
Swiss tax authorities tightening practice against tax planning structures

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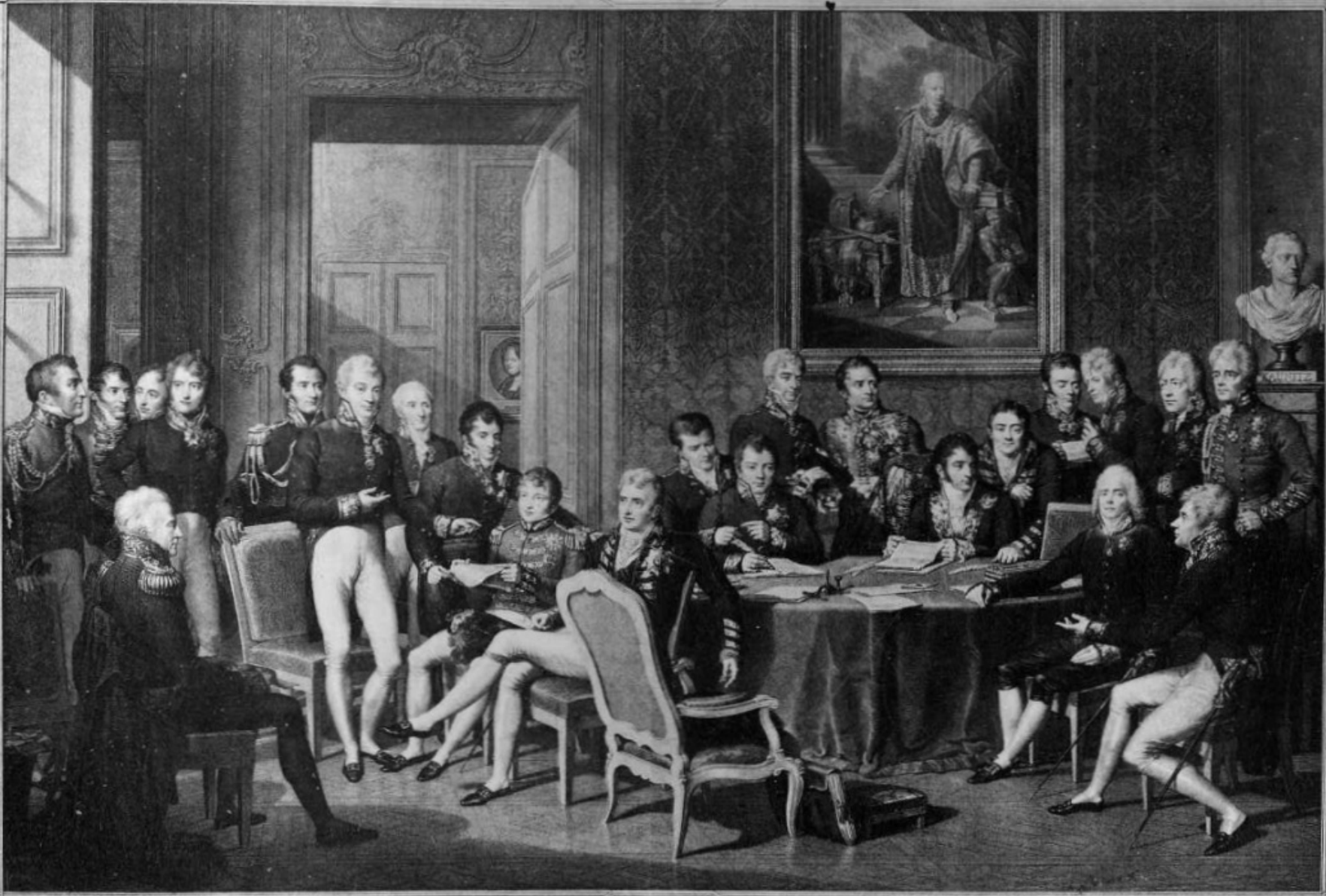
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Introduction



CONGRES DE VIENNE.

SEANCE DES PLÉNIPOTENTIAIRES
DES SEPT PUISSANCES SOUVERAINES
DU TRAITÉ DE PARIS.

Introduction

- At the Vienna Congress 200 years ago, after Napoleon was exiled for the first time to Elba ...
 - A great meeting of government representatives took place, and it put an end to the Revolutionary and Napoleonic threat
 - It restored the prerogatives of the monarchies
 - It reshaped the “world” (i.e. its European part) and drew new boundaries
 - All the relevant actors of the time were involved
 - ... and the Swiss were left alone (more or less, but Swiss neutrality was recognized!)

Introduction

- Today's perceived threats to government “prerogatives” (*i.e.* tax revenues):
 - Globalization
 - Digitalization
 - Economic crisis
 - Bank secrecy and tax evasion
 - Aggressive tax planning

Introduction

- The OECD's BEPS project: Fight against Base Erosion and Profit Shifting
- Concerted effort of the G20/OECD
- Central role played by the media (public opinion-driven)
- Taxation to occur in accordance with economic reality
- Prevent double non-taxation and fight abuses
- “Substance” requirement
- Exchange of information, CRS (individuals AND corporations)
- Address challenges of the digital economy

Introduction

Action 1: Addressing the Tax Challenges of the Digital Economy

Action 2: Neutralising the Effects of Hybrid Mismatch Arrangements

Action 3: Designing Effective Controlled Foreign Company Rules

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

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

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

Action 7: Preventing the Artificial Avoidance of Permanent Establishment Status

Actions 8 – 10: Guidance on Transfer Pricing

Action 11: Measuring and Monitoring BEPS

Action 12: Mandatory Disclosure Rules regarding Aggressive Tax Planning

Action 13: Guidance on Transfer Pricing Documentation and Country-by-Country Reporting

Action 14: Making Dispute Resolution Mechanisms More Effective

Action 15: Developing a Multilateral Instrument to Modify Bilateral Tax Treaties

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Introduction

- Action 5: Countering Harmful Tax Practices More Effectively, Taking Into Account Transparency and Substance
 - Directly relevant for Switzerland
 - Repeal of “tax regimes”, amongst which Swiss Finance Branches
 - Substantial activity requirement
 - Exchange of tax rulings
- Action 5 is a “minimum standard”

Introduction

- Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances
 - Fight “treaty shopping”
 - Principal Purpose Test (PPT), Limitation on Benefits (LOB)
 - «a **benefit** under this Convention **shall not be granted** (...) if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit **was one of the principal purposes of any arrangement or transaction** that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention.»
- Action 6 is a “minimum standard”

Introduction

- Switzerland supports BEPS
- Long-standing tax ruling practice of Swiss tax authorities:
 - Favors a collaborative relationship between taxpayers and tax authorities
 - But: no sophisticated tax litigation culture
 - Few cases make it to court, a lot of “bad” individual cases that gain general relevance to standard cases
- In effect: tax authorities can introduce new practices that are seldom checked in court: taxpayers generally “plan around” it
- Economic approach as a factual method of interpretation of the law: double-edged sword

Tool Box of the Tax Authorities

Tool Box

- Hidden profit distributions
- Economic approach
- Abuse of law theory
- Old Reserves
- Place of effective management
- Beneficial ownership
- Simulation
- Reclassification of income
- Arm's length tax adjustments
- Etc.

Hidden profit distribution (1/8)

1

- Clear disproportion between performance and consideration

2

- A related person is the beneficiary

3

- The disproportion is recognizable for the acting bodies of the company

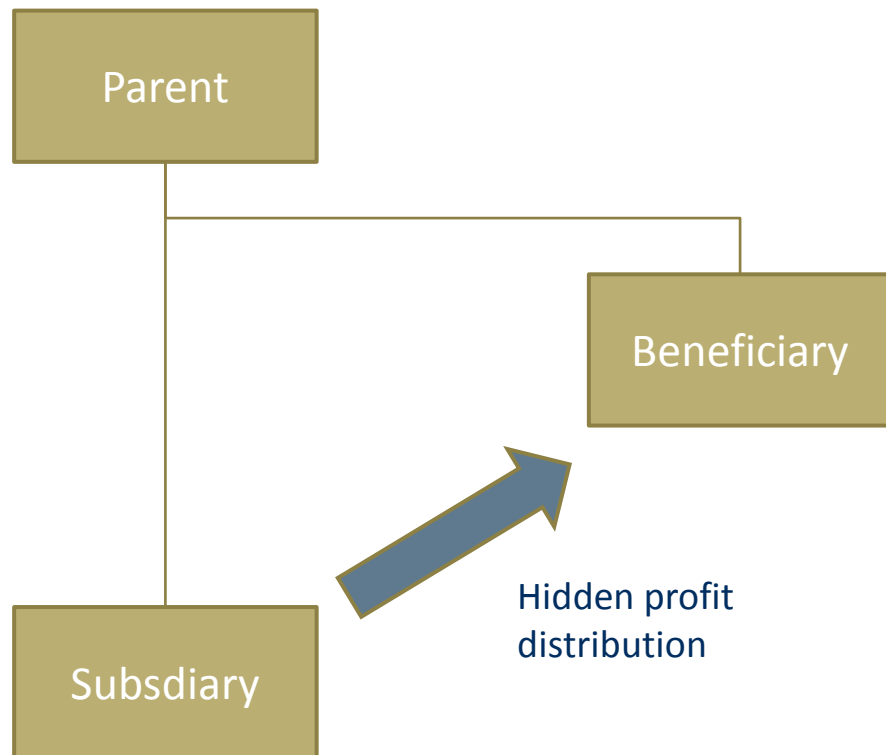
Hidden profit distributions (2/8)

- Consequences

- Primary Adjustment of the taxable income of the company (e.g. no deduction)
- Potentially Corresponding Adjustment on the level of the economic counterparty
- Secondary Adjustment (not necessarily) : Aligning commercial reality with the tax classification, e.g. prepayment etc. Beware of withholding tax consequences (Ruling)
- Triangular theory vs. Direct beneficiary theory
- Tax liability of the board?
- Potential criminal sanctions?

