 24.22 No 2 (Federal High Court of 5 September 1985), StE 1999 BE A. 22.22 No 3 (Federal High Court of 29 April 1999).

36 Cf BVGE 2011/45, A-629/2010 of 29 April 2011. The indication for a benefit for the shareholder or related parties is sufficient where no other reasons for the unusual relationship can be seen. The taxpayer can then prove the commercial justification. See also Federal Court, 2C-76/2009 of 23 July 2009, 2C-265/2009 of 1 September 2009 where the hidden dividend distribution or benefit in kind (*geldwerte Leistung*) is seen as a tax increasing fact which has to be evidenced by the tax authority.

payer needs to evidence, upon request, the exact circumstances and the commercial justification.[37]

4. CFC legislation

Switzerland has no written CFC rules and currently has no known intention of introducing such rules. This can be seen as an advantage and gives more flexibility to the jurisdiction; however, the limited number of court cases and the interpretation of the tax authorities as described above (see section 2.1 above) impose a significant uncertainty on the taxpayer and tax advisers regarding specific requirements or tax consequences. Whereas in the past structures like converters (see section 1.3.2.1 above) could be confirmed in tax rulings, such structures have recently been challenged and, once discovered by the tax authorities, disapproved of (usually for future tax periods only).

As the current trend of the tax authorities develops to give more scrutiny to certain cross-border structures of Swiss companies, more business reasons, substance and functions should be established in foreign establishments. A solid set-up, e.g. qualifying for a foreign branch exemption, can and should still be confirmed with the tax authorities in an advance tax ruling.

Despite the apparently stricter approach of the Swiss tax authorities to certain cross-border structures, the tax authorities should be aware of the important advantage of no having no CFC legislation in Switzerland. It still remains to be seen whether the objections by the tax authorities will in practice be limited to specific (anti-abuse) cases. In the reporters' opinion, the tax authorities should apply the anti-avoidance rules very carefully in order to preserve the attractiveness of Switzerland as a business location for multinational groups and domestic businesses.

5. General treaty issues

The commentary to article 7 paragraph 14 of the OECD model tax convention states that:

> "the purpose of paragraph 1 is to limit the right of one Contracting State to tax the business profits of enterprises of the other Contracting State. The paragraph does not limit the right of a Contracting State to tax its own residents under controlled foreign companies provisions found in its domestic law even though such tax imposed on these residents may be computed by reference to the part of the profits of an enterprise that is resident of the other Contracting State that is attributable to these residents' participation in that enterprise."

Switzerland, however, considers that CFC legislation may, depending on the relevant concept, be contrary to the spirit of article 7.[38] The OECD model tax conven-

[37] BGE 2C_88/2011, 2C_89/2011 of 3 October 2011.
[38] See cipher 27.9 of the commentary on para. 1 of the OECD model tax convention.

tion and respective double tax treaties should eliminate international double taxation which occurs when the same income is taxed in the hands of the same taxpayer in more than one state during the same period of time. However, this does not cover economic double taxation where the same income is also taxed more than once, but in the hands of different taxpayers.[39]

Hence, for the question of whether the approach of the Swiss tax authorities with regard to cross-border structures (see above section 2) is compatible with the provisions of double tax treaties, it must be analysed whether this approach might lead to international double taxation, or economic double taxation only.

As discussed, the first two approaches are based on a (broad) interpretation of the legal terms "effective management" and "permanent establishment". If a foreign subsidiary is deemed to have its effective management or a permanent establishment in Switzerland, the foreign entity would be subject to tax in Switzerland. If the company is subject to tax in the foreign jurisdiction as well, this approach would lead to an international double taxation.

