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Pitfalls leading to creation of tax liability in Switzerland

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Pitfalls leading to creation of tax liability in Switzerland

To avoid creating a tax liability, taxpayers should be aware of the criteria to be taken into consideration when carrying out business activities in Switzerland, whether through use of a Swiss branch or a Swiss place of effective management, explains Rolf Wüthrich of burckhardt.

When carrying out business activities in Switzerland by use of a legal entity one might face different tax consequences in Switzerland, such as corporate income and capital tax, stamp duty, transfer duty or withholding tax on dividends or interest. The Swiss corporate tax law, the stamp duty law and the withholding tax law define, however, tax liability differently. While Swiss tax consequences are rather clear for legal entities incorporated in Switzerland, surprises may arise for non-Swiss incorporated companies having a branch or a place of effective management in Switzerland or being considered as native persons for stamp duty or withholding tax purposes. It has been observed lately that (branch) structures are implemented which have no or minimal substance at the place of incorporation of an entity, while considerable substance shall be based and activities shall be carried out in Switzerland. The pitfall of such structures may be surprisingly high Swiss tax costs.

Income and capital tax

Swiss tax law (federal and cantonal taxes) states that legal entities are subject to unlimited tax liability in Switzerland if their formal incorporation (commercial register registration) or their place of effective management is in Switzerland. Even if in practice tax authorities are reluctant to apply the theory of the place of effective management and even if they normally take into consideration, as a first step, the place of incorporation as criteria to determine tax liability, both the place of incorporation as well as the place of effective management are equivalent. Thus, the tax administration can apply at any time the theory of the place of effective management to a non-Swiss company to determine tax liability.

In existing case law the definition of the place of effective management has been inconsistent and different definitions can be found. So the place of effective management was defined as:

- the place where the business activities or where the activities of a company are carried out to reach the statutory purpose;
- the place where the company has its effective centre of existence; or
- the place where the management functions are carried out.

Under the place of effective management test all available indications are considered on a case by case basis and a judgment based on all the available indications shall be made. For example:

- What kind of business operations are carried out?
- How is the company organised with respect to the preparation, negotiation and decision of business deals, the contract conclusion as well as the implementation of and the post-processing for such activities? Where are business activities finally carried out and implemented?

- Does the company dispose of its own employees and where is their working place?
- What does the office infrastructure of the company look like at the place of incorporation?
- Where are important decisions taken?
- Who is the board of directors composed of (residence and function of the individual board members)?
- How is the administration of the company organised?
- Where are the books kept and archived?
- Where do shareholder meetings and board meetings take place?
- Does the company have the same management or board members as the parent company or a possible related Swiss service provider?
- Does the company have, for example, a Swiss post address, phone or fax number?
- Are all or most of the contractual partners of the company based in Switzerland?
- Are the agreements concluded by the company signed in Switzerland and/or to they contain the choice of Swiss law and Switzerland as place of jurisdiction?

In each case all available indications must be considered. Based on an overall valuation of the facts it shall be decided where the place of effective management is. If the activity of the board members is reduced to controlling the directors operating the business and to taking general business decisions, then the place of effective management shall be where the directors carry out daily business activities.

When considering the various criteria the business activity of a company must also be considered. For instance, in cases of financial or holding companies the business activities of such companies shall be considered as not as intensive as the management of an operative company. Possible management activities of a holding or an investment company can therefore be, for example, the taking of decisions about the acquisition and the sale of securities and investments, the representation of shareholder rights and the implementation of shareholder decisions and of board resolutions.