Hidden profit distributions (3/8)

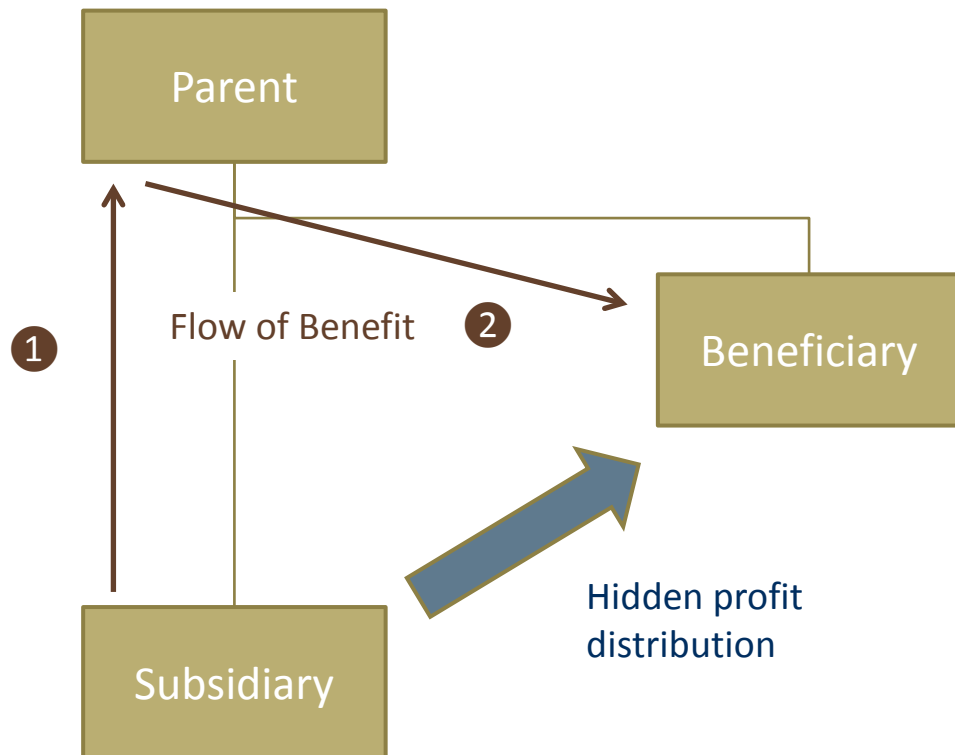
- Consequences



- Hidden profit distribution could be:
 - Excessive interest payments
 - Insufficient remuneration for a service performed by Subsidiary
 - The beneficiary has no economic reality and receives a payment without performing value adding functions (potential tax fraud)

Hidden profit distributions (4/8)

- Consequences

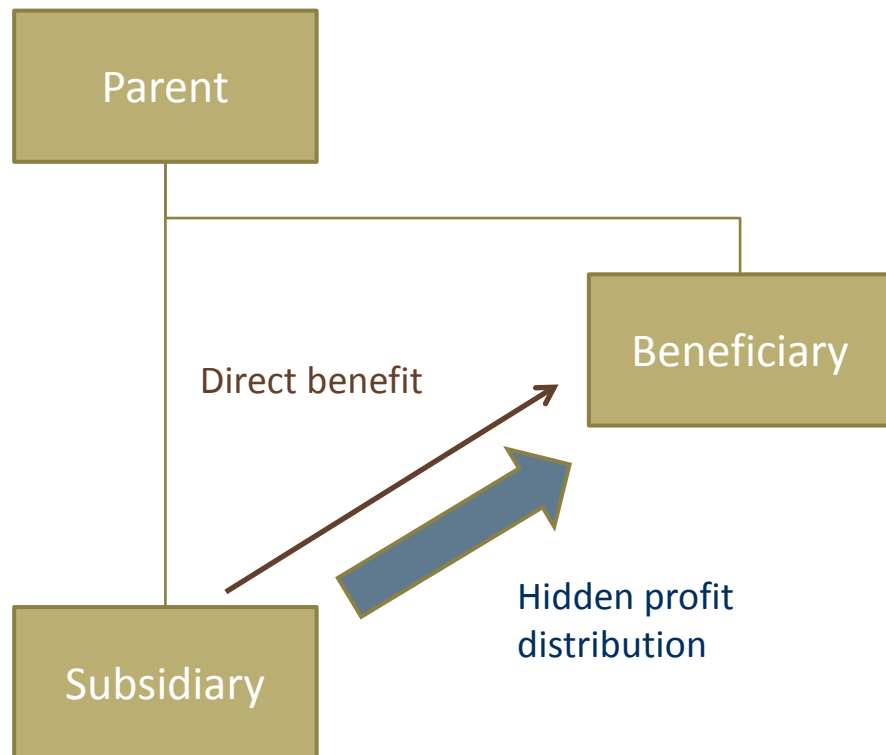


Triangular theory

- «Standard» for income taxes
- No deduction for Subsidiary
- **1** Income for Parent
- Certain exceptions may apply
Parent is corporation holding owns books (amortization)
- **2** Hidden capital contribution to Beneficiary (No stamp duty, no capital contribution reserves)
- If individuals are involved:
potentially gift tax between shareholder and beneficiary

Hidden profit distributions (5/8)

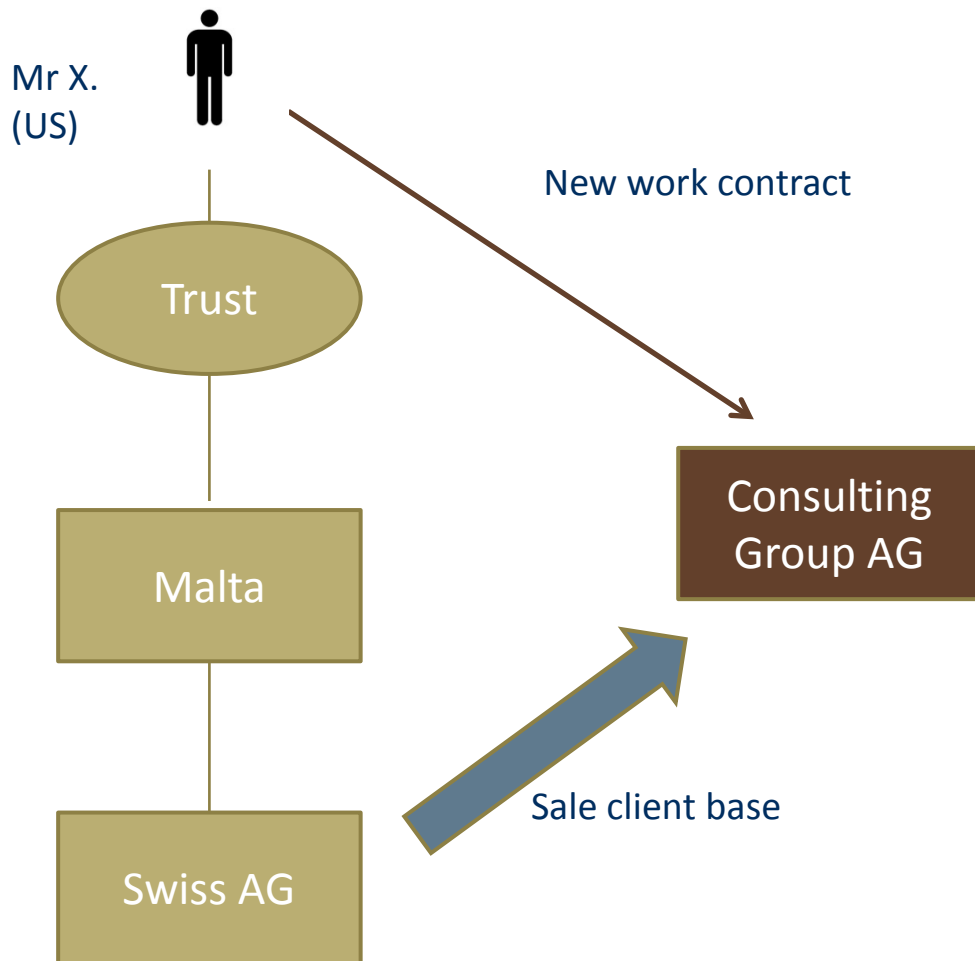
- Consequences



- Direct beneficiary theory for withholding tax purposes
- Economic approach
- Some exceptions (financial assistance)
- Usually detrimental in international / double tax treaty situations

Hidden profit distributions (6/8)

