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Key practical issues to eliminate double taxation of business income

Switzerland

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Summary and conclusions

It is unlikely that the Swiss rules to avoid international double taxation will be changed in the next couple of years. The existing rules, particularly the calculation of foreign tax credits, will rather be modified in order to provide full relief for international double taxation and to eliminate any existing disadvantages of taxpayers resident in Switzerland receiving income in foreign countries. Failing to do so might in times of melting profit margins result in the exit of companies from Switzerland to jurisdictions where double taxation is completely avoided.

In particular, apart from the strict limitation on tax credits for companies with special tax privileges, consideration should be given to income from foreign countries, whether or not there is a residual withholding tax levied and whether or not a double tax treaty exists for the calculation of the maximum amount of tax credits granted. Furthermore it has been discussed whether tax credits should be granted to Swiss branches of foreign entities which are basically not entitled to claim treaty benefits or whether tax credits should be allowed to be carried forward in certain cases.[1] As far as can be seen today, no decisions have been made by the Ministry of Finance or by the Federal Tax Administration.

1. Introduction

According to the Swiss Federal Tax Act[2] and the respective cantonal tax laws, foreign active income is not taxed in Switzerland if the profit was generated in a fixed place of business or in a permanent establishment outside Switzerland or from landed property outside Switzerland. Even if the profit arises within the same legal entity, it is deducted from the tax base for Swiss tax purposes, usually following a proportional allocation method. Due to the fact that the Federal Tax Act states a proportional tax rate, the profit taxed in Switzerland at the same time determines the applicable tax rate.

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1 Robert Waldburger, presentation at the International Fiscal Association Conference dated 10 June 2010.

2 Swiss Federal Tax Act of 14 December 1990.

Some of the cantonal tax acts provide for progressive tax rates. In these cases the worldwide profit is taken into consideration in order to determine the applicable tax rate. However, this still does not constitute any form of full or even partial double taxation.

As mentioned above, the exemption method applies to active income and income from landed property only. Passive income, such as dividend, interest or royalty payments, is subject to tax in the receiving entity if this entity, from a tax point of view, is resident in Switzerland. The income is taxed irrespective of the amount and of the source, unless a double tax treaty limits the right to tax in Switzerland. If a double tax treaty is applicable to foreign dividend, interest or royalty payments, the treaty usually includes the right of the taxpayer to set off the foreign taxes paid from the Swiss tax burden. In fact, only effective double taxation is avoided. Should the receiving entity not be subject to unlimited taxation in Switzerland, i.e. not be resident in Switzerland for tax purposes (e.g. a Swiss branch of a foreign entity), access to a double tax treaty between Switzerland and the source country would be denied and therefore no relief from double taxation would be granted.

With regard to the methods for elimination of double taxation, Switzerland applies both the exemption and the credit method. As said above, whereas the exemption system basically applies to any kind of active income achieved through a foreign place of business or permanent establishment as well as income generated by non-Swiss landed property, the credit system strictly applies to the mentioned types of passive income (dividend, interest, royalty). Whereas domestic Swiss tax law excludes the active income mentioned irrespective of any applicable double tax treaty, the limitation of the right to tax dividend, interest and royalty payments is subject to the rule in an applicable dedicated double tax treaty. However, should a particular structure be considered as tax avoidance according to the anti-avoidance regulations, no tax credit would be allowed.

These principles have been developed over the last 40 years and are not about to be changed or significantly amended in the near future.

However, basically it can be stated that Switzerland's mechanisms for the elimination of double taxation are fairly simple, not only due to the domestic limitation of taxation of foreign (active) income, but presumably also because of the lack of taxation of consolidated group income.

2. Key factors of unrelieved double taxation

2.1. Diverging views on taxable income

2.1.1. Existence of income

As already mentioned in the introduction, tax credits are only allowed if they relate to dividend, interest and royalty payments. Any other income generated abroad in a fixed place of business, a permanent establishment and/or from landed property (outside Switzerland) is basically tax exempt. Therefore, a diverging view on the existence of income is only relevant with regard to dividend, interest or royalty payments.