On the other hand, the approach of the mandate relationship and the general abuse of tax law doctrine generally apply to the Swiss parent company and not the foreign subsidiary. Hence, the additional tax liability at the level of the Swiss entity leads to an economic double taxation only. This should generally be in line with the commentary on article 7 paragraph 14 of the OECD model tax convention mentioned above and should therefore in the reporters' view not be contrary to double tax treaties since the elimination of economic double taxation is not compromised by the convention. An international double taxation can occur, however, where the abuse of tax law doctrine results e.g. in the denial of a foreign permanent establishment.

In case of an international double taxation, the applicable double tax treaties need to be taken into account. In this respect it should be noted that according to the commentary on article 1 paragraph 7 of the OECD model tax convention, the principal purpose of double taxation conventions is not only to promote exchanges of goods and services and the movement of capital and persons by eliminating international double taxation, but also to prevent tax avoidance and evasion. According to the commentary, however, Switzerland does not share the view according to which the purpose of double taxation conventions is to prevent tax avoidance and evasion,[40] as this seems to be in contradiction with the footnote to the title of the model tax convention, which mentions that "states wishing to do so may follow the widespread practice of including in the title a reference to either the avoidance of double taxation or to both the avoidance of double taxation and the prevention of fiscal evasion". On the other hand, the Swiss Federal High Court took the view in 2005[41] that double tax treaties without express anti-abuse provisions include a non-written/implicit anti-abuse provision and as such do not hinder the taxation of tax avoidance schemes (the so-called *Denmark* case).

However, as the focus of the tax authorities is generally on non-tax or low-tax jurisdictions with no double tax treaties in place, this question is not usually relevant for the application of their practice on cross-border structures. Structures with treaty countries (even if favourably taxed, e.g. in Luxembourg) are generally, in the reporters' experience, less scrutinized.

39 Sara Andersson, *CFC rules and double tax treaties*, Jönköping Business School, August 2006, p. 16.
40 See cipher 27.9 of the commentary on para. 1 of the OECD model tax convention.
41 BGE 2A.239/2005.

As said (see above section 4), Swiss companies themselves are often regarded as low-taxed companies from a foreign tax perspective and are therefore subject to foreign CFC legislation. Whether such CFC legislation is compatible with the provisions of double tax treaties must be considered on a case by case basis. As an example, the French Supreme Court decided on 28 June 2002 in the so-called *Schneider* case [42] that the French CFC rules were incompatible with article 7 of the France–Switzerland tax treaty. The profits of a Swiss company could not be taxed in France unless that company had a permanent establishment in France since the article stipulated that tax on profits could be levied only by the country in which the company ran its business. Consequently, tax treaty law was invoked to prevent the application of the CFC rules.

On the other hand, the Swedish Supreme Administrative Court announced on 3 April 2008 a decision[43] to give the Swedish CFC rules precedence over the Swedish-Swiss tax treaty since the CFC rules had been enacted after the double tax treaty. According to the Supreme Administrative Court, incorporation acts and the CFC rules have the same status. The court used the principles of *lex posterior* (acts enacted later take precedence) and *lex specialis* (special acts take precedence over general acts).

Considering this uncertainty, a business set-up with reasonable functions, qualified personnel and substance is highly recommend as structures with sufficient substance and activity in Switzerland make it more difficult for foreign countries to attack them (see above section 3.4).

6. EU law issues

Switzerland is not a member of the European Union. Nevertheless, the GAARs and SAARs applied by the tax authorities in practice described above seem generally to comply with EU initiatives (e.g. on wholly artificial arrangements). However, Switzerland has been put under pressure by the EU about its privileged tax regimes since 2005. The European Commission has decided in 2007 [44] that certain company tax regimes in Swiss cantons in favour of holding, mixed and management companies were a form of state aid incompatible with the proper functioning of the 1972 free trade agreement between the EU and Switzerland. In view of the European Commission, certain tax benefits granted by Switzerland for these regimes qualify as harmful state aid or are viewed as not being in line with the EU code of conduct and therefore lead to a distortion of cross-border competition. Therefore, such tax regimes should be abolished or modified by Switzerland.