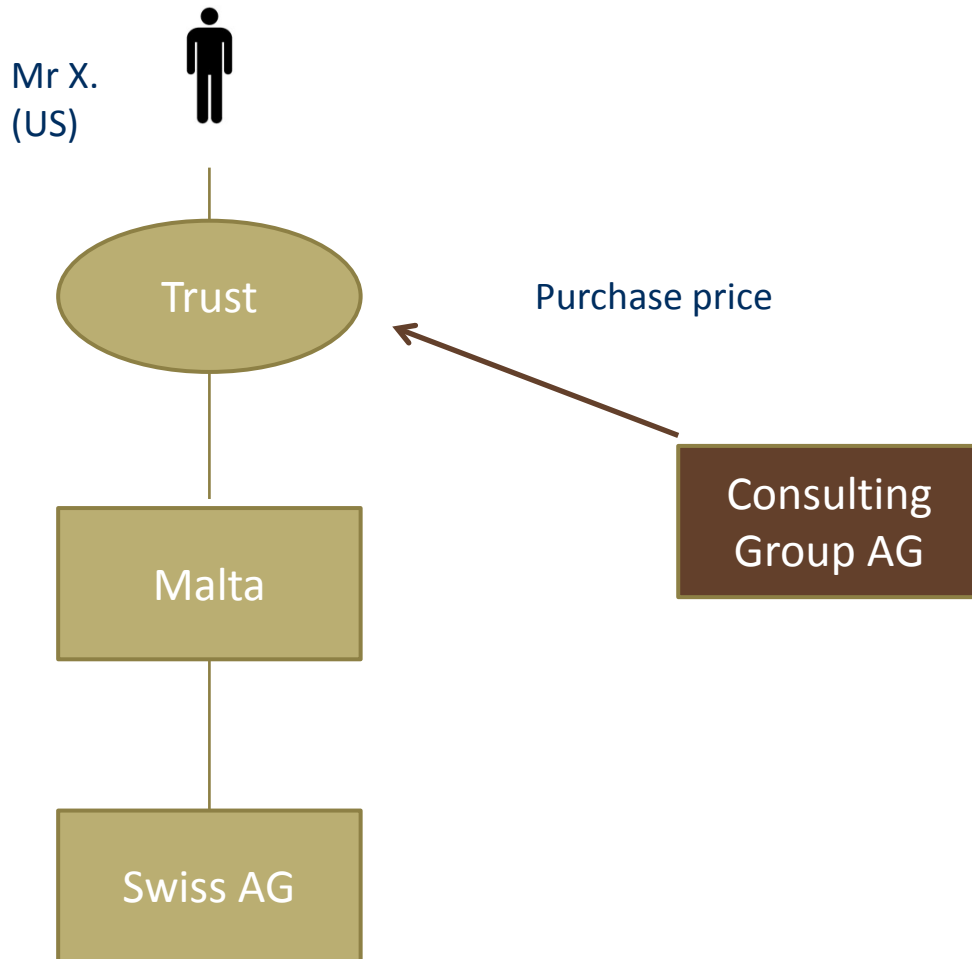
- Sale of client base



- Mr X. is reputed and well-known advisor in his field of activity
- He intends to sell his business to his competitor Consulting Group AG. He will also be hired as a senior employee at Consulting Group AG
- Price for the client base: CHF 3m (= *at arm's length*)

Hidden profit distributions (7/8)

- Consequences



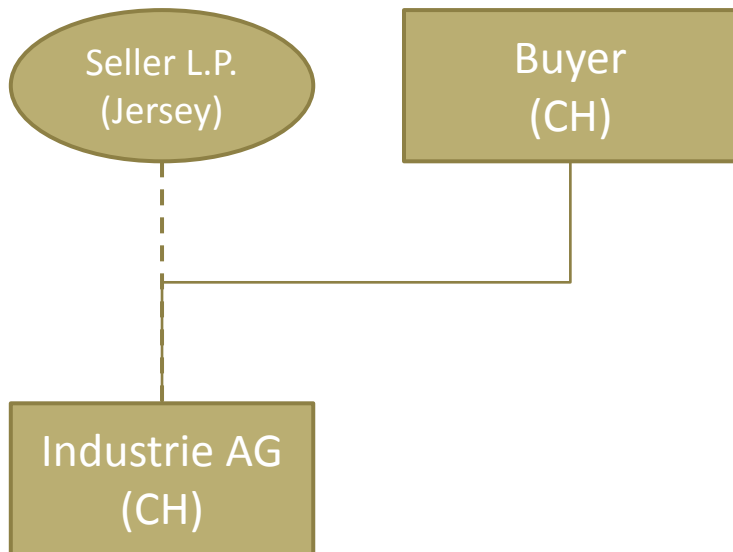
- The following act as Sellers and parties to the agreement :
 - Swiss AG
 - Malta Company
 - Trustee for the Trust
- Pursuant to the instructions from Mr. X, CHF 3 m were wired on 1 October 2016 to the Trustee by Consulting Group AG
- The accountant of Swiss AG has no knowledge of the transaction (client base was not capitalized).
- No profit is recorded in the Swiss books.
- In line with the recommendations of his US lawyer, Mr. X has reported the CHF 3m in his US tax return (Form 1040)
- There is a lot of pressure to liquidate the Swiss AG asap.

Hidden profit distributions (8/8)

- Consequences

- No profit recorded in Switzerland: Typical case of a waiver of income in favor or a related person (= typical case of a hidden profit distribution)
- Tax adjustment on the level of the Swiss company, who is the “real” seller
- Hidden profit distribution to Mr. X.: *Direct beneficiary theory*, DTC CH-USA: Withholding tax of at least 15% (best case)
- Wrong accounts: Tax fraud (corporate income tax, withholding tax)?
- Sale = factual (economic) liquidation? -> Tax liability of the factual liquidator (*i.e.* Swiss board member)
- Taxation in the US is irrelevant from a Swiss perspective
- Before the 2016 tax return is filed in Switzerland: Correction of balance sheet and P/L since not in line with commercial law
- Mr. X: liable to pay compensation to Swiss AG based on civil law
- Further challenge: Tax efficient repatriation of funds through letter box structure

Old Reserves/ Acquisition of a Swiss company

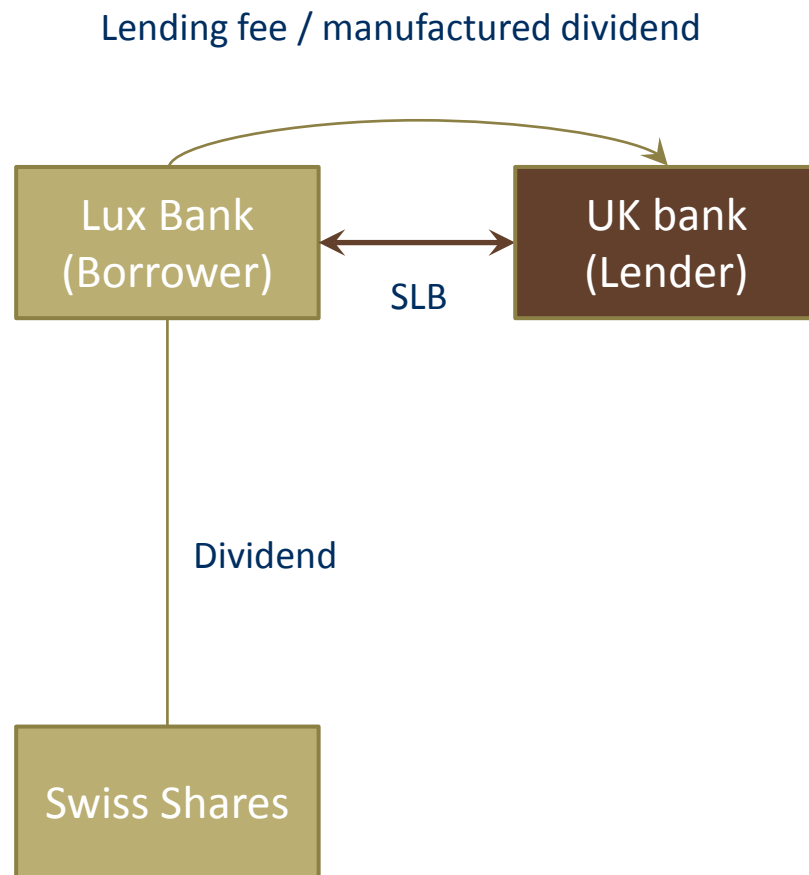


- Seller (L.P.) is a PE Fund based in Jersey. Four years ago, it acquired 100% of a Swiss profit-making industrial company (Industrie AG). Industrie AG produces aircraft components
- Buyer is active in the aircraft industry and acquires Industrie AG for commercial reasons for CHF 40m (value chain optimisation)
- The last financial statements (30.06.2017) of Industrie AG are as follows:

Cash and cash equivalents: 10m	Total liabilities: 12m
Rest of assets: 20m	Share capital plus legal reserves: 2m
	Retained earnings: 16m
Total Assets: 30m	Total Liabilities: 30m

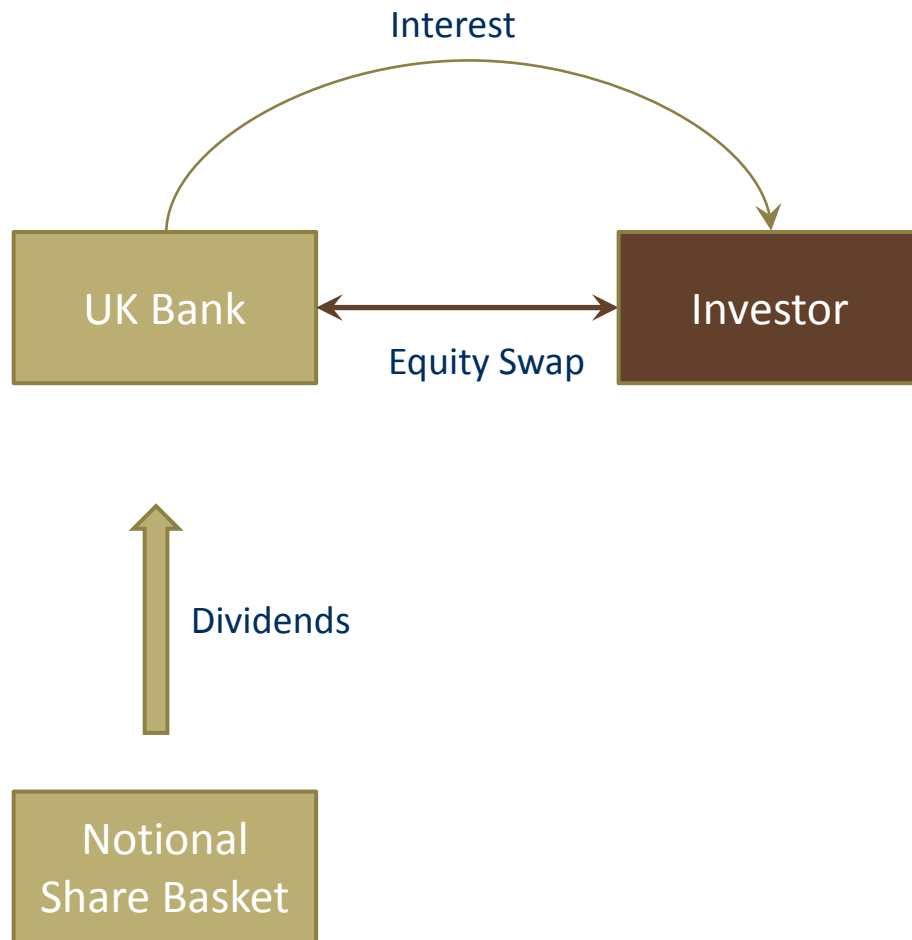
- As per end of the calendar year, Buyer wishes to dividend out excess cash of Industrie AG (8m)
- Swiss WHT on 8m: 2.8m. Is there an issue?