However, if there was no taxation of an income payment in Switzerland, due to the fact that Switzerland did not recognize a certain contribution as a dividend payment, no tax credit would be granted. The maximum amount of any tax credit granted is basically equal to the Swiss corporate income tax on the gross income (reduced by income and administrative costs) from the foreign source. Hence, if the source country considered a certain payment to a Swiss company as a deemed dividend distribution (e.g. with the argument that the payment did not meet the arm's length principle), such income of the Swiss company would be ordinarily taxed in Switzerland as part of the profits and at the same time the payment or parts thereof would be subject to source tax abroad. In this case, the receiving company resident in Switzerland would have to adjust its accounting and declare the income as a dividend payment. If such an adjustment were made the tax credit should be granted (unless the dividend qualifies for the participation exemption).[3]

2.1.2. Source of income

It may of course happen that the competent tax authorities in Switzerland do not recognize certain premises abroad as a permanent establishment and therefore do not recognize the income thereof as foreign source. As a consequence, no exemption from the tax base would be accepted. But the opposite may also happen: the Swiss tax authority may accept the allocation of part of the corporation's income to a permanent establishment abroad, while the foreign state, to which the income is allocated, does not impose any tax since according to that state's practice the conditions for a permanent establishment are not met. As a result, a portion of the income would remain untaxed. From a Swiss point of view, there is no "subject to tax" clause.

As with regard to tax credits on foreign income, such as interest payments, a tax credit should be granted irrespective of whether the income is generated in foreign treaty state A or foreign treaty state B, unless the source of income was allocated to Switzerland itself. The tax credit usually requires that the source country effectively levies a residual tax, according to its domestic law and in line with the applicable double tax treaty.[4] Therefore, if a taxpayer is able to give evidence that a source country has effectively imposed any residual withholding tax under existing treaty rules, it is very likely that Switzerland will accept these taxes and grant the tax credit.

A tax treaty usually contains the definition of a permanent establishment. Therefore, it is easier to determine whether the conditions for allocating part of the company's income to the foreign country are met or not. If the Swiss tax authority was not willing to accept the taxation of part of the company's income by a treaty state there would be a classic double taxation issue which would need to be resolved by the mutual consent of the two countries' tax authorities, according to the procedure

3 Dividend payments qualifying for the participation exemption are not taxed in Switzerland and therefore no tax credit can be granted; see section 2.4 below.

4 Art. 1 para. 2, first sentence Tax Credit Ordinance.

defined in the double tax treaty. With regard to tax credits it has to be mentioned that this procedure is invoked on residual source taxes levied under a double tax treaty only.

Unless there is a case of tax avoidance which would result in the denial of any tax credit, a maximum tax credit equal to the tax credit that would normally be granted with regard to the state that Switzerland considers to be the source state should be accepted.

2.1.3. Nature or character of income

For Swiss tax purposes, the reclassification of income which is exempt from taxation in Switzerland could have an impact on the Swiss tax base, if the reclassification led to the income of a foreign permanent establishment being qualified as passive rather than active income. Although in theory this cannot be excluded, it is difficult to find an example of how this could happen. Such a reclassification would rather affect the determination of the source of income, i.e. whether the source of the income was in Switzerland or abroad.

Also, if from a Swiss point of view certain income components cannot be treated as dividends qualifying for the participation exemption, but instead as interest payments, a higher tax rate would result. This, however, is in fact not a question related to international double taxation, but rather of a purely domestic definition of participation income.

However, it is possible that income which is subject to source tax abroad (e.g. dividend payments) may be treated from a Swiss point of view as an interest payment. This reclassification could have an impact on the tax credit granted if according to a double tax treaty source taxes on dividend payments were allowed to be imposed whereas interest payments were relieved from foreign source taxes. If the double tax treaty does not contain a definition of dividend and interest payments, or if the conflict caused by the reclassification cannot be resolved despite the definition clause in the treaty, then there is a classic double taxation case, which needs to be resolved by the two tax authorities involved.

