13. The Swiss Answer to BEPS (Part I)

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"Courage is grace under pressure."
— Ernest Hemingway

Introduction

The world economy has never been as global and interconnected as nowadays.

International taxation is very much impacted by this global trend, creating genuine business opportunities while at the same time making tax planning even more challenging. CFOs and Directors of Tax of multinational companies (MNC) are also under pressure from different stakeholders to maximize profits by reducing costs. One item of expenses that is regularly scrutinized is the effective tax rate. For a few years, while under pressure to drive down the effective tax rate, MNCs are also regularly scrutinized by major media outlets. Leaks from Luxembourg have triggered discussions at the highest level in the European Union (EU) and the Group of Twenty (G20). More recently, leaks from Panama have led to finger pointing and accusations of tax abuse at celebrities and government officials. While taxes were in the past a subject being primarily discussed amongst tax practitioners, the wider public has discovered this topic as well. However, the discussion in the public arena takes a very generic, not at all legalistic approach, extremely emotionally and result driven. In other words, the feeling that something cannot be right, even if perfectly in line with the law, is decisive. A discussion that has left the path of a scientific approach is difficult to win.

Many foreign states, motivated by budget deficits and public demands that "everyone pay their fair share of tax" are calling for greater transparency into the global tax details of MNCs, in many cases pursuing this with unprecedented resolve. As a result, G20 Leaders commissioned the Organization for Economic Cooperation and Development (OECD) with drafting an ambitious and comprehensive Action Plan in September 2013 aimed at preventing the alleged abusive "base erosion and profit shifting" (BEPS). The OECD's BEPS Project Final Reports (BEPS Report) were released in October 2015 and include 15 "Action Items".

For a few years, the international community has on a recurring basis voiced some concerns that some of Switzerland's tax regimes could be considered to be ring-fencing. Those features have certainly contributed to make the country such an attractive jurisdiction for MNCs. Since 2005, the EU initiated a "discussion" with Switzerland which has led to a series of planned tax amendments, called Corporate Tax Reform III (CTR III).

In this article, we will consider whether Switzerland will be able to maintain its attractiveness for MNCs in light of CTR III and its response to Actions 1-6 of the BEPS Report, excluding detailed analysis of the exchange of information provisions from Action 5 and the respective potential effects on Switzerland.

Swiss Response to the New Standards

Switzerland has enjoyed being an attractive location for MNCs for its appealing political, infrastructural, social and tax aspects. Some of the attractive features have been around for more than half of a century. The time has come to update its tax legislation and to adapt to the new international standards.

Some aspects of the Action Items from the BEPS Report are already covered to a certain extent by Swiss tax legislation. For instance:

- Prevent treaty abuse (Action 6): Switzerland introduced already in 1962 some form of a limitation of benefits clause by way of a decree[1)];
- Neutralizing the effects of hybrid mismatch arrangements (Action 2) since the participation exemption is not available if the revenue is deductible in the source country[2)];
- Limit base erosion via interest deduction and other financial payments (Action 4) by introducing thin capitalization rules in 1997[3)].

Nevertheless, several recommendations from the BEPS Report will require Switzerland, like many other participating countries, to make further amendments to its current tax system even beyond the planned changes provided by CTR III. Two examples which are urgent and have a clear commitment from participating countries include exchange of information on tax rulings and country-by-country reporting.

Under CTR III, Switzerland will abolish its current principal, Swiss finance branch, holding, domiciliary and mixed company regimes each of which is being criticized by the EU and OECD, replacing these with new compliant tax incentives.

CTR III, which was initiated in 2013, has already progressed from a consultation draft through parliamentary discussion.

The main measures suggested under the current version of the CTR III package include a patent box and research and development (R&D) super deduction, a notional interest deduction (NID), a uniform treatment for situations where companies lose their special regime and also when assets and liabilities are "on-shored", and a general reduction in statutory corporate income tax rates at a cantonal level.

Closer Look at Actions 1-6 of the BEPS Report and the Current or Expected Swiss Response

Action 1. Addressing the Tax Challenges of the Digital Economy

According to the OECD, "while the digital economy and its business models do not generate unique BEPS issues, some of its key features exacerbate BEPS risks"[4)].

The work with respect to Action 1 will be continued, based on the outcome of other BEPS measures that are expected to mitigate some risks linked to the digital economy. A report in this regard should be produced by 2020.

Therefore, Switzerland as well as other countries is not currently expected to make changes specifically in response to Action 1.

In addition, it should be taken into consideration that the unilateral definition of what constitutes a permanent establishment (PE), is already relatively broad. According to Swiss domestic law, it is defined as a fixed place of business, which is wholly or partially engaged in the business activities of an enterprise, in particular: branches, manufacturing plants, workshops, sales offices, permanent agencies, mines, building sites or constructions or installations projects, if it lasts for at least twelve months[5)]. In addition, in a long-standing series of cases, the Swiss Federal Court has defined PE as a fixed place of business through which an enterprise engages in an essential qualitative and quantitative part of its technical or commercial activity[6)]. The creation of a PE by foreign enterprises is therefore usually curtailed by the treaties. Switzerland's double tax treaties generally follow the OECD Model Tax Treaty. Should the OECD Model Tax Treaty or the interpretation of its Article 5 change then the Swiss tax practice is expected to follow the new approach unless - of course - if Switzerland makes reservations to the Article or certain paragraphs of the commentary.

