14. The Swiss Answer to BEPS (Part II)

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On October 5, 2015, the OECD published its final reports under the Base Erosion and Profit Shifting (BEPS) project. Out of the 15 Actions included in the initial BEPS Action Plan only some led to the adoption of minimum standards to be implemented by all OECD Member States. These include amongst others minimum standards relating to the exchange of rulings (Action 5), transfer pricing guidelines (Actions 8-10) and transfer pricing documentation. This contribution will review the position of Switzerland regarding the adoption of these minimum standards.

Action 5 - Exchange of Rulings

The final report on BEPS Action 5 has developed a framework for the spontaneous exchange of tax rulings. In this framework, the report lists five categories of rulings which pursuant to the OECD might give rise to BEPS concerns and should therefore due to their foreseeably relevant character for other jurisdictions be subject to an exchange of information with foreign competent authorities without any specific request from their side.

To date, Swiss domestic law does not allow for such a spontaneous exchange of information. The necessary legal basis therefore has still to be enacted to allow for this mechanism. This process is currently in progress. In 2013, Switzerland signed the Convention for Mutual Assistance on Tax Matters which provides in its article 7 for the spontaneous exchange of information. The Swiss Federal Council in January 2015 initiated a decree allowing for the ratification of the Convention and the amendment of the Swiss law on administrative assistance to introduce the mechanism into Swiss law. As it stands today, the Swiss law is likely to become effective in 2017, also in a scenario where there would be a national referendum.

The framework and the procedures required for the spontaneous exchange of information, including those applying for the exchange of tax rulings have been defined in a draft ordinance issued on April 20, 2016. With respect to the spontaneous exchange of rulings, the draft ordinance refers to the framework set by the final report on BEPS Action 5. This means that in line with the report only rulings providing legal protection on which a taxpayer may rely would be covered. In that respect it should, however, be noted that the term “ruling” is interpreted broadly by the draft ordinance as it does not only refer to a tax ruling in a strict sense, but also to similar documents, provided they are issued at the request of the taxpayer and relate to the tax consequences of the presented facts and circumstances.

Further, rulings would need to fall within one of the five categories listed by the report on Action 5. From a Swiss perspective, the following rulings would mainly fall within this scope: (i) rulings related to one of the regimes to be abolished under the upcoming Swiss Corporate Tax Reform III (domiciliary company, mixed company, holding company, principal company, Swiss finance branch); (ii) patent box regime rulings as exists currently in the Canton of Nidwalden or as anticipated under the upcoming Swiss Corporate Tax Reform III (iii) rulings addressing cross-border transfer pricing, also when issued in line with the OECD Transfer Pricing Guidelines, (iv) permanent establishment (PE) rulings and (v) rulings relating to back-to-back loan arrangements, double-dips or any other arrangements leading to a deduction with no corresponding taxation of income at the level of the recipient. From a timing perspective and in line with the Swiss principle of non-retroactivity, only tax rulings issued on or after January 1, 2010 and still applicable after the introduction of the spontaneous exchange of information in Swiss law, i.e. rulings issued as from January 1, 2010 and still valid on January 1, 2018 or rulings granted after January 2018, will be affected by the rule and thus exchanged. The Federal Council would have the liberty to sign supplementary agreements with selected countries, which would foresee an exchange of information earlier, i.e. in 2017. So far, however, no such supplementary agreements have been concluded. The exchange of other rulings will only be possible through traditional forms of information exchange such as in the context of a specific request based on a double tax treaty.

As to the nature of the spontaneous exchange, it is not the ruling as such that will be exchanged. Indeed, the BEPS report only provides for the exchange of a summary of the ruling as well as basic information gathered on the basis of a common template.

This information should in principle be sent to the country of residence of all related parties with which the taxpayer enters into a transaction for which a ruling is granted or which gives rise to income from related parties benefiting from a preferential treatment, the country where the PE is established or the head office resident in case of rulings related PE and the residence country of both the immediate and the ultimate parent company.

The taxpayer will, however, generally be informed about the forthcoming spontaneous exchange of information regarding the ruling they have concluded.

To make a few practical examples, the mixed company ruling, which is still valid on January 1, 2018 and is granted to a Swiss company acting as the European entrepreneur of a US group, which allows the residual profit allocated to the Swiss company to be taxed at reduced effective tax rate, will most likely be exchanged by the Swiss authorities. However, an agreement that would be concluded by a Swiss company to settle a tax audit would clearly not fall within the scope of ruling exchange as it lacks the characteristics of a ruling.

Action 8 -10 – TP Guidelines

The final report on BEPS Actions 8 to 10 amends the OECD TP Guidelines with regard to the definition of the arm’s length standard, intangibles, intra-group services and cost contribution arrangements.