Beneficial Ownership: Securities lending and borrowing



- Long borrowing: Borrowers acquires legal ownership
- Determining factor according to current case law: is there a mutual legal interdependence between the SLB and the holding of the underlying shares?
- Borrower asked for a refund (case now pending at the Federal Supreme Court)
- Under the SLB agreement, the manufactured dividend is due *“irrespective of whether the Borrower received the same ...”*
- SFTA’s circular (2006) letter considers the Borrower to be the beneficial owner.
- Under the new draft (2017) for the circular letter it is proposed version, that it is no longer the Borrower but the Lender who is entitled to the refund of the withholding tax, provided the Lender:
 - shows that the original dividend subject to the withholding has been passed on to him
 - discloses the whole chain of transactions

Beneficial Ownership: Equity Swap



- Swap entered into in 2007/2008
- UK bank to make equalization payments for dividends paid out by equities in the (notional) share basket
- Only one Swiss equity among two dozens others: e.g. UK, that are not subject to WHT. It contained a mixture of dividend-paying and non-dividend paying equities
- Swap lasted for 16 months
- UK bank hedged Equity Swap and purchased underlying shares but had no contractual obligation to hedge its liabilities under the equity swaps over the contract period.
- Effective risk: Sharp decline of share price due to financial crisis, not possible to get rid of it or only with a big loss
- SFTA rejects refund, case is pending at Federal Administrative Court

Beneficial Ownership

- SFTA's main arguments:
 - Lack of beneficial ownership
 - Risk borne is not relevant
 - Conduit structure
 - Lack of cooperation by claimant
- What about other derivative products, where external parties participate in Swiss securities?
- Who is the beneficial owner?

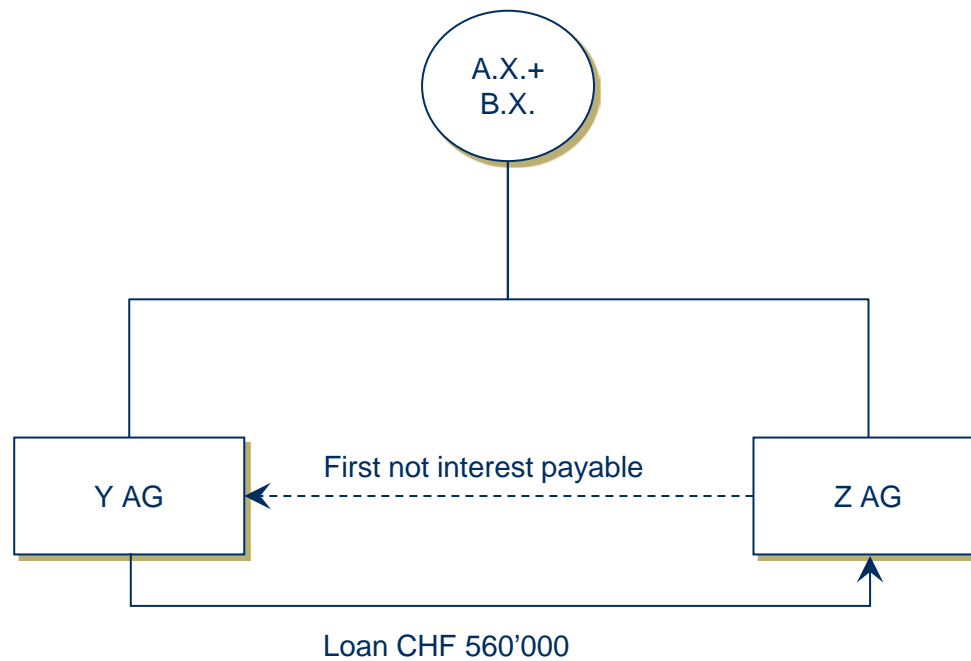
Simulation (1/7)

Facts (BGE/ATF 138 II 57)

- Spouses A.X and B.X. are sole shareholder of the companies Y AG and Z AG
- End 2002 there are loans outstanding granted by Y AG to Z AG in the amount of CHF 560'000
- Some agreements are not in writing, no securities
- In the beginning no interest payable
- Starting 2004 a arm's length interest is agreed
- The loans were capitalized in both companies
- At the time of the Supreme Court judgment all loans had been paid back

Simulation (2/7)

Facts



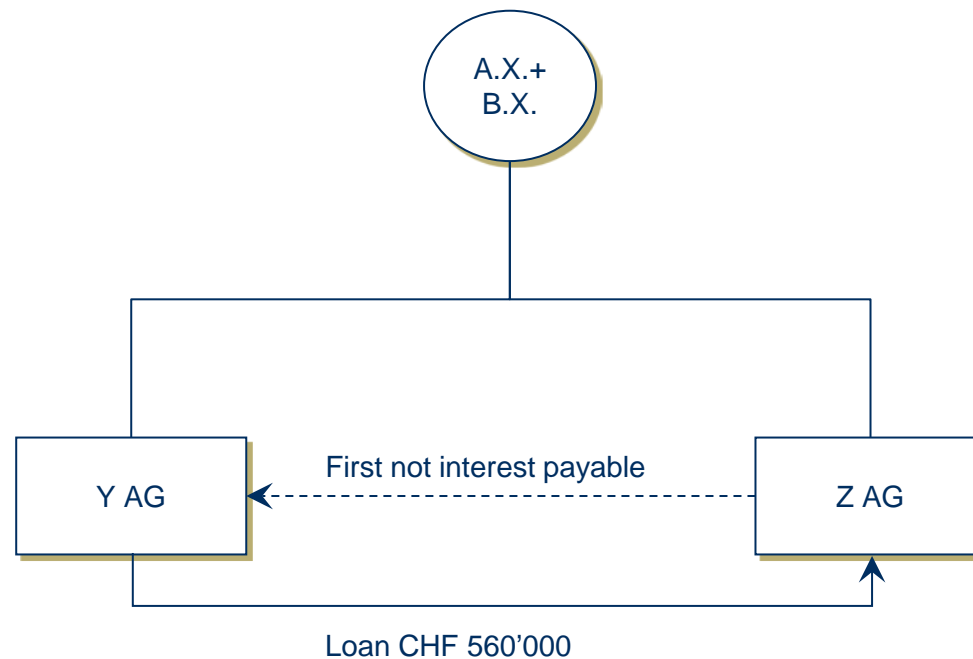
Simulation (3/7)

Position of the tax administration

- “The situation is not in line with the arm’s length principle”
- “The loan of CHF 560’000 was merely simulated, there was a gratuitous transfer from Y AG to Z AG”
- “There was a hidden profit distribution from Y AG to Z AG, which was not commercially justified and non-deductible”
- “Based on the ‘triangular theory’ the common shareholders are taxable on a hidden profit distribution (‘deemed dividend’) of CHF 560’000”
- The subsequent repayment is not relevant

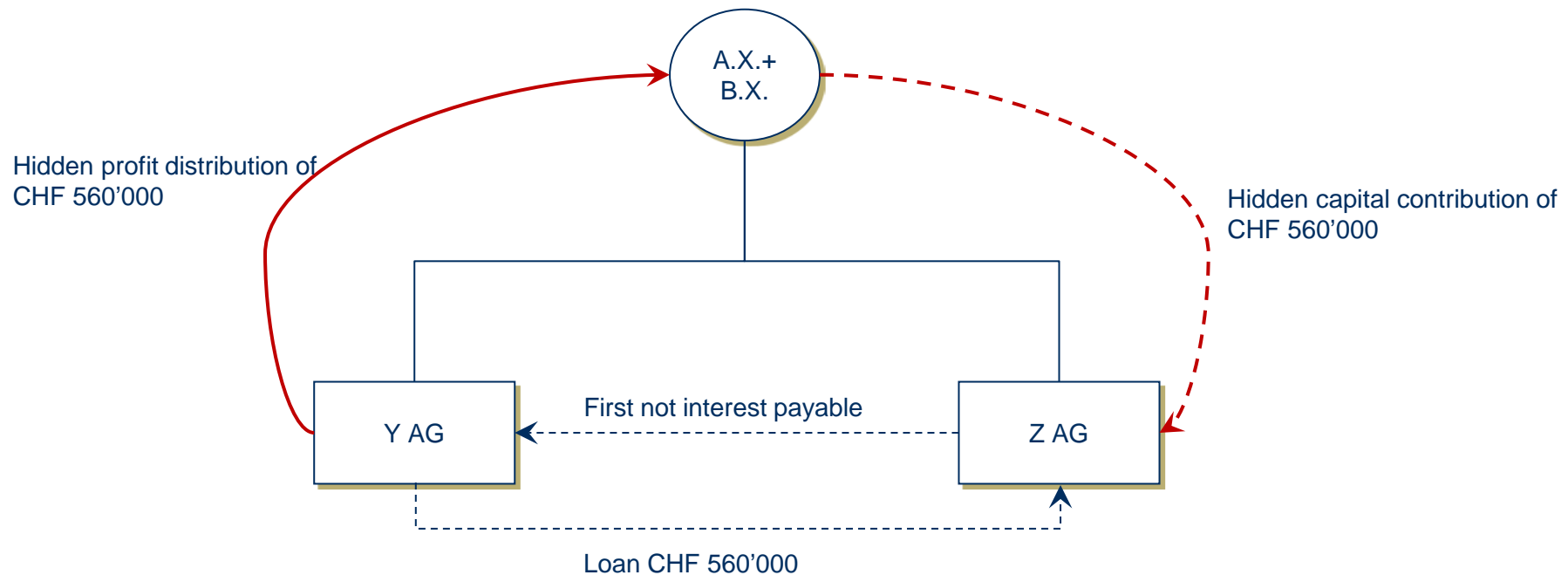
Simulation (4/7)