Furthermore, it should be noted that specific indirect tax provisions already exist in the Swiss legislation for the supply of digitally provided services. In case of supplying electronic and telecommunication services (e.g. radio and television services, the provision of websites, webhosting, tele-servicing of programs and equipment, electronic provision of software and its updating, as well as electronic provision of images, texts, information, databases, music, films and games, etc.)[7)], a foreign business needs to register for VAT purposes in Switzerland if such services are provided to non-taxable persons in Switzerland and exceed the threshold of CHF 100,000[8)].

Action 2. Neutralizing the Effects of Hybrid Mismatch Arrangements

Hybrid mismatch arrangements may take advantage of differences in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to achieve a lower or non-taxation, including long-term deferral. Structures involving these types of arrangements may lead - as the case may be - to concerns from the OECD's BEPS perspective. Action 2 provides recommendations to address mismatches in form of linking rules that align tax treatment in one country with that in the counterparty jurisdiction, including the rule order, i.e. a primary rule and a secondary or defensive rule. The recommended primary rule is that countries deny the taxpayer's deduction for a payment to the extent that it is not included in the taxable income of the recipient in the counterparty jurisdiction. If the primary rule is not applied, then the counterparty jurisdiction can generally apply a defensive rule, requiring the deductible payment to be included in income or denying the duplicate deduction depending on the nature of the mismatch[9)].

Switzerland has had a rule in place since 1998 to deny a participation exemption on "dividend" income if a payment is deductible in the source country[10)], i.e. income that represents an economically justified expense for the company conducting the payment will not be taken into account for the determination of the participation exemption relief. This rule represents an equivalent of the defensive rule proposed by the BEPS Report.

Further, in accordance with the Swiss tax practice on tax avoidance, three cumulative conditions need to be met in order for a fact pattern to qualify as tax avoidance[11)]:

- the legal structure chosen by the parties is unusual, inappropriate or strange and is in any case not suited to the targeted business purpose;
- the choice of the legal structure was arbitrarily decided only to save taxes compared to a usual and appropriate legal structure;
- the legal structure chosen would effectively result in substantial tax savings, if it were accepted by the tax authorities.

If all three requirements are met, then the tax authorities may disregard the legal structure chosen and apply the tax consequences that would occur if the "usual and appropriate legal structure" would have been chosen. While in the past this rule seems not to have been applied to hybrid mismatches, it could be that in the future, due to the change of the overall perception, the tax authorities might try to scrutinize hybrid mismatch arrangements from this angle.

Action 3. Designing Effective CFC Rules

CFC rules respond to the risk that taxpayers with a controlling interest in a foreign subsidiary can strip the tax base in their country of residence by shifting income into a CFC[12)]. These rules provide for a mechanism for a parent company state to tax profits of a foreign subsidiary before its distribution. The BEPS Report provides recommendations only, rather than minimum requirements.

There are no current plans for Switzerland to change its treatment of CFCs. Currently, under the general rule, the income of a CFC of a Swiss company would not be taxed in Switzerland before making a distribution unless the CFC's place of effective management is in Switzerland, has a PE in Switzerland or the structure is set up purely for tax avoidance purposes[13)]. Further, Switzerland's generally competitive corporate tax rates do not motivate companies to shift profits to lower tax jurisdictions.

Action 4. Limiting Base Erosion Involving Interest Deductions and Other Financial Payments

MNCs may structure their intra-group financing such that interest deductions are available in high tax jurisdictions while the corresponding interest income is recognized in low or zero tax jurisdictions. The BEPS Report responds to this by recommending a fixed ratio rule which limits an entity's net interest deductions to a percentage of its earnings before interest, taxes, depreciation and amortization. As a minimum, this should apply to MNCs.

There are currently no expectations that Switzerland should change its existing rules in this regard, notably because Switzerland already has thin capitalization rules which apply to transactions between related parties. The SFTA issued safe harbor guidelines[14)] where the allowed debt level is determined based on the book value of a company's assets, unless a justification of a higher fair market value could be provided. Moreover, the SFTA has a long standing history in publishing annually safe harbor interest rates for intercompany financing.

Last but not least, it is interesting to note that the representatives of the cantons are requesting in the context with CTR III a rule that would limit the benefits of the tax regimes (patent box, R&D super deduction, NID and potentially the step-up)[15)] to the threshold of 80%. In other words, at the level of cantonal and communal tax a minimum level of income tax should remain payable.

Action 5. Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance

The focus of Action 5 is to better realign taxation of profits with substantial activities. This includes improving overall transparency through a ruling exchange between countries and a review and assessment of preferential regimes in view of the so-called nexus approach.