The same would happen if for instance Switzerland as resident country qualified certain payments from a foreign source as management fees, whereas the source country qualified them as royalty payments, subject to withholding tax. Since there is no tax credit granted on management fees, double taxation would occur if the conflict of classification could not be resolved on a mutual basis by the tax authorities involved.

Although some of the above-mentioned situations may arise in Switzerland, in practice they are not a really big issue. Usually it should be possible to find an acceptable solution with the competent Swiss tax authority. At least, if no other solution can be found, it should be possible to tax only the net amount of the payment, i.e. the amount received by the Swiss entity after deduction of the foreign source tax.[5]

5 Art. 2 para. 3 Tax Credit Ordinance.

2.2. Inconsistent allocation of deductions between domestic and foreign sources

As with regard to different places of operation within Switzerland, in the international context the Swiss practice follows a proportional method in order to allocate e.g. interest expenses to Swiss and foreign operations. In other words, the determination of profits through the allocation of financing costs will be done according to the relationship between the assets within Switzerland and those outside Switzerland. This means that where a large amount of assets is allocated abroad, the interest expenses are allocated to the foreign operations in the same proportion. As a result, only the smaller amount (proportional to the Swiss assets) will be deducted from Swiss income, irrespective of whether the financing costs effectively were incurred in Switzerland or not. Should the foreign state follow a direct method and consider the interest expenses as not related to the foreign operation, the costs may not be deducted from the foreign income. As a result, unrelieved double taxation would occur.[6]

Of course, the opposite may happen as well: should the majority of assets be located in Switzerland, the larger portion of interest expenses (financing costs) would be allocated to Switzerland, even if the financing was used to acquire or to build up the foreign operations. This would mean that a large portion of the interest expenses were deducted from the Swiss income, whereas the profit from the foreign operations (e.g. through a permanent establishment) would be exempt. Should, on the other hand, the foreign jurisdiction follow the direct allocation method and allow the deduction of all the interest expenses incurred by the foreign operations, the profit taxed by the foreign jurisdiction would be lower than the profit exempt from the Swiss tax base. Part of the overall profit would remain untaxed.

The Swiss international interest expense allocation rules were explained above. The more assets are allocated to foreign operations, the more interest expenses are allocated to the foreign business, only reducing the tax exempt foreign profit. Therefore, from a Swiss tax planning and accounting point of view, it is advantageous to keep the vast majority of assets in Switzerland, allowing the deduction of a larger proportion of interest expenses from Swiss income.

As far as can be seen, currently there is no concern over base erosion in Switzerland.

Apart from the interest expense allocation in proportion to the allocation of assets described above, there are no further rules limiting interest deductions on funds borrowed to finance foreign direct investments. However, at this stage it should be mentioned that dividend income received from a foreign subsidiary of a Swiss company will – despite the participation relief – be set off against losses, leading to a reduction of loss carryforwards. In other words, a Swiss company which borrows funds in order to purchase a (Swiss or foreign) subsidiary, will not be able to generate both Swiss tax loss carryforwards and tax-free dividend income. The dividend income, whether from Swiss or from foreign sources, will reduce the tax loss in Switzerland.

Since Switzerland has so far not implemented a consolidation system for tax purposes, there is no effect with regard to any foreign tax credits. As tax credits are

6 Supreme Court Decision dated 21 August 2007.

granted only for residual withholding taxes on dividend, interest or royalty income, such tax credits will be granted to the receiving entity only. Should the receiving entity provide no taxable income or even a loss, no tax credit would be granted.

2.3. Inability to deduct foreign losses against domestic income

Switzerland, at least for federal tax purposes but in the most cantons also for cantonal tax purposes, follows the so-called principle of total loss compensation. This means that foreign tax losses may be offset against Swiss income in the year the foreign losses arise. However, this compensation will be revised if during the following seven years the foreign operations result in a profit which can be set off in the foreign jurisdiction against the tax loss genuinely set off from Swiss income. In the case of foreign profit abroad it will be up to the taxpayer to demonstrate that there is no set off with the former tax losses accepted abroad.[7]