Switzerland rejects the interpretation of the EU and argues that the EU code of conduct is not applicable to Switzerland. However, the Swiss government has

[42] Case No. 232276.

[43] RegR 2655-2005.

[44] European Commission, "EU-Switzerland: State aid decision on company tax regimes", press release

offered to the European Commission to start a dialogue about certain controversial topics with regard to corporate taxation.[45]

The discussions are still going on. Although the outcome is entirely uncertain, it is not unlikely that Switzerland will abolish certain tax regimes at some point in time.[46] However, the experience with regard to abolished tax regimes in other jurisdictions (e.g. coordination centres in Belgium or the 1929 holding regime in Luxembourg) shows that a grandfathering period of up to 10 years is not unlikely. In addition, Switzerland may be finally forced to seek alternative solutions due to the pressure to remain competitive. Political discussions about alternative tax regimes which are generally in compliance with EU law and initiatives (e.g. licence box or R&D incentives)[47] or general reductions in corporate income tax rates are in process. It is the reporters' expectation that if Switzerland adjusts its corporate tax system and abolishes the criticized privileged tax regimes, even more attractive taxation models might be introduced in return.

The generally low corporate tax rates, the favourable participation exemption and the extensive treaty network are not affected by the current discussions with the EU. Hence, the general trend of decreasing corporate income tax rates in Switzerland continues. As stated in section 1, maximum ordinary tax rates currently range from 12 per cent to 24 per cent (including federal, cantonal and communal tax) depending on the location of the company and discussions about further reductions are in process on all political levels.

In connection with the discussions with the EU, political initiatives[48] aim for the beneficial EU jurisdiction for EU-based CFC companies (after the *Cadbury Schweppes* decision of the European Court of Justice)[49] to be extended to Swiss entities, to ensure that Swiss entities are not discriminated against by other EU entities (which can also benefit from low taxes or beneficial tax regimes in the European Union). Switzerland aims to remain a competitive tax environment, without being discriminated against as CFC location in the European Union, i.e. it intends to even strengthen its position within the European Union. It remains to be seen how the European Union will react to this approach, if it is brought up in the discussions.

of 13 February 2007, from http://europa.eu/rapid/pressReleasesAction.do?reference=IP/07/176.

45 Staatssekretariat für internationale Finanzfragen SIF, *Unternehmensbesteuerung: Der Dialog mit der EU-Kommission*, from http://www.sif.admin.ch/themen/00502/00759/index.html?lang=de&download=NHzLpZeg7t,lnp6I0NTU042l2Z6ln1acy4Zn4Z2qZpnO2Yuq2Z6gpJCDdXt,gmym162epYbg2c_JjKbNoKSn6A—.

46 For further details, see Stefan Kuhn and Sebastien Maury, "Switzerland reengineering itself to more competitiveness", *International Tax Review*, July 2012, from http://www.internationaltaxreview.com/Article/3068222/Switzerland-Switzerland-reengineering-itself-to-more-competitiveness.html.

47 Andreas Müller, Ralph Graminga and Thomas Linder, "Forschungsstandort Schweiz – mehr Attraktivität durch steuerliche Anreize, Konkreter Vorschlag für die Einführung von steuerlichen Fördermassnahmen", *Der Schweizer Treuhänder*, 2008/10, pp. 803 *et seq.*; Thomas Linder and Andreas Müller, "Steuerliche Anreize für Forschung und Entwicklung, Ein Standortvergleich – Handlungsbedarf für die Schweiz", *Der Schweizer Treuhänder*, 2008/3, pp. 146 *et seq.*; KPMG, *Steuerliche Förderung von F&E in der Schweiz*, 2011.