If one comes to the conclusion that a company is dual resident, that is, is formally incorporated outside of Switzerland, but its place of effective management is in Switzerland, then the company might face international double taxation and the question arises how such double taxation can be avoided. The country of incorporation as well as Switzerland could, in such a situation, claim taxing power over the company. To eliminate international double taxation, these two solutions could theoretically be considered: a company is incorporated in a country which does not levy income (and capital) tax. As a consequence, only Switzerland levies tax, based on the Swiss place of effective management,. This solution, however, might run into double taxation should the country of incorporation change its tax law. As an alternative a tax treaty solution might ensure higher reliability. The determination of tax residence looks first to a person's tax liability as a resident under the respective domestic tax law. If, however, a person is resident for tax purposes in two countries which have concluded a tax treaty with each other, then the tax treaty proceeds, where possible, to use tie-breaker rules to assign a single state of residence to such a person for the purposes of the treaty. Article 4 paragraph 3 of the OECD Model Convention (and also various tax treaties concluded by Switzerland) states that a person other than an individual resident in two contracting states shall be deemed to be a resident only of the state in which its place of effective management is situated. Thus, if a company is formally incorporated in a country with which Switzerland has concluded a tax treaty and the treaty contains as a tie-breaker the place of effective management rule, then the taxation power has to be assigned to Switzerland if the effective management effectively is carried out in Switzerland. As a consequence double taxation is eliminated.

In the case of a branch structure (foreign entity with Swiss branch) Switzerland will tax the income and capital allocable to the branch. To ensure clarity on the allocation of income and capital between the country of incorporation and Switzerland as branch country it is advisable to obtain an advance tax ruling on the international allocation of

Biography

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Rolf Wüthrich is an international tax lawyer focusing his areas of expertise on national and international tax planning, inbound and outbound transactions, especially between the US and Switzerland, corporate restructuring and acquisitions as well as general corporate secretarial services.

burckhardt provides its clients and their businesses with comprehensive, tailored advice on national and international tax planning issues and structuring, offers a corporate secretarial and notary service, supports clients with professional expertise and broad international experience on restructurings, mergers and joint ventures, and advises on inbound and outbound investments and in all matters related to employment, trade and transport law.

income and capital. However, if the foreign head office has no appropriate substance and decisive decisions are taken and activities only are carried out in Switzerland, then under the theory of the place of effective management the whole company runs the risk of being qualified as subject to unlimited tax liability in Switzerland. As a general tendency it can be stated that the requirements for the requested substance at a foreign head office have increased over the last years constantly and that minimal substance such as a few part-time employees on the payroll with assistance functions at the head office do no longer generate sufficient substance for acceptance of a head office.

Stamp duty and transfer duty

The Swiss federal law on stamp duties (*Stempelsteuergesetz*) regulates stamp duty (*Emissionsabgabe*) and transfer duty (*Umsatzabgabe*). Among other things, the initial contribution or a later increase of the formal capital in a native company is subject to stamp duty of 1%. Not only the formally increased capital, but also a possible premium payment is subject to stamp duty. The first SFr1 million of capital of a company, tax neutral restructurings as well as recapitalization contributions up to SFr10 million in the case of overindebtedness are exempt from stamp duty. For transfer duty purposes, a security dealer is defined as, among other things, a native stock corporations owning securities with a book value of more than SFr10 million. As a consequence of being a security dealer, the purchase and the sale of taxable securities are subject to transfer duty. The transfer duty rates are applied to the paid or received consideration and amount to 1.5% for securities issued by a Swiss party and 3% for securities issued by a non-Swiss party. Simply, said taxable securities are bonds and shares issued by a Swiss or a non-Swiss party as well as shares in collective investment vehicles. A Swiss branch of a foreign corporation does not, in principle, qualify as a security dealer as it is not a Swiss native corporation and therefore does not fall under the SFr10 million – qualification rule.

Whether a company is subject to stamp or transfer duty depends, among other things, on whether the company qualifies as a native company (*Inländer*) or not. Article 4 paragraph 1 of the Swiss stamp duty law describes a native person as a person (individual or legal entity) having its civil law residence, its permanent presence, its statutory seat or its legal seat in Switzerland or as a person being registered in the Swiss commercial register.