2.4. Foreign tax credit limitations

Swiss tax credits are on the one hand limited to the aggregate amount of any residual source taxes levied in the treaty states per calendar year according to an applicable double tax treaty. On the other hand this amount is limited to the amount of Swiss federal and cantonal/ municipal income taxes levied on the net income which is subject to foreign residual withholding tax.[8] The term "net income" means that interest and administrative expenses related to the income have to be deducted from the gross amount taxed in Switzerland.[9] As with regard to dividend payments the respective ordinance of the Federal Ministry of Finance provides for a lump sum deduction for administrative expenses of 5 per cent of the dividends. As with regard to royalty payments the deduction for both interest and administrative expenses amounts to 50 per cent.[10] In both cases the taxpayer is allowed to prove that the effective expenses are lower (or higher). This all means, in fact, that often less than the whole residual withholding tax will be credited, due to lower maximum amounts based on the Swiss taxation.

Another limitation refers to the source of income: as already mentioned, tax credits are only granted on dividend, interest and licence income and only on such income from treaty states. Therefore, any other income is restricted from tax credits; however, according to long-standing practice, the taxpayer is at least allowed to account for the net amount in the profit and loss statement,[11] which does not effectively prevent double taxation but reduces the amount on which taxes are levied. In other words, the tax base in Switzerland would be reduced by allowing accounting for net instead of gross income.

As already mentioned, if there is no profit taxable in Switzerland or even if there is a loss situation, no credit can be granted related to the income from foreign source. However, this in fact does not lead to effective but to virtual double taxation. It could be argued that the missed tax credit should be granted in later

7 Art. 52 para. 3 Swiss Federal Tax Act.
8 Peter Locher, *Einführung in das internationale Steuerrecht der Schweiz*, 3rd edn 2005, p. 495.
9 Art. 1 para. 1 Tax Credit Ordinance.
10 Art. 4 paras. 2 and 3 Tax Credit Ordinance.
11 Art. 3 Tax Credit Ordinance.

business years, when a profit can be taxed again, since without the foreign income the tax loss in Switzerland would be higher and would allow the taxpayer to set off this larger amount of tax losses against future income. However, in fact, no such argumentation will be made and there is no "tax credit carryforward" in the Swiss tax system.

At this stage it should also be mentioned that if a company is taxed as a holding company in Switzerland, and therefore its income is taxed only at a federal, but not at a cantonal and municipal level, there is a strict limitation of tax credits on residual withholding taxes of two-thirds.[12] Depending on the respective cantonal tax rate this limitation of tax credits by two-thirds can cause double taxation, since nowadays there are several cantons where the ordinary cantonal and municipal tax rate is significantly less than double the federal rate (8.5 per cent; the cantons of Nidwalden, Lucerne, Zug and Appenzell have ordinary cantonal and municipal tax rates of less than 10 per cent).

A partnership is not subject to tax itself from a Swiss tax point of view. Therefore, the partners are taxed directly if they are resident in Switzerland or they have a place of business in Switzerland, which is usually the case. In the latter case, the particular partner who is subject to tax is entitled to a tax credit on foreign taxes corresponding to his participation in the partnership.

As mentioned above, the tax credit is limited to the amount of tax effectively imposed in Switzerland on the foreign income in question. Therefore, non-profit organizations, holding companies which benefit from the holding privilege and from the participation relief or any other companies are not usually entitled to any tax credit.

The impact of a tax loss situation on tax credits has already been described above: in the case of a tax loss, no tax credit is granted and nor can it be deferred. In other words, the tax credit would be lost. Where no tax loss results, but where the income from foreign sources is higher than the overall income (i.e. loss on domestic income), the tax credit granted would be reduced proportionally to the amount of foreign income which is effectively taxed in Switzerland. This can be shown with the following example: gross royalty income from a foreign subsidiary: CHF 200. Taxable profit of Swiss company: CHF 100. Only 50 per cent of the tax credits would be granted. The current Swiss legislation does not allow any carryforward of tax credits.