Facts according to the taxpayer



Simulation (5/7)

Facts according to the tax administration



Simulation (6/7)

Judgement of the Supreme Court

- A loan between sister companies constitutes a taxable profit distribution if the loan is not commercially justified and only exists because the two companies have a common shareholder
- Typical cases of a Simulation:
 - From the outset the repayment is not intended by the parties
 - No accounting of the loan
 - Debtor uses the funds for private purposes
 - The debtor is in such a difficult financial situation that makes it impossible for him to meet his obligations
- The absence of written form is not yet sufficient
- The repayment is indeed relevant for the characterization as a “real” loan

Simulation (7/7)

Judgement of the Supreme Court

- The fact that merely the terms of the loan are not at arm's length (especially interest, securities) does not necessarily lead to a simulation of the loan *per se*
- A simulation can also occur *subsequently* (i.e. in the form an effective waiver), clear indicia must however exist
- Due to the renunciation of an appropriate risk-reflecting interest, the Court found there was indeed a hidden profit distribution that was considered to amount to 6.75% (i.e. CHF 37'800 p.a.): taxable income on the level of the shareholders
- By the way, it is also permissible to assume that the parties are related if the terms and conditions of a transaction substantially depart from what would be usual between unrelated parties (Judgement Supreme Court of 26 October 2012, 2C_565/2011, consid. 4.2.2.)

Case studies / court decisions

- Case I: Effective place of management as ruled by Zurich courts
- Case II: Family Office structure
- Case III: Group financing structure
- Case IV: Offshore asset manager
- Case V: Offshore limited partnership
 - Onshore (EU)
 - Offshore alternative

Case I

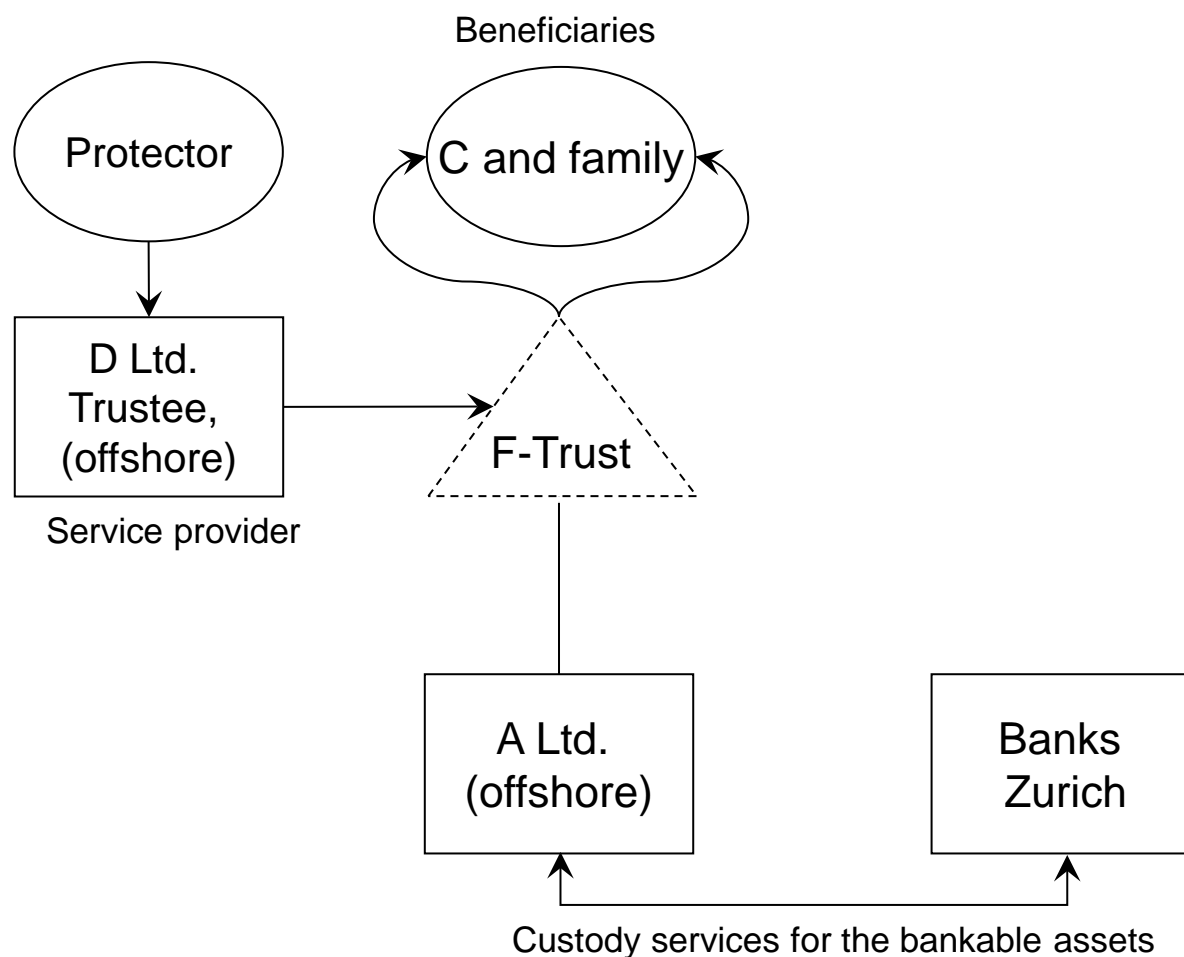
Effective place of management as ruled by Zurich courts (1/7)

(Court decision by the Verwaltungsgericht ZH dated 2 April 2014, SB.2013.00037)

Effective place of management as ruled by Zurich courts (2/7)

- C, resident in the Canton of Zurich, established in 1997 the F-Trust, in order to manage non-declared family assets.
- D Ltd. (offshore) acted as trustee and E, a lawyer, as protector.
- The Trust incorporated A Ltd. (offshore), which was the legal owner of the non-declared assets (e.g. bank account holder, etc.).
- D Ltd. provided the directors and the company secretary, was mandated for the bookkeeping and accounting as well as for any other administrative services.
- In 2010, C and his wife filed a voluntary disclosure with the competent tax authorities in Zurich. The tax authorities assessed that A Ltd. was effectively managed out of the Canton of Zurich respectively at the domicile of C. Consequently, A Ltd. was subject to unlimited tax liability in Switzerland.
- The Zurich *Steuerrekursgericht* rejected on 25.03.2013 the appeals filed by C (DB.2012.293 und ST.2012.330).

Effective place of management as ruled by Zurich courts (3/7)



Effective place of management as ruled by Zurich courts (4/7)

- It has to be decided whether A Ltd. was resident in Zurich due to its effective place of management, in particular as there was only a formal domicile offshore («letter box»).
- The function of the Trust itself was of low interest to the *Steuerrekursgericht* and of no interest at all to the *Verwaltungsgericht*. The Trust was qualified as transparent and C was considered as direct shareholder of A Ltd. («look through approach»).
- The effective place of management follows the fact where the management is effectively carried out. However, it has to be clarified that neither the board of directors / shareholders' meeting nor mere administrative functions (e.g. accounting) duly represent and constitute the management. The scope and daily operations of the management has to be assessed based on the article of purpose.
- With regard to asset management / portfolio companies, the power / authority to dispose over the managed assets is relevant.

Effective place of management as ruled by Zurich courts (5/7)

- The management cannot be delegated to external service providers. The directors had no real powers and were merely installed for formal purposes («window dressing»).
- C had sole power to initiate distributions from the Trust and was entitled to amend the asset management agreements (exchange of the asset manager, change of the investment strategy). Furthermore, he has executed substantial cash transfers from A Ltd. to himself. In that regard, he was part of the daily business operations and acted as a manager; far beyond of just being a board member.
- C met personally at least twice per year the competent relationship manager of the bank (probably in Zurich). Furthermore, C himself had a broad expertise in financial matters which has most likely also been used for private investment purposes (assumed by the court).

Effective place of management as ruled by Zurich courts (6/7)

- The *Steuerrekursgericht* had even brought forward a further argument: The purpose of the company is primarily the holding and custody of (bankable) assets. However, this activity has been delegated to the financial institutions. The company was left with the monitoring of the delegated duties and had to ensure that the performance was in line with the agreed scope. This monitoring function was the «remaining» business activity and was solely performed by C (a qualified financial expert) in the course of his semi-annual meetings with the bank in his capacity as BO.

Effective place of management as ruled by Zurich courts (7/7)

- The Zurich administrative court made even a further statement in its conclusion:
 - «In addition, it might be justified as well to rule in this situation – in which a company was incorporated through a Trust, whose primary purpose is the investment and management of non-declared assets of an individual by using external asset managers located at the domicile of said individual –that the determination of the effective place of management follows the residency of the individual who has the power to dispose of the assets (which are legally owned by the company), but not the general principle where the business is carried out on a daily basis.»
- In return, it can be said that asset management companies located abroad (offshore), but managed in Switzerland will most likely not be considered as Swiss tax resident, if the BO is not resident in Switzerland for tax purposes.