Thus, a company qualifies as a native person for stamp duty law purposes if its statutory or legal seat is in Switzerland or if it is registered in the Swiss commercial register. Companies subject to Swiss income and capital tax based on their Swiss place of effective management do not, however, automatically qualify as Swiss native persons for stamp and transfer duty purposes. The Swiss stamp duty law as a transactional tax law refers and ties to the formal seat (seat of incorporation) of a company, and not the income tax liability based on the criteria of the place of effective management.

Withholding tax

Levy of withholding tax

Dividends from shares issued by a native company are subject to Swiss withholding tax. Though the withholding tax law refers to the term "native person", the definition is different from the definition of the same term found in the stamp duty law.

Article 9 of the withholding tax law describes a native person as a person having its civil law residence, its permanent presence or it statutory seat in Switzerland or as a person being registered in the Swiss commercial register; native persons qualify, however, as also legal entities which have their statutory seat abroad, but their effective management is carried out in Switzerland.

The second sentence of the article describes the economic interpretation of the term native person. It requires the existence of an effective factual seat in Switzerland. The Swiss seat – place of effective management – is, however, only relevant under the Swiss withholding tax law if, in addition to Swiss effective management, an active business activity is also carried out in Switzerland. Native persons according to the economic interpretation are only legal entities, which are formally incorporated abroad, but which carry out their internal administration activities as well as their external business activities in Switzerland. The reason for this provision is that it is not possible to avoid Swiss withholding tax liability by incorporating a legal entity with place of incorporation abroad, which is effectively managed in Switzerland and which actively participates in business activities in Switzerland. If a company qualifies for Swiss withholding tax purposes as a native person, then possible dividend distributions made by the dual resident company will be subject to Swiss withholding tax of 35%.

Switzerland does not charge branch profit withholding tax. Thus, net profits earned by branches can, in principle, be repatriated to the head office of the Swiss branch without having to pay Swiss withholding tax. However, if the Swiss tax administration comes to the conclusion that there is no substance at the place of the head office and that the place of effective management of the company (and not only of the branch) is carried out in Switzerland, then the company may be qualified as a native person for Swiss withholding tax purposes and withholding tax may be levied on profits repatriated from the Swiss branch to its foreign head office.

Refund of withholding taxes levied

If qualifying as a Swiss native company for withholding tax purposes, a company must, in principle, deduct 35% withholding tax from a gross dividend, leaving only 65% of the gross dividend to be distributed.

However, if the dividend receiving shareholder of the dual resident company is a Swiss company, then the withholding tax reporting procedure (*Meldeverfahren*) can be applied and no withholding tax must be deducted. If the parent is a non-Swiss company, then the Swiss withholding tax consequences (reporting procedure, application of refund procedure, no refund at all) depend on the existence of a tax treaty between Switzerland and the state of residence of the parent:

- If Switzerland and the state of residence of the parent have concluded a tax treaty, then Swiss withholding tax is limited to the applicable treaty rate for dividends; and
- If Switzerland and the state of residence of the parent have not concluded a tax treaty, no refund will be granted and a final withholding tax of 35% will be levied.
- If the shareholder is an individual, then the company will be obliged to deduct 35% withholding tax. Whether or not a refund will be granted by the Swiss tax administration will depend on the applicability of a tax treaty.

No common liability

Tax liability for Swiss corporate income tax, stamp and transfer duty and withholding tax arise from different criteria. While the stamp duty law as transactional-related law strictly refers to formalities (place of incorporation, commercial register registration), the corporate income tax law as well as the withholding tax law take a more economic approach to define tax liability. For these last two taxes, the place of effective management is a decisive criteria for non-Swiss incorporated companies to create Swiss tax liability. There is no clear definition of the term place of effective management and each individual case must be investigated separately. It can be observed then that the threshold of acceptable foreign substance tends to increase and that structures are questioned more often. Offshore or branch structures with no real substance at their place of incorporation or head office should reconsider carefully and be brought in line with substance requirements to avoid unpleasant Swiss tax surprises in the future.

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