

THE ROLE OF SWITZERLAND IN INTERNATIONAL TAX PLANNING

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When we look at the trends in international tax over the last few years, we see that many jurisdictions have lowered their tax rates – for example, Bulgaria, Cyprus, Ireland, Latvia and Lithuania have tax rates of 15% or less. Such jurisdictions try to attract the mobile activities of companies. Companies, with an international focus and the help of their advisers, may benefit from the tax laws of the different jurisdictions and may structure their corporate affairs in a tax efficient way.

Another trend is the fight against harmful tax competition and the exchange of information between tax authorities. We have all seen the work done by the OECD, the European Union and, quite recently, by the G20. Hence we can conclude that the tax system of a country needs to be recognised by the rest of the world.

Switzerland has traditionally been a top location for individuals and corporations. So what has Switzerland to offer? First, we have continuity of law. This is primarily based on our system of direct democracy, i.e. changes in law take a lot of time: Some law proposals are presented to the people who can vote in a referendum whether or not to accept the proposal. This has also led to a stable and transparent tax system. Second, we have a system of rulings. A ruling is a common understanding of the tax consequences of certain facts between the taxpayer and the tax administration: the taxpayer can approach both the federal tax authorities and the cantonal tax authorities with a complex case and agree on the tax consequences in a binding agreement.

Corporate income tax is levied on three levels: the first level is federal, the second is cantonal, and the third is communal. In Switzerland, the average corporate income tax rate is about 21%. Currently, the most beneficial tax rates are in the Cantons of Obwalden and Appenzell, which have an overall effective tax rate of 12.7%. However, the Canton of Schwyz has recently amended its tax law (to come into effect in 2010), so that in the community of Wollerau the effective tax rate is only 11.3%. Not only do we see an international tax competition but also tax competition between the Swiss cantons. There have even been some suggestions recently that Switzerland should abolish corporate income tax altogether. But the tax haven route is not one which Switzerland is going to follow.

In Switzerland we apply the participation exemption for dividends received, and this extends to offshore dividends, and for capital gains realised from the sale of qualifying participations. Further we generally apply the exemption method, and we have no CFC or any *subject to tax* rule. In 2008, the Corporate Tax Reform No. 2 – the first one was done ten years ago, in 1998; as I said, changes in law happen quite slowly – introduced two further important aspects: The first one is the reduction of economic double taxation of dividends. Before the recent Reform, dividends paid out by a Swiss company were fully taxed in the hands of the individual shareholder. Now, the Reform has introduced a tax relief for individual shareholders provided they hold at least 10% of the share capital of the paying company. The second one is the tax-free repayment of shareholders equity. Up to now, only the repayment of nominal share capital has been tax exempt.

Let us look now at some special regimes for companies at the Cantonal level. We have special tax relieves for holding companies, for domiciliary companies and for mixed companies.

The holding company, taking into account the participation exemption for federal tax purposes, is basically not taxed, either at the cantonal or federal level.

The domiciliary company is one which has its commercial activity abroad, and has only administrative activities in Switzerland. Administrative activities could be, for example, the management of intellectual property, factoring or debt collection. There is no cantonal tax on this foreign-source income, but there is federal tax of, effectively, 7.83%.

Domiciliary Company

Alternative 3	
Gross turnover	50'000'000
Cost of Goods	40'000'000
Subtotal	10'000'000
Commissions/Licenses (30%)	3'000'000
Expenses*	150'000
Income Taxes	571'357
Income after tax	6'278'643
Total Tax	571'357

- This option includes payments of commissions (for example to agents) and licenses (e.g. for the use of a brand)
- Payments represent 30% of net profits
- Payments must be commercially justified, no artificial arrangements

* Office, staff, external boardmembers, etc. (assumption)

The diagram illustrates an example. The Swiss domiciliary company purchases goods from a manufacturer in Country A for €40m. and sells them to customers in Country B for €50m., realising a taxable profit of €10m. It pays commission or licence fees of €3m. and €150,000 expenses. At the bottom of the diagram you can see the overall tax due for this example.