48 E.g. Daniel Fässler, Motion 12.3585, Eckwerte für allfällige Steuerverhandlungen mit der EU, 15 June 2012, from http://www.parlament.ch/d/suche/seiten/geschaefte.aspx?gesch_id=20123585; Hannes Germann, Motion 12.3636, Klare Eckwerte für Steuerverhandlungen mit der EU, 15 June 2012, from http://www.parlament.ch/d/suche/seiten/geschaefte.aspx?gesch_id=20123636.

Addendum – 15 February 2013

With the decision of 12 October 2012 (2C-708/2011), published on 1 February 2013, the Swiss Federal High Court decided on the tax treatment of a financing branch of a Swiss company located in the Cayman Islands. The Swiss company's purpose consisted of services, in particular the financing of group companies. This activity was performed in a branch in the Cayman Islands with four part-time employees (20 per cent each) in rented offices. Based on a ruling with the cantonal tax authorities, the net finance income was fully allocated to the branch and – in line with the unilateral, domestic branch exemption according to Swiss tax law – not subject to Swiss cantonal, communal and federal income tax. The Swiss Federal High Court ruled, however, that the (financing) activities of the branch in the Cayman Islands did not constitute a foreign permanent establishment and did therefore not justify a corresponding profit allocation. As a result, the whole profit would be subject to (federal) tax in Switzerland. Due to the protection of confidence established by the tax ruling for cantonal, but possibly also for federal, tax purposes, the lower tax court has now to decide as of which point in time the different profit allocation may be applied for.

In the decision at hand, the Swiss Federal High Court discussed first the definition of a permanent establishment according to Swiss tax law in general. Although the legal definition of a permanent establishment is stated in the paragraphs constituting the limited tax liability in Switzerland, but is not defined in the following paragraphs regarding the exemption of foreign permanent establishment profits, it shall be nevertheless a consistent term according to the Swiss Federal High Court. Based on this term, a permanent establishment is defined as a fixed place of business in which the business activity of an enterprise is wholly or partly performed. Whereas the fixed place of business with office and employees in the Cayman Islands was given, the Swiss Federal High Court denied the business activity in the case at hand.

As already discussed (see above section 1.3.1.1), such strict requirements for the qualification as business are based on the intention to limit the tax exemption of foreign business activities in outbound scenarios. The Swiss unilateral rule to exempt income from a foreign permanent establishment applies irrespective of a double tax treaty and applies also to foreign "tax haven" jurisdictions. However, in inbound cases, the assumption of a Swiss permanent establishment usually does not need to meet such strict criteria, as e.g. a Swiss finance branch does not need to show – from a Swiss perspective – a business activity to be taxed in Switzerland. In the present case, the Swiss Federal High Court applied unfortunately such a distinction between a Swiss and a foreign permanent establishment: the Swiss unilateral rule to avoid double taxation should rather be construed to the benefit of a Swiss taxation right as double tax treaties would ensure a limitation of such a taxation right. Further, based on a teleological view, the unilateral rule to exempt foreign permanent establishment profits should reduce the risk of double taxation, but also avoid, to the extent possible, double non-taxation. Thus the requirements for a foreign permanent establishment should be higher and in the case at hand, the necessary substance and business activity were not fulfilled. In our view, a different qualification of a business or permanent establishment for outbound and inbound cases is not in line with the Swiss tax law and cannot be justified with a teleological interpretation. The same criteria for inbound cases should also be applicable for outbound cases. If an activity would justify a Swiss permanent establishment if pursued in Switzerland, the same activity should qualify as a foreign permanent establishment if performed abroad.

The Swiss Federal High Court explicitly stated that this result was not based on a "group taxation" approach, i.e. an allocation of profits to the parent of a group. In addition, the question of whether the structure could be seen as an "abuse of tax law" (see explanation in section 2.1.4 above) was irrelevant in the case at hand according to the Swiss Federal High Court. It is unclear whether the Swiss Federal High Court introduced a new method to attack foreign passive income with its reference to a "group taxation" approach as such argumentation has not been applied so far (see section 2.1 for methods to tax foreign passive income).