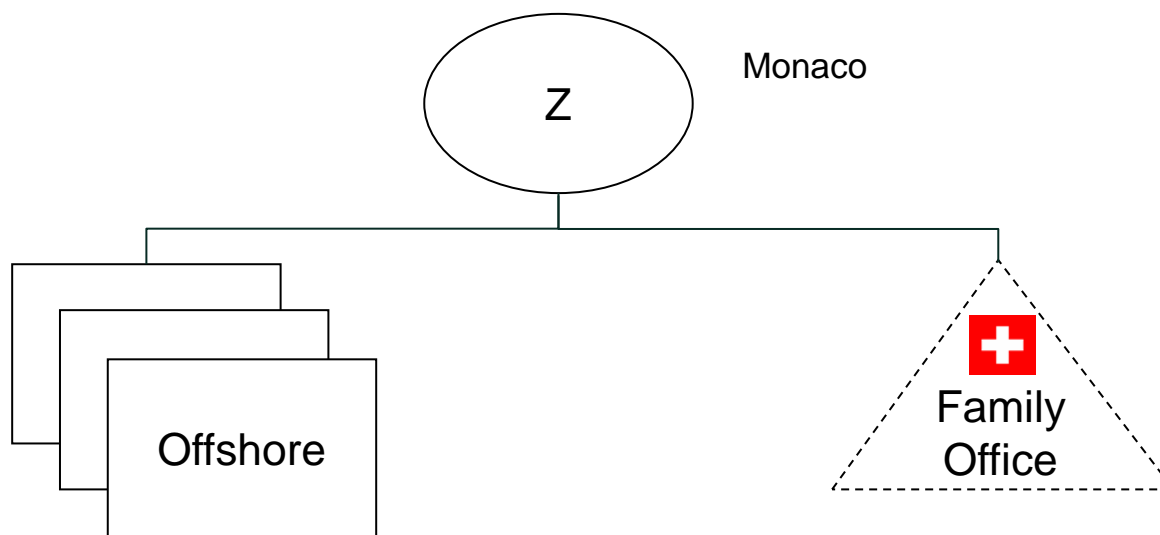
Case II

Family office structure (1/10)

Facts:

- The BO (Z) has relocated in 2012 to Monaco in order to avoid net wealth taxes.
- All assets (e.g. bankable assets, collection of antiques; except for Swiss properties) are held indirectly through offshore companies.
- The family office is located in Switzerland, has sufficient premises and three employees and manages all the assets of the offshore companies.
- The Swiss tax authorities have started in 2017 an investigation followed by an official inquiry regarding tax evasion. They argue that Z is a professional antiques dealer and her family office is regarded as a permanent establishment (PE) for her business activities.

Family office structure (2/10)



Family office structure (3/10)

Issue

Is there a sufficient legal basis to assume a PE in Switzerland or is Z protected by the offshore companies?

- Question of substance and function of the offshore companies as well-defined from the activities of the family office.
- Tax authorities have to prove that the offshore companies have no substance and are therefore not in a position to properly deal with antiques (e.g. no expertise, no accurate storage available, etc.).
- Provided this can be proved, the offshore companies may be disregarded for tax purposes («look through»).
- Allocation of (trading) activities to Z.

Family office structure (4/10)

Issue

Which reaction has to be expected from the Swiss tax authorities, if Z can sufficiently argue that her activities are shielded by the offshore companies, in particular as most of the duties have been delegated to the family office (no interaction by her)?

- Offshore companies may become subject to unlimited tax liability in Switzerland due to their effective place of management or qualification as PE (caused by the activities of the family office).
- Discussion regarding the taxable basis (full or partial), profit vs. loss situation in the previous years.
- (profitable) sales could be taxed; in absence of sales respectively capital gains, only the capital tax might be due.

Family office structure (5/10)

Issue

Is a PE in Switzerland feasible, if Z has solely expanded the (family) collection with further antiques, but not made any sales?

How has the case to be assessed, if Z has only sold some antiques in order to cover her living expenses. In such case, the proceeds would have been distributed from the offshore companies by way of ordinary dividends. Are these dividend distributions (retrospectively) subject to Swiss withholding taxes at a rate of 35%?

Family office structure (6/10)

Option: no sales

- No qualification as professional antiques dealer due to a lack of activities, consequently no PE can be justified in Switzerland.
- Eventually, it could be argued that the family office renders certain consulting/management services to the offshore companies.
- In that regard, it had to be assessed what would be the arm's length remuneration. The applicable transfer pricing method would most likely be cost-plus 10% - 15%.

Family office structure (7/10)

Option: sales in the previous years

Provided that the offshore companies are not disregarded («no look-through approach»)

- Dividends qualify as taxable investment income; but due to residency in Monaco, no tax consequences in Switzerland.
- Swiss withholding taxes would be due, if the offshore companies would be regarded as Swiss resident according to the legal requirements. This might be the case, if they perform certain business activities (through the family office) in Switzerland; Swiss withholding taxes have to be levied and charged to the recipient; if it cannot be charged to the recipient, the 35% will be added-up (final tax burden of 53.8%!).

Family office structure (8/10)

Provided that the offshore companies are disregarded («look-through approach»)

- Safe haven rule pursuant to circular letter 36 dated 27 July 2012 («professional securities dealer»)? Not clear whether it would apply as securities trading cannot be regarded as equivalent to trading with antiques.
- If applicable; save haven rule does not apply, because the proceeds have been fully used to cover living expenses (50%-threshold exceeded)
- But no real trading activities as the proceeds from the sales have been exclusively used to cover living expenses and are therefore considered as a use of substance (management of private assets, no reinvestment).

Family office structure (9/10)

Issue (optional)

Assumption is made that the offshore company, which runs the Swiss resident family office, has not or not sufficiently been remunerated for its services rendered to the other offshore companies. Is there any risk from a Swiss withholding tax perspective?

- Yes, provided however that the offshore companies are regarded as Swiss resident according to the legal guidelines (e.g. effective place of management).

Family office structure (10/10)

Issue

Has Z any legal obligations to support the tax authorities with regard to the inquiry?

- As long as no tax liability has been officially confirmed, no legal obligations to support the tax authorities arise. However, it might be recommendable to cooperate with the tax authorities in order to avoid further investigations.
- Z can ask at any time for an official order from the Swiss tax authorities regarding the existence of a Swiss tax liability (e.g. based on a PE), if any, and challenge any adverse orders up the Supreme Court.

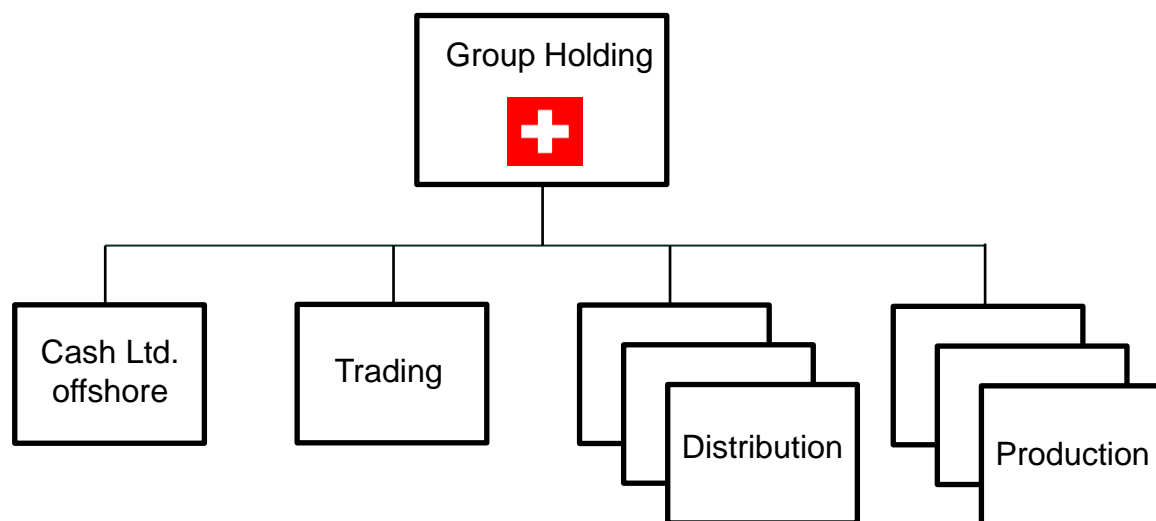
Case III

Group financing structure (1/9)

Facts:

- Swiss group with headquarter in Switzerland and local subsidiaries for distribution purposes abroad.
- Any excess cash is pooled as equity in a financing company (Cash Ltd.) offshore. The liquidity is used to finance the business activities of the group companies (group-internal loans).
- Cash Ltd. is also the exclusive distributor of the products for the Asian market.
- Cash Ltd. has rented an office in a business center and has 3 part-time employees (each 30%).
- The transfer prices as applied to Cash Ltd. are fixed at more preferable rates compared to the other group companies.
- Swiss tax authorities are challenging now the position of Cash Ltd.

Group financing structure (2/9)



Group financing structure (3/9)

Issue

What options are given to the Swiss tax authorities in order to tax the profits of Cash Ltd. in Switzerland? Is there any difference between the profits resulting from the trading/distribution and the financing activities?

The Swiss tax authorities might challenge the position of Cash Ltd. based on following approaches:

- Effective place of management in Switzerland
- Permanent Establishment (PE) in Switzerland
- «Look-through» approach (disregarding the legal entity)

Group financing structure (4/9)

Partial allocation of profits to Switzerland based on transfer pricing methods; Cash Ltd. might qualify only for a taxation on a cost-plus basis (service company, only supporting functions); Remaining profit (spread) will be added back to the taxable profit of the Swiss group company:

- Differences between trading vs. financing activities:
 - Financing activities are low profile («small footprint»), therefore it is more difficult to sufficiently demonstrate that the real execution is taking place offshore.
 - Trading functions require a certain infrastructure, therefore the offshore execution can be easier demonstrated due to the substance (e.g. employees, office, invoicing, etc.)
 - However, it has to be verified whether the 3 part-time employees are really carrying out the trading functions or whether they simply follow instructions from Switzerland (execution only; PE, effective place of management).