A mixed company is one whose commercial activities are, essentially, oriented abroad: if you have more than 80% of your income and expenses abroad, you can apply for special tax treatment as a mixed company, and the taxation of your foreign-source income is done on a percentage basis, whereas the Swiss-source income is subject to ordinary tax. In Appendix I below are some guidelines about the taxation of mixed companies issued by the Canton of Zug.

These special regimes are obviously a thorn in the European Union's flesh. In September 2005, the European Union requested more information about these taxation regimes from the Swiss Government. In December 2005, the European Commission sent a letter arguing that the cantonal tax regime was not compatible with Art. 23(1)(iii) of the Free Trade Agreement which was concluded between Switzerland and the European Union in 1972. The text of this Agreement is in Appendix II. The arguments by the Commission are that the domiciliary and mixed companies provide a form of State Aid and distort competition and trade between Switzerland and the European Union. They based their arguments on the fact that foreign-source income and Swiss-source income are taxed differently. Eventually, they requested from the Swiss Cantons that these special tax regimes be abolished. The Swiss Government obviously has a different opinion on the interpretation of this Free Trade Agreement, and they said that the taxation of companies did not fall within the scope of the Agreement. In addition, they said that the Code of Conduct and the European State Aid provisions did not apply to Switzerland because Switzerland was not a Member State of the European Union, and they also said that the cantonal special tax regimes did not favour certain undertakings or a sector and therefore could not be considered as State Aid. Nevertheless, there have been a couple of rounds of discussions between the European Union and Switzerland in recent months, and this has led to uncertainty amongst investors and

advisers. So, what is going to happen with these special cantonal regimes? Can we still promote them in an international tax planning context? In 2008, the Swiss Government decided to commission a Working Group and to prepare, believe it or not, the next Corporate Tax Reform. I will not go into detail - I have included some pages in Appendix III - but I want to highlight here that one of the recommendations made by the special Task Force “International Tax Competition” is to eliminate the domiciliary company regime. However, they have not mentioned the mixed company, so for advisers that may mean that we have to talk to clients who have domiciliary companies and explore the possibilities of changing the business and transforming the domiciliary companies into mixed companies. However, the situation is not entirely clear, and my personal view is that it will be many years before we have enacted these changes.

Let us move on to some international tax aspects: As is well-known, Switzerland levies 35% withholding tax on dividend payments made by a Swiss company. So, in order to reduce this withholding tax burden, you want to benefit from a double tax treaty or from Article 15 of the EU Savings Tax Agreement. You may for example have a Cyprus company holding the Swiss company. There is no tax treaty between Switzerland and Cyprus, but you may be able to take advantage of Article 15 of the saving tax agreement. In order to benefit from Article 15, one of the important requirements is that you have to hold the participation for at least two years before the benefits are fully granted. Also we have to take into consideration anti-abuse provisions. In the past, the Swiss tax authorities looked at the substance of the parent company. But, recently, they have changed the focus, because they understand that, in a case where a Cyprus company is holding only one Swiss company, you do not actually need a lot of staff to look after this holding, and you do not need a lot of business office space, telephone lines, etc. They are therefore now looking at how the parent company is

financed. The authorities have given some safe harbour rules: If the parent company is financed with at least 30% of equity, then you may benefit from Article 15 or from a double tax treaty (you can also get a ruling to that effect).

A few years ago, the Government became conscious that the country was losing investment fund business to places like Luxembourg, the Cayman Islands or Ireland, and decided to introduce a new law for Swiss investment funds, introducing the limited partnership, the SICAV and SICAF. Unfortunately, the new law has not been a great deal of a success, and the reason for this is that the taxation of private equity and hedge fund managers in Switzerland is unclear. The industry has asked for clarity and the Federal Tax Administration has announced the publication of guidelines in a circular letter, but we are still waiting for these guidelines. The issue with those managers is the following: If you realise a gain following the sale of privately-held assets, the gain is a capital gain and tax-free, whereas if the assets are held as business assets, the gain is regarded as income from self-employment. Hedge fund or private equity fund managers will themselves invest in the funds in order to show to the other investors that they believe in the investments they make. The question then is, whether these shares are privately-held assets, because they are making a private investment, or constitute business assets, because they do this in the course of carrying out their profession as fund managers. The solution suggested by the tax authorities is that you have to look at whether the funds paid out to the fund managers are disproportionate or if they are proportionate. If the funds paid out to the fund managers are disproportionate, this constitutes income from self-employment. If the funds are paid out to fund managers proportionately they may realise a tax-free capital gain. If we have, for example, a fund manager who invests 20% in a partnership and the other investors invest

80%, his 20% participation will be considered proportionate. But if the fund managers invest only 10% but receive a 20% carried interest or performance fee, that will be disproportionate.