A spontaneous exchange of rulings was agreed by Switzerland and according to current planning Switzerland would start spontaneously exchanging information from January 1, 2018 onwards with respect to rulings (but not the rulings themselves which could be exchanged only upon a separate request for assistance) granted from January 1, 2010 that are still in effect on January 1, 2018.

Switzerland is already prepared to align with the international community with respect to addressing preferential tax regimes. For this purpose the planned CTRIII is expected to replace current regimes by introducing the following features:

- NID at federal and cantonal levels;
- Patent box compatible with the international nexus approach;
- R&D incentive through super deduction of R&D expenditures;
- Reduced rate to be applied to the revenues generated by built-in gains realized during a certain period of time after the abolishment of the privileged tax regimes (sometimes referred to as step-up);
- Reduction of cantonal income tax rates.

The proposed measures are not new to the international tax community. NID is an internationally agreed concept already introduced in countries like Belgium, Italy, Liechtenstein and Luxembourg. Patent box regime exists in 12 European countries (e.g. Cyprus, Malta, and the United Kingdom). However, according to the work conducted by the Commission, none of them currently complies with the nexus approach. R&D expenses super deduction is known in countries like Belgium, Croatia, Hungary, Singapore, South Africa, Brazil, China, etc. and is generally accepted since encouragement of R&D is a legitimate tax policy goal. The step-up in tax basis also does not represent a tax novelty as it is already stated in most of the Swiss cantonal laws that built-in gains may become taxable upon the change of a company's tax status from ordinary to preferential[16)]. In other words, the step-up in tax basis in the opposite case follows from the law.

Action 6. Preventing the Granting of Treaty Benefits in Inappropriate Circumstances

Treaty abuse and in particular treaty shopping, is one of the main BEPS concerns. As a remedy, it was decided to introduce an anti-abuse provision in the treaties, including a minimum standard to counter treaty shopping.

As mentioned above under Action 2, according to the Swiss domestic tax law and practice, there is a general concept of tax evasion. In addition, there is a more particular set of provisions of the 1962 Abuse Decree applied in situations[17)] when a non-qualifying person claims an unintended benefit under a double tax treaty. The latter set of rules is not applicable to treaties to the extent they contain even more far-reaching rules regarding specific anti-abuse provisions (e.g. substance requirements, anti-conduit rules, subject to tax requirements, beneficial ownership rules). This follows from the general principle that provisions of double tax treaties prevail over domestic law should they be more restrictive.

Switzerland has started to propose introducing the anti-abuse clauses recommended by the OECD in its treaties negotiations. Switzerland is also participating in the preparation of the multilateral instrument which should be able to amend all treaties simultaneously and which seems to be a very ambitious goal. It remains to be seen to what extent this may be achieved.

As a conclusion: Is Switzerland still a competitive location for MNCs?

Switzerland is on the verge of losing many of the attractive tax regimes which have been a significant draw for MNCs for more than 50 years. However, most of the competing countries are facing similar issues. The time has come for Switzerland to think about the future path and how to walk alongside.

The most sustainable, attractive and effective solution is reducing the effective tax rates. However, more advanced and elegant measures are also required in order to accommodate the needs of all the mobile activities. Switzerland is trying to offer the MNC-friendly yet stable elements of CTRIII while complying with the new international standards. At the same time, it retains all the advantages that business appreciates so much: political and legal stability, quality of life, infrastructure, good faith relationship with the tax authorities and many others.

1) Federal Decree on Measures Against the Improper Use of Tax Treaties concluded by the Swiss Confederation dated December 14, 1962 (1962 Abuse Decree)
2) Federal Direct Tax Law (FDTL) Art. 70 (2) let. b
3) Circular letter no 6 issued by the Swiss Federal Tax Administration (SFTA) on hidden equity of corporations and cooperatives dated June 6, 1997
4) OECD/G20 Base Erosion and Profit Shifting Project. 2015 Final Reports. Executive Summaries (Executive Summaries). Action 1. Pages 5-6
5) FDTL Art. 4 (2), 51(2)
6) Federal Court Decision 110 Ia 190, 193 as of November 2, 1984
7) Value Added Tax (VAT) Ordinance, Art. 10 (1)
8) VAT Law Art. 10 (2) let a, b
9) Executive Summaries. Action 2. page 10
10) FDTL Art. 70 (2) let. b
11) Federal Court Decisions 131 II 627 as of August 9, 2005; 2A.470/2002 and 2A.473/2002 as of October 22, 2003
12) Executive Summaries. Action 3. page 13
13) Federal Court Decisions 131 II 627 as of August 9, 2005; 2A.470/2002 and 2A.473/2002 as of October 22, 2003
14) Circular letter no 6 issued by the SFTA on hidden equity of corporations and cooperatives dated June 6, 1997
15) Please refer to a more detailed explanation of the nature of a step-up under Action 5
16) Federal Court Decision 2C_842/2013 as of February 18, 2014
17) 1962 Abuse Decree; Explanatory Circular dated December 17, 1998 revised in 2001 and 2010

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