Group financing structure (5/9)

Issue

What are the Swiss withholding tax consequences of not dealing at arms' length with regard to the Asian market? Does it have an impact how Cash Ltd. is treated for corporate profit and capital tax purposes in Switzerland?

- If Cash Ltd. is a group company, it is regarded as a *Geldwerte Leistung* (*hidden profit distribution*).
- Direct beneficiary theory (*Direktbegünstigungstheorie*): Swiss withholding tax of 35% on the price difference. Swiss withholding tax is non-refundable as no double tax treaty is applicable (offshore).

Group financing structure (6/9)

- Reporting procedure/refund of the Swiss withholding tax applicable, provided that Cash Ltd. qualifies as Swiss resident according to the Swiss withholding tax act.
- The effective treatment regarding corporate profit and capital taxes is of no relevance as the Swiss withholding tax act has its own legal qualification.
- Qualification as Swiss resident: Place of effective management (decision makers) is in Switzerland; according to current practice as applied by the Swiss tax authorities, there is a low level to qualify for having the effective place of management in Switzerland.
- Further, it is required to voluntarily apply the Swiss stamp duty act in order to have access to the refund procedure (standing practice of the Swiss Federal Tax Administration).

Group financing structure (7/9)

Issue

Can we expect that the Swiss tax authorities will respectively has to accept the current group structure and the respective group-internal business operations / activities? Which reactions shall be expected? Is there any relevance that Cash Ltd. provides financing to group companies as well as trading business with third parties?

- The transfer prices will certainly be adjusted; at least to the same level as the other group companies purchase internally the goods;
- No «look-through» approach as there should sufficient substance at the level of Cash Ltd.;

Group financing structure (8/9)

- No assumption of effective place of management in Switzerland, in particular if it can be sufficiently demonstrated that the trading functions are effectively performed offshore (e.g. supporting documents, business set-up, etc.);
- The same applies to the PE risk (analysis of facts/functions);
- Swiss Federal Tax Administration has no interest to qualify Cash Ltd. as Swiss resident, because this would entitle the company to qualify for Swiss withholding tax refund.
- If Cash Ltd. would be a subsidiary of the respective Swiss group company, the Swiss withholding tax would not apply (no hidden profit distribution). The underpriced sale of goods would be regarded as a capital contribution into a subsidiary.

Group financing structure (9/9)

Issue

Is there any risk of (tax) criminal procedures?

- Hidden profit distributions («*Geldwerte Leistungen*») have to be self-declared.
- Switzerland does not know any (criminal) sanctions for «Mis-Transfer Pricing».
- However, there might be a risk for a criminal tax procedure due to tax evasion as the mis-transfer pricing has been put in place by purpose.
- Swiss withholding tax: criminal proceedings according to Art. 62 I a Swiss Withholding Tax Act

Case IV

Offshore asset manager (1/4)

Facts:

- Mr. X is resident in Switzerland and has mandated an asset manager (third party) located offshore to manage his bankable assets (securities portfolio + liquidity of up to CHF 40 Mio.).
- The asset manager has employees, offices and a substantial infrastructure offshore.
- The asset manager has been instructed as follows:
 - Very active management of the assets in order to increase the wealth;
 - Authorization to highly leverage the assets with Lombard loans (advance against collateral);
 - Authorization to use derivatives, but not for hedging purposes.

Offshore asset manager (2/4)



Offshore asset manager (3/4)

Issue

Is there any chance for Mr. X by referring to recent court decisions of the Supreme Court regarding professional securities dealer to argue that the income realized by the asset manager has to be exempt from Swiss taxation (foreign PE) and is therefore only relevant in order to determine the applicable tax rate («*Progressionsvorbehalt*»).

This mainly based on the fact that the professional management of assets is attributed to the beneficial owner, which, however, is performed offshore.

Offshore asset manager (4/4)

- Mr. X would be regarded as professional securities dealer, if he would perform the same asset management activities as currently performed offshore in Switzerland. This tax treatment follows the official regulations (circular letter) and the case law.
- According to the Supreme Court, any actions of third parties (e.g. asset manager) will be attributed to Mr. X (different practice of the tax authorities with regard to banks; therefore no rule from the Supreme Court in that regard)
- Question: to which extent the attribution may apply?
 - Only activities or although location of the activities?
 - If location: Mr. X would have based on the attribution an offshore PE; wealth and income would be tax-exempt in Switzerland due to exemption on an unilateral basis.

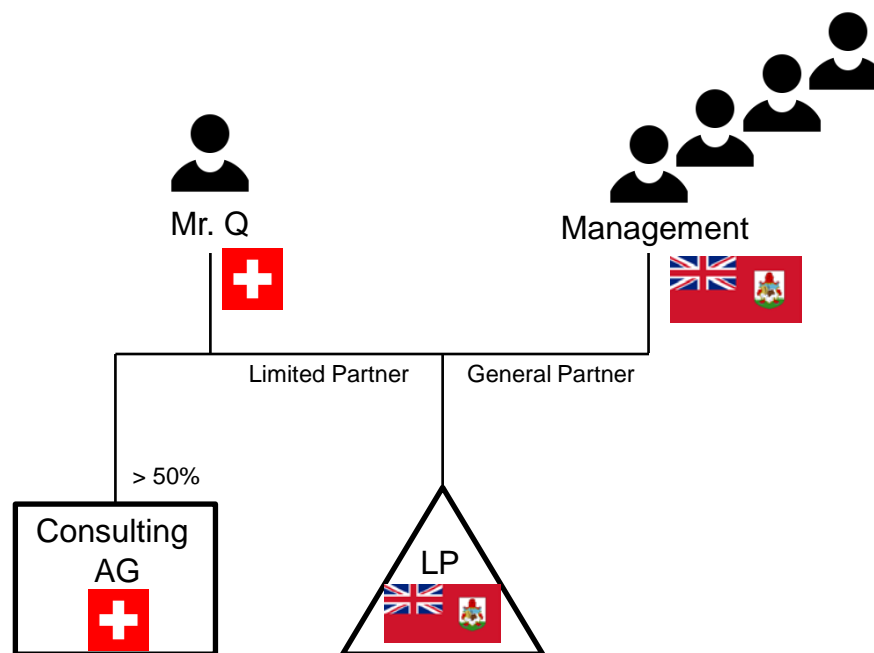
Case V

Offshore limited partnership (1/9)

Facts:

- Mr. Q is resident in Switzerland and has a net wealth of approx. CHF 2 billion, whereof CHF 500 million is invested in Switzerland (e.g. properties and portfolios with Swiss banks).
- Mr. Q is sole limited partner of an offshore limited partnership (LP) which holds the remaining assets. The management is representing the general partner through a limited company offshore.
- LP has invested the assets on- and offshore in hedge funds, private equity funds and other alternative investments.
- The management is fully engaged and makes all decisions with regard to the investments of the LP.
- LP employs 4 managers and 2 assistants; they have offices and a fully-equipped infrastructure.
- LP receives in addition advisory services from Swiss resident Consulting AG.

Offshore limited partnership (2/9)



Offshore limited partnership (3/9)

Issues 1 and 2

Will the profits of the LP be allocated to Switzerland and therefore be subject to federal as well as cantonal/communal taxation or will they be exempt from taxation in Switzerland? Legal basis?

Question: International tax assessment with income allocation between Switzerland and offshore?

Current regulation

- No Swiss tax liability for a fixed place of business or a permanent establishment located abroad; income and net wealth allocation follows the principles of the inter-cantonal case law; definition of permanent establishment is ruled in the law for limited tax liability, but applies to unlimited tax liability as well.

Offshore limited partnership (4/9)

Application to issues 1 and 2

- Place of management?; PE?; Differences?
- Case law regarding definition of PE: requirements regarding an unlimited tax liability in cross-border matters?
- Fixed place of business; but there are also real business activities required.
- Regress to case law regarding inter-cantonal tax matters possible; i.e. Mr. Q has a foreign PE, provided that
 - there is a LP carrying out commercial activities abroad; or
 - there is an LP performing «asset management» services based on a fixed place of business (e.g. offices) and real infrastructure.

Conclusion: Mr. Q has a fixed place of business/PE offshore

Offshore limited partnership (5/9)

International allocation rules

- Advance payment for Switzerland due to the function of the limited partner (e.g. 20% - 30% for the capital contribution for investment purposes)?
- Alternatively, OECD authorized approach applicable?
- If OECD-principles regarding OECD-MA 7 II applicable:
 - significant people function;
 - same rules regarding transfer and allocation of risks and capital

Offshore limited partnership (6/9)

Results of issues 1 and 2

- The legal basis for federal and cantonal/communal taxes is basically speaking identical so that the same tax treatment is justified at both levels.
- Mr. Q can request an international income and net wealth allocation between Switzerland and offshore with regard to the profits of the LP.
- There are good reasons for and contra an advance payment for Switzerland.
- From a practical perspective, it is recommended that Mr. Q should either accept an advance payment or not to contribute all assets into the LP in order to avoid not paying any taxes in Switzerland (with the exception of Swiss based assets and income therefrom); i.c. CHF 500 mio. = 25% of the total wealth. Sufficient?

Offshore limited partnership (7/9)

Issue 3

Is Mr. Q entitled to apply (Swiss) double tax treaties in order to claim treaty benefits (e.g. partial withholding tax refund) with regard to investment income realized by the LP? Further, is there a refund of Swiss withholding taxes to Mr. Q with regard to investment income realized by the LP? Application of DTT?

