Memorandum

To
Clients and Friends

From
Peter Reinarz

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Zurich, 23 June 2005
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Re
Abolition of Swiss "50-50" Tax Practice

The Federal Tax Administration has on 22 June 2005 published the new Circular No. 9/2005 concerning "proving the commercially justified business expenses in foreign-to-foreign transactions". The Circular will bind the Federal Tax Administration for the federal income taxes and the withholding tax on dividends, as well as the cantonal tax authorities as far as they are applying federal tax laws. The Cantons are not bound by the Circular for the assessment of cantonal and communal taxes on income and net worth.

A General Background

The key element of the new Circular is the abolition of the "50-50 practice" that had been applied in Switzerland for decades to Swiss companies and Swiss branches of foreign companies that conducted the bulk of their business outside Switzerland.

The 50-50 practice allowed Swiss companies and branches engaging principally in business transactions that have no real nexus to Switzerland ("foreign-to-foreign transactions") to claim a lump-sum deduction for business expenses incurred abroad in the maximum amount of 50% of the entity's gross profit (e.g., gross trading margin) and exempted such entities from the need to specify and prove in detail the "business justification" of such expenses. The remaining 50% of the gross profit could only be reduced by minor Swiss administration charges (typi-

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cally for a maximum of CHF 10,000 per annum). The 50% expense allowance was typically used by taxpayers to pay interest, royalties, commissions, or other fees to foreign entities incorporated by, on behalf or in the interest of the ultimate, foreign resident beneficial shareholders of the Swiss entity in a foreign tax-free zone. In the "classic" traditional setting, a foreign resident individual who was not able to get access to the benefits of any Swiss international double tax treaty would have been able to do foreign business through a Swiss incorporated entity and a tax-haven entity at an overall tax burden (including roughly 10% Swiss corporate taxes and 35% federal withholding tax on the distribution of the taxable profit) of some 22.5 % (before any taxes payable in individual's home jurisdiction).

Over time, sophisticated tax payers found ways to further optimize the overall tax burden by introducing corporate holding structures for the shares in the Swiss based entity to mitigate or even eliminate the effect of the 35% Swiss withholding tax, or by using Swiss branches of foreign entities exposed to a lesser withholding tax burden compared to the withholding tax arising on profit distributions by a Swiss resident entity. The Swiss authorities have apparently felt pressure from foreign governments, especially in the OECD framework, to do away with the regime that was perceived as a measure of potentially harmful tax competition.

B Details of the New Régime

1 No lump-sum expense allowances

Swiss companies and branches engaging into "foreign-to-foreign" business will no longer benefit of any lump-sum expense deductions. Therefore, also expenses incurred abroad must be ordinarily accounted for (as in the past), and they need to be proven and "commercially justified" as any other business expenses in order to be accepted as tax-deductible expenses. The new Circular specifically mentions expenses relating to the acquisition and the use of intellectual property and other intangibles.

2 Arm's length standard to apply

In particular, any expenses benefiting the shareholders or persons "close" to the shareholders must meet an arm's length standard. The Circular makes reference to Switzerland's undertaking to adhere to the OECD's transfer pricing guidelines of 1995. Payments or benefits made to shareholders or "close" persons are considered constructive dividends and are hence non-deductible for corporate income tax purposes, to the extent that they do not meet the arm's length standard. If made by a Swiss resident company, such payments or benefits are also subject to 35% dividend withholding tax.

3 Definition of "close person"

Moreover, the Circular makes reference to the very extensive interpretation adopted by the federal tax authorities and the Federal Supreme Court of the notion of "close person". Such interpretation includes not only persons or companies affiliated with, or related to the shareholders, but effectively any person which under the individual circumstances must be considered the main reason for the "unusual" payment or benefit. In particular, the Swiss authorities consider any person as "close" who may use the Swiss company for transactions with the consent of the company's shareholders.

4 Disclosure requirements

The Swiss tax authorities will require the disclosure by the Swiss taxpayer of the ultimate beneficiaries of payments to bank accounts or foreign tax haven companies as a condition for tax deductibility.

5 Scope of binding advance tax rulings

Advance tax rulings providing for lump-sum cost charges will no longer be granted. However, binding tax rulings concerning transfer pricing issues will still be available. Rulings on transfer pricing issues relating to salaries, fees, commissions, royalties etc. will require the submission of financial budgets and business plans and the "commercial justification" of the proposed expenses must be proven by the tax payer. The Circular states that "if the taxpayer cannot fully provide such proof, the tax authorities have to use their discretion at best knowledge in assessing the taxable profit and make sure that no tax deficiencies will arise". It will be interesting to see how the tax authorities will use their discretion in their future ruling and tax assessment practice.

6 Entry into force of new rules

The new Circular No. 9 will come into effect as of 1 July 2005. Tax rulings issued before that effective date providing for lump-sum foreign expense allowances in accordance with the previous régime will remain valid, for federal income tax and federal dividend withholding tax purposes, until the last fiscal year closing prior to 1 January 2009.