2.5. Distortions due to temporal differences in the recognition of taxable income

Switzerland has not adopted any particular deferral rules. Income achieved by corporations is usually subject to tax when accounted in the profit and loss statement. According to the Swiss accounting rules income has to be accounted when realized, meaning when the receiving entity has a claim or even when the payment is made. Normally, any tax on the payment will be imposed at the same time in the foreign jurisdiction, with the consequence that no deferral should occur. However, with regard to foreign payments which were not accounted in the year they became due, it is justifiable to refer to the later accounting date when determining the maximum

[12] Art. 12, Tax Credit Ordinance.

amount of tax credits allowed, provided the accounting is done not later than three years after the due date.[13]

Similar to the lack of deferral rules, there are no explicit anti-deferral rules, except the time limit for which foreign tax credit can be claimed (see below). However, as with regard to the different ways in which income can be repatriated in any other way than as dividend payments, the arm's length principle has to be observed. This means that a subsidiary is allowed to grant an upstream loan – unless purely pretended – whereas in fact both parties, the lender (subsidiary) and the borrower (parent company), unanimously consent that no repayment will ever be made. The same will apply if no third party would have granted a loan to the parent company, due to its severe loss situation or to other circumstances. As a consequence, interest payments made or accounted by the parent company in favour of its subsidiary would not be accepted as deductible from the taxable profit.

Since there are no explicit tax deferral rules in Switzerland, no economic or financial impact can be reported.

Foreign tax credits can be set off against Swiss income tax within three years after the due date. This means, during this time, that even a different attribution of the income for the tax period will not cause a loss of the tax credits. After more than three years, basically no tax credit can be granted any longer. However, in practice, if, for certain reasons, the income subject to tax in the foreign country could not be reported or accounted in Switzerland, the tax credit should still be granted even after more than three years. In fact, the only reason why a claim for a dividend or interest payment not accounted in the books of the Swiss company would normally be accepted would be if the fulfilment of the claim was not certain, due to the severe financial situation of the company which was obliged to pay.

In the opposite case, if Switzerland taxed the income earlier than the source country, no difficulties or limitations arising from this deferral should occur, since the grant of a tax credit is not conditional on a subject to tax clause in Switzerland.

2.6. Inconsistent classification of foreign entities

2.6.1. Classification of foreign entities

The Swiss tax credit system does not allow any indirect credits for taxes paid by foreign corporations on the income out of which a dividend is paid to the taxpayer resident in Switzerland.

However, depending on the legal character of the foreign entity, it is sometimes difficult to determine whether a foreign entity has to be treated as one legal entity or whether it rather constitutes a partnership, with the consequence that the particular partners or shareholders become subject to tax in Switzerland. Moreover, partnerships with predominantly passive income may under certain conditions not be recognized as having their legal domicile abroad but instead as being resident in Switzerland or in a third country. As a consequence, the partnership or the partners will be taxed on the same income which was taxed in the foreign country. No tax credit would be granted.

13 Locher, *op. cit.*, p. 497.

2.6.2. Partnerships, not-for-profit organizations

Some countries (e.g. the USA, see Internal Revenue Code, section 894) require that the profits achieved through a tax transparent vehicle – be it a fund or a partnership – are taxed on a current basis, whether distributed or not. If this condition is not met, the entitlement to any relief granted by the double tax treaty will be denied. The Swiss accounting rules, which have to be followed for the purpose of the annual tax statement, generally do not allow any income to be shown before it is realized, i.e. prior to its distribution. In other words, income cannot be shown in the accounts and therefore cannot be taxed if it has not yet been distributed.

This means that a Swiss corporate taxpayer which invests in US equities through a tax transparent investment vehicle, i.e. a Swiss or foreign fund, will have difficulties in applying the USA–Switzerland treaty and claiming the treaty benefits on US source income if the income is accumulated in a fund instead of being distributed on an annual basis, since the income will not be taxed in Switzerland prior to its distribution.

It should, however, be mentioned here that Swiss pension funds which very often invest through foreign tax transparent partnerships or funds in US (and other) equities, due to the scaling effect achieved with this structure, should not suffer the disadvantages described above, since Swiss pension funds are legally required to account for their assets at the annual net asset value. Given the assumption that any accumulated (not distributed) dividend received by a fund should increase its net asset value, it can be argued that the difference between the net asset value at the beginning of the business year and the net asset value at the end of the business year provides the taxable income and therefore any accumulated dividend income (including that from US sources) is included in the tax base. Therefore, Swiss pension funds should be entitled to obtain the treaty benefits irrespective of whether they invest in accumulating or distributing funds. As far as can be seen no practice exists.