- LP has from a double tax treaty perspective an angle in Switzerland (Mr. Q) and a PE offshore (cf. OECD 3 I d)
- Conclusion: DTT Switzerland with respective source state applicable; refund of Swiss withholding taxes, however, will not be granted according to the (problematic) practice of the Swiss Federal Tax Administration.

Offshore limited partnership (8/9)

Issue 4

May Consulting AG qualify as a PE of LP and will therefore statute a limited tax liability in Switzerland?

- Consulting AG renders only advisory services to LP and can therefore not qualify as a PE of LP (no investment and asset management services).

Offshore limited partnership (9/9)

Issue 5

How has the remuneration of Consulting AG to be fixed with regard to the advisory services provided to LP?

- Consulting AG is an affiliated company
- At arms' length is required
- Cost-plus?
- Third party advisory companies are not an adequate benchmark, if LP is the only customer of Consulting AG
- Can a profit split be applied? According to the head account?
 - Profit split is only justifiable, if Consulting AG makes investment and disinvestment decisions, pure consulting is not sufficient.
 - Capital allocation has to be taken into account, if afore-mentioned would apply.

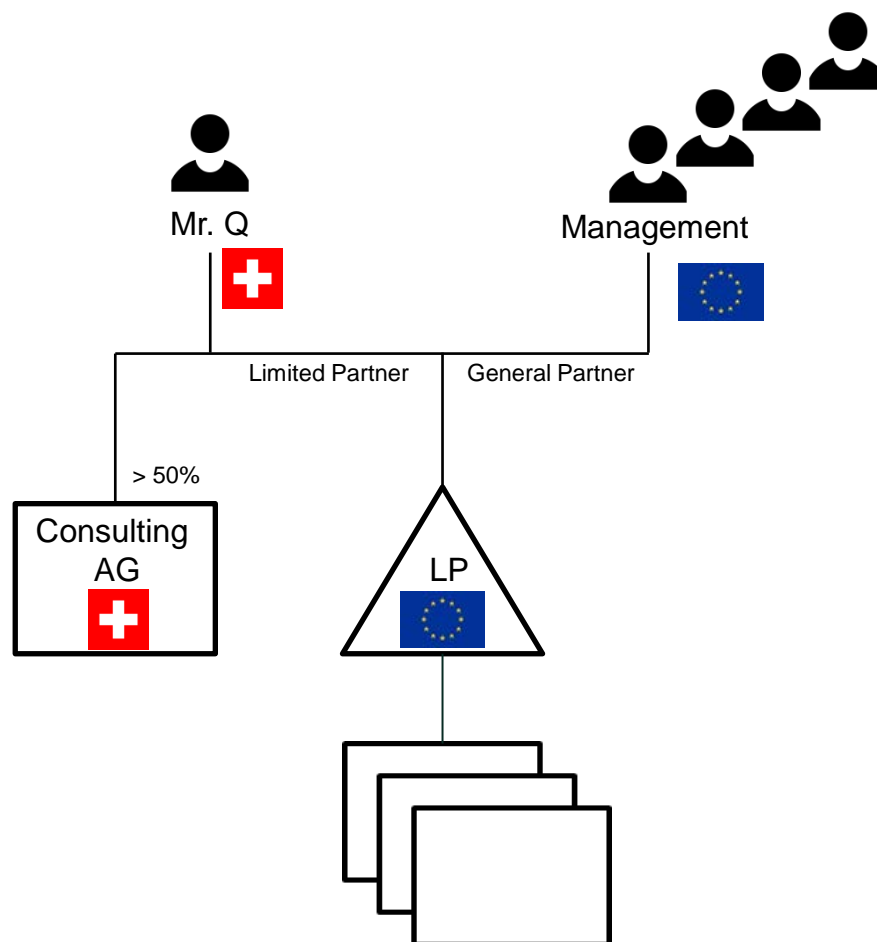
Onshore limited partnership (1/4) - (EU)

Facts:

- In general same facts, with the following variations:
 - LP invests only indirectly through various subsidiaries.
 - LP renders certain services to its subsidiaries and is therefore taxed on a «cost-plus» basis in the EU member state.

Onshore limited partnership (2/4)

- EU



Onshore limited partnership (3/4)

- EU

Issue 1

Is there a different tax treatment of Mr. Q regarding his personal income and wealth tax situation in Switzerland compared to the basic case?

- The tax assessment regarding Switzerland does not change (international tax assessment with an allocation of income and wealth between the involved jurisdictions).
- Consequence of the qualification for the EU member state: conflict of qualification in favor of Mr. Q.
- Result: With the exemption of the cost-plus margin, the entire profit (less expenses) will in principle be taxed in the jurisdictions where the subsidiaries are domiciled.

Onshore limited partnership (4/4)

- EU

Issue 2

Will the OECD-BEPS-project have any impact on the current tax situation?

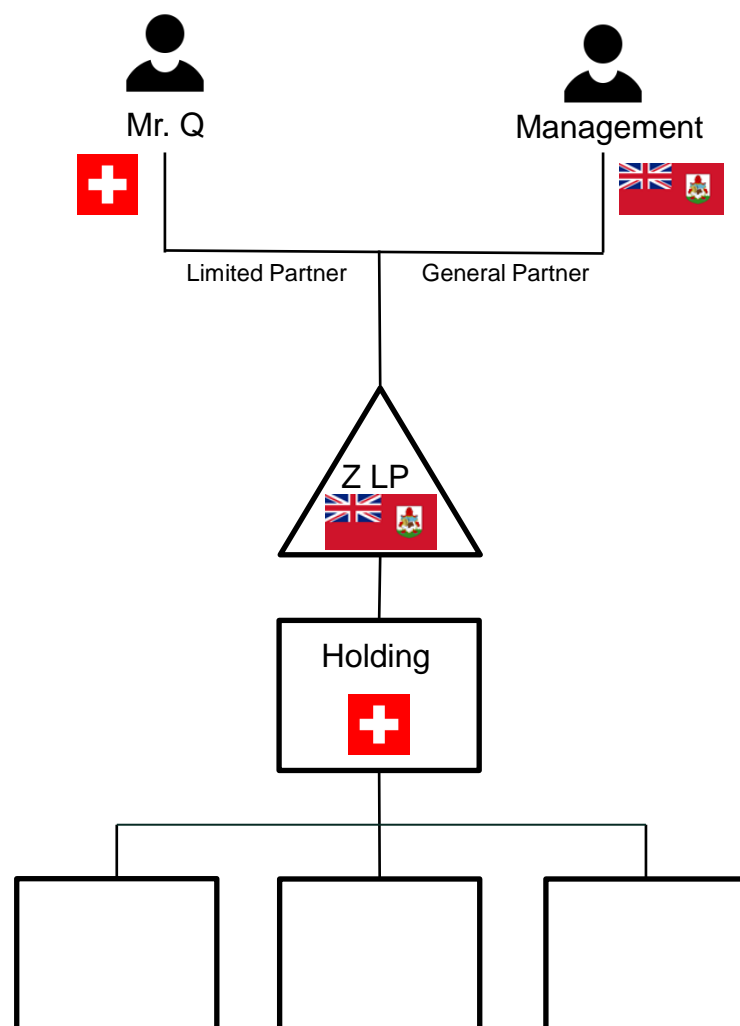
- There is a «mismatch» in view of BEPS.
- There is no legal basis in order to reject the application of an international tax (assessment) allocation in Switzerland.
- Question, however, whether the respective EU member state may reject a cost-plus taxation due to new BEPS regulations, follows local rules. If yes, the structure might no longer be attractive, because all profits would be allocated to the LP. Alternatively, a restructuring might be required in order to achieve a tax treatment as in the basic case.

Offshore limited partnership (1/5) - alternative

Facts:

- LP owns indirectly through a Swiss resident holding 3 substantial shareholdings in listed companies with a total value of CHF 1.5 bn and has further invested CHF 200 mio. in funds and private equity.
- LP makes sit own investment decisions respectively does not require any advisory services from third parties.
- LP has one manager and one assistant on its payroll.

Offshore limited partnership (2/5) - alternative



Offshore limited partnership (3/5) - alternative

Issue

Is there a different tax treatment of Mr. Q regarding his personal income and wealth tax situation in Switzerland compared to the basic case?

- Same legal basis and regulations applicable as in the basic case.
- Question: permanent establishment / fixed place of business available?
- By applying the inter-cantonal tax case law, the following can be said:
 - The mere holding of 3 substantial shareholdings in listed companies does on its own not qualify for a limited partnership carrying out a commercial business;
 - The volume of CHF 200 mio. regarding the other investments might most likely also not qualify for carrying out a commercial business through a limited partnership (see above).

Offshore limited partnership (4/5)

- alternative

- Case law by Supreme Court regarding limited partnerships carrying out an asset management business: Although in view of substantial wealth, this might not be sufficient, respectively there is only an assumption of a limited tax liability of the limited partner at the domicile of the limited partnership (no green light *per se*);
 - There is an additional requirement for a fixed place and establishment of business.
- Further, there is a common principle that offshore entities are allocated directly to the beneficial owner (disregarding of the entity).

Offshore limited partnership (5/5) - alternative

Summary:

- Clear case?
- Most likely no acceptance as a limited partnership carrying out a commercial business offshore according to case law by the Supreme Court.
- Most likely although no international tax (assessment) allocation between Switzerland and offshore applicable as there is no real demand for a fixed place of business / infrastructure.
- Allocation of the participations to Mr. Q?

Conclusion / Mitigation Strategies

Mitigation strategies

- Substance: Functions and risks are key
- Principal Purpose Test: Commercial reasons should be the driver for structurings
- Advance tax rulings
- Supporting documents for any transactions, in particular with regard to business partners offshore
- Analysis of functions
- Transfer pricing reports / benchmark studies

Thank you!

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