In the suggested “loan financing model” assets are contributed to the fund by the other investors by way of a loan or by hybrid instruments, then, when the fund comes to an end, what happens is that, first, the debt is paid back to the other investors, and then the remaining profits are split 20:80 between the fund manager and the other investors – so that the fund manager can still have his gain tax-free.

Another model - the “two-way model” - is to have the fund constituted as a limited partnership of which the general partner is a corporation. The carried interest or the performance fee is paid to the general partner, and the fund manager is either a shareholder or is employed by the general partner – or both – and receives dividends or salary from the general partner. As a result of the Tax Reform No. 2, which I mentioned earlier, a fund manager benefits from this special tax relief on the dividends he receives. So the overall tax burden should amount to between 10% and 30%, depending on the location of the company and on the Canton and Commune in which the fund manager is resident.

You can also use offshore structures when setting up a private equity fund or hedge fund. This has also been considered by the Tax Administration. So, for example, you can incorporate the limited partnership in the Cayman Islands, and you can even base the general partner offshore. The Swiss tax authorities will carry out a function and risk analysis of the activities in Switzerland and offshore; in other words, the authorities allow a certain part of the income to be allocated offshore. Again, you should discuss such a structure before you set it up with the tax authorities and agree on the tax consequences in a ruling.

Exchange of information was a hot topic during the last meeting in Monaco. I just want to give a quick update on recent developments. Once upon a time Switzerland made a reservation to the Commentary of the OECD Model Tax Treaty regarding Article 26. The Swiss said they would only exchange information as is necessary for carrying out the performance of the respective tax treaty. The practice of Switzerland changed following the Report issued by the OECD in 2000 regarding the access to bank information, and also when the Savings Tax Agreement was concluded between Switzerland and the European Union. Switzerland changed its practice and granted assistance to foreign tax administrations for carrying out domestic tax law in cases of tax fraud and the like. There has probably been a lot of discussion about what tax fraud means, and especially what “tax fraud and the like” means. In certain Memorandums of Understanding, which have been concluded between Switzerland and the respective countries with which they have a tax treaty, “tax fraud and the like” is defined, although there has never been any general definition of this expression. However, that is all now history: on Friday, 13th March, our Government announced that Switzerland withdrew the reservation that was made to Article 26 in the past, following the G20 meeting in London. In Appendix IV there is additional information about the announcement and about the consequences that it brings, especially for the financial sectors. From a Swiss point of view, it is important to mention that we do not think that there is any requirement for automatic exchange of information, but only upon a specific request, and – interestingly – the OECD itself refers to “exchange of information upon special request” as one of the forms of information exchange (see Appendix V). If a foreign tax administration approaches Switzerland, they have to come up with a concrete case, so they need to present the name of the taxpayer, they need to say where he is holding a bank account, at what bank and in what location.

Since 13th March 2009, Switzerland has started treaty negotiations with a couple of countries, and at the end of May 2009 it was announced that the first revision of tax treaty has been signed with Denmark implementing the OECD standard regarding Art. 26. Since the revised tax treaty with Denmark entails new obligations to the Swiss Government, the revision will be subject to a people's referendum. That means that we – the Swiss voter – have the possibility of expressing our agreement with this new tax treaty. And I am sure, knowing our political parties, there are going to be a lot of debates in the upcoming days, about whether or not we should agree to the proposed revision of this treaty. We are also just beginning negotiations with Japan, and there are some negotiations going on with the United States, following the pressure by the US Internal Revenue Service on UBS. The IRS is asking for information about 50,000 or so taxpayers that are allegedly holding bank accounts in Switzerland, and the suggestion is that in return for Switzerland agreeing to the OECD standard with regard to information exchange, the IRS should drop the case.