For entities other than pension funds, alternative solutions will need to be found. One solution could be to disclose and tax the accumulated profits exclusively for tax purposes while the income is not shown in the commercial accounts. A taxpayer following this method would have to make sure that the profit achieved on the sale or redemption of the shares in the fund was – for tax purposes – reduced by the profits already taxed on an annually arising basis. A ruling from the competent tax authorities is recommended.

If no such solution can be found, it is likely that the USA will not grant any relief from US withholding tax on dividends paid by US equities. In other words, the entitlement to any double tax treaty relief will be denied. However, this denial is based on US domestic law, whereas according to the double tax treaty[14] the source country (USA) would be allowed to impose a residual withholding tax of 15 per cent at maximum. This means, from a Swiss point of view, that at least a tax credit of 15 per cent should be granted in Switzerland. Nevertheless, due to the denial of any relief based on the tax treaty, double taxation will still remain.

From a Swiss point of view, tax treaty benefits, i.e. any tax relief according to the double tax treaty, should usually be granted where a foreign taxpayer, investing

[14] Art. 10 s. 2(b) Switzerland–USA double tax treaty.

through a tax transparent collective investment vehicle in Swiss equities, claims full or partial relief of Swiss withholding tax. The taxpayer will have to give evidence about his share and his entitlement to the dividend payment which was subject to Swiss withholding tax. Such evidence requires proper and comprehensive tax reporting, providing the portion of entitlement of each shareholder as per any due date of any Swiss dividend for which a treaty benefit is claimed. With respect to international double taxation it also should be mentioned that according to the practice of the Federal Tax Administration[15] the participation exemption on dividends received from Swiss and foreign equities held through a collective investment scheme is denied. As a result, with regard to foreign participations, the same income is taxed twice, initially as profit of the foreign entity and then as the dividend income of the receiving Swiss entity. However, if the dividend payment is taxed at source in the foreign country, a tax credit should be granted.

All the above shows in a certain way the ambiguous relationship that Swiss practice has towards tax transparent partnerships. Swiss collective investment schemes are entitled to reclaim Swiss withholding tax on behalf of Swiss investors, whereas with regard to foreign withholding tax each investor has to claim the applicable amount of source tax based on the appropriate double tax treaty for himself.

Despite the fact that Swiss collective investment schemes are not considered "resident" from an international tax point of view, they are entitled to obtain treaty benefits as a result of negotiations by the Swiss authorities.[16] And finally, it has to be mentioned that various double tax treaties between Switzerland and foreign countries allow partnerships to obtain treaty benefits on behalf of their shareholders, although the partnership itself is not treated as resident and nor is it entitled to treaty benefits in its own name.[17]

Although not a matter of double taxation, but closely related to these questions, it should be mentioned that a Swiss shareholder in a foreign partnership will not be entitled to claim the refund of Swiss withholding tax on dividends paid by Swiss equities. He will suffer the whole withholding tax of 35 per cent, whereas for the non-Swiss partners of the same partnership at least a partial refund based on the respective double tax treaty will be granted.

3. Pros and cons of credit versus exemption

3.1. Complexity and sophistication

While the exemption method does not cause any particular difficulties apart from the common rules related to international profit allocation, the credit method may cause not only difficulties but also disadvantages for the taxpayer in situations where the taxpayer as a company is not fully taxed in Switzerland for either federal or cantonal purposes.