In the absence of specific Swiss transfer pricing legislation the Swiss tax authorities have already in the past applied the OECD TP guidelines in the determination of transfer prices for multinationals. Therefore, unless any specific measure included in the revised guidelines would be in contradiction with existing Swiss legal requirements, the Swiss tax authorities will going forward apply the revised guidelines, which are outlined below.

With respect to the application of the arm's length standard, the revised guidelines provide that if the written contract put in place between related parties is the starting point to delineate their transactions, the conduct of the parties will be essential to confirm said delineation. More specifically, the contractual allocation of a risk and the remuneration thereof to a party will only be sustainable in case this party can exercise meaningful and specifically defined control over this risk and has the financial capacity to assume it. As a consequence, the allocation of non-routine profits to an entity will therefore require substantive decision making functions at the level of said entity. The location of key functional substance will therefore, compared to contractual entitlement, be increasingly important for the allocation of profits as part of a transfer pricing analysis. One example underlined by the revised guidelines in that respect relates to so-called cash box companies, i.e. entities with high capital, but limited or no functionality, which are only entitled to a risk-free return for funding.

The same principles will apply to intangibles. Legal ownership of an intangible does not as such entitle to the return from the exploitation of this asset. Consideration should be given for that purpose to the significant value driving functions related to the development, enhancement, maintenance, protection and exploitation (the so-called DEMPE functions) as well as to the risk assumed and the assets used for these purposes. Allocating all profits of the group intangibles to an IP company that is lacking any substance and the sole function of which is to hold these intangibles is therefore not sustainable under the revised guidelines.

Shifting away from a substance over form approach, the revised guidelines, however, only allow a transaction to be disregarded for transfer pricing purposes when it lacks the commercial rationale of agreements that would be agreed between unrelated parties. Nevertheless, since a transaction can under Swiss tax law only be disregarded in case of tax avoidance, this particular OECD guideline would in principle need to be specifically implemented into Swiss domestic tax law before it can be applied by the Swiss authorities. To date, however, no such project has been initiated.

As to intra-group services, the only substantive change brought by the revised guidelines relates to the introduction of a simplified approach for low value-adding services for which it fixes a cost plus 5%.

Finally, in regard to cost contribution arrangements made between related parties, the revised guidelines state that the contribution of each group member should be appraised at value rather than cost, except in specific circumstances such as for low adding-value services.

Action 13 – TP Documentation

Action 13 of the BEPS Action Plan mandated the development of rules to enhance transparency for tax administrations. As a result, the OECD established a new three-tiered approach for transfer pricing documentation, introducing, besides the master and local file, a Country-by-Country report.

In essence, the Country-by-Country report provides an overview of key financial and tax figures on a country-by-country basis and allows tax authorities to perform a high-level computation of key ratios. Based on the OECD recommendations, multinationals with consolidated group revenues of more than EUR 750 million would be required to report several key indicators and statistics for each tax jurisdiction. Key indicators include revenue, EBT, income tax paid and headcount, allowing tax authorities to map economic activity and substance to reported revenue and tax payments. The Country-by-Country reports should be filed in the jurisdiction of the ultimate parent company, but should this country not require or allow the filing of a Country-by-Country report, then a designated entity in another country needs to file a report. The report should subsequently be exchanged among tax jurisdictions participating in the information exchange.

Switzerland has announced its intention to implement the Country-by-Country report for multinationals with a consolidated revenue exceeding CHF 900 million. The automatic exchange of the Country-by-Country reports with other jurisdictions requires, however, a legal framework. To that purpose, Switzerland on January 27, 2016 signed the Multilateral Competent Authority Agreement on the Exchange of Country- by-Country Reports (CbC MCAA) which sets out the conditions under which the tax authorities of two countries will automatically exchange Country-by-Country reports. The Federal Council has now submitted the CbC MCAA, together with its draft implementing act, for consultation. It will go through the standard Swiss legislative process before entering into force, most likely in 2018. The exchange of the first CbC reports by Switzerland is expected for 2020.

Switzerland will, however, not exchange the Country-by-Country reports with all countries which are party to the CbC MCAA, but will, as allowed by the agreement, choose the countries with whom the exchange will be effected.

As outlined in this contribution, although not going beyond what is strictly required by the OECD or allowed under its legal framework, Switzerland will comply with the minimum standards required by the OECD in terms of exchange of information, transfer pricing standards and transfer pricing documentation. Appropriate substance will therefore, as in any OECD member state, become of paramount importance for all intragroup transactions. The increased transparency created by the exchange of rulings combined with the Country-by-Country reporting will allow foreign tax authorities to identify any Swiss entity that would lack the required substance. However, where careful consideration has been given upfront to risk allocation and it is appropriately reflected in the contractual arrangements and conducts of the parties, taxpayers should not expect their transactions to be challenged by the Swiss tax authorities, nor fear an exchange of their Swiss tax information with foreign authorities, be it through an exchange of rulings or through Country-by-Country reporting.

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