15 Circular resolution 25 s. 4.4.

16 Circular resolution 24 s. 2.1.10, 1-3.

17 See negotiation protocol Switzerland–Germany dated 18 June 1971; Andreas Kolb, "Abkommensberechtigung ausländischer Personengesellschaften und anderer Unternehmensstrukturen", *IFF Forum für Steuerrecht* 2006, pp. 137 *et seq.*

Since the tax credit granted is reduced by a fixed percentage in the case of certain tax privileges (mixed company or even holding company) this reduction may be too high in cantons with low corporate tax rates, since such cantonal tax privilege does – compared with the federal tax – not reduce the tax burden in the same ratio as the reduction of the tax credits.[18]

Furthermore, the Swiss tax credit system does not avoid international double taxation in full, since on one side it is the gross income which is subject to tax in Switzerland but the tax credit granted is calculated on the net income.[19]

Currently it is under discussion whether there will be a reduction of the tax credits granted in those cases where a company benefits from the new rules around the so-called licence box (e.g. in the canton of Nidwalden), which allows an ordinarily taxed company to reduce the tax on its royalty income by 80 per cent at the cantonal level. At present, there is at least no legal basis for such a reduction of foreign tax credit.

3.2. Administrative burden

For ordinarily taxed companies, there are no particular administrative burdens related to the claiming of tax credits. As already mentioned above, difficulties may arise from situations where a company benefits from certain tax privileges, e.g. from holding status or mixed privilege, with the consequence that the profit is not or only partially taxed at the cantonal level. This leads to a limitation of the tax credit which is calculated on a static basis.

Apart from that and probably due to the fact that there is no consolidated taxation of group income in Switzerland, no further difficulties should arise.

For those income components for which the exemption system applies (foreign landed property, foreign fixed place of business), the proper allocation of the income is key. In particular, income from foreign branches is subject to being challenged by the Swiss tax authorities. However, in fact, due to the usually lower tax rates in Switzerland compared to foreign tax rates, Swiss companies with foreign branches tend to allocate a rather bigger portion of their income to Switzerland than to the foreign company.

Once a foreign branch is recognized by the Swiss tax authority, the usual transfer pricing guidelines apply.

Particularly with respect to financial institutions there is a risk of being challenged in both Switzerland (country of residence) and the foreign (branch) country: the foreign country may claim a certain capital allocation, depending on the nature of the activity of the branch located in this country. As an example, if a Swiss bank is running a branch through which loans to bank customers are provided, the branch country may claim that an amount of reserves, corresponding to the loans granted, has to be allocated to this country. As a consequence, the same branch country will claim a reasonable profit related to the reserves or capital allocated. This may lead to double taxation if the Swiss financial institution claims that the loans granted are processed and managed in Switzerland and that the risk of failure of these loans is allocated to Switzerland.

18 Robert Waldburger, General Meeting of Interational Fiscal Association, 10 June 2010.
19 Günther Schäuble and Reto Giger, "Lizenzbox in Nidwalden", *Steuerrevue* 2010, p. 718.

Whether or not a foreign tax credit is granted is not conditional and therefore not scrutinized on the amount of tax effectively paid in the foreign country but much more on the applicable double tax treaty which states the amount of residual withholding tax on any income. The tax credit has to be claimed at the same time as the annual tax return is filed, but in most cantons from a different department of the tax authority than the tax return is sent to. The tax exemption, i.e. the international tax allocation, is part of the ordinary tax return and is therefore subject to scrutiny within the annual tax assessment or in the course of an ordinary tax audit.

3.3. Sensitivity to international tax planning and tax avoidance

The exemption of profits made through a foreign fixed place of business (i.e. a foreign branch) makes it advantageous for companies resident in Switzerland to claim a foreign fixed place of business. This allows the allocation of a certain amount of the profits to the foreign branch irrespective of whether the foreign country recognizes the branch or not. Due to the fact that there is no subject to tax provision in Switzerland the most effective tax saving occurs if the domestic tax authorities accept the claimed foreign branch exemption whereas the foreign country does not impose any tax on this branch, either because it has no information about the claimed branch, or because it follows other criteria about what constitutes a branch and allows taxation. From that point of view tax planning with situations where the exemption method applies is much more attractive than with regard to income components which are subject to foreign tax credits.

Furthermore, tax credits are denied in cases of tax avoidance, according to the Swiss anti-avoidance rules. This would mean that if such an anti-avoidance rule was applicable, double taxation of the income component would occur. The only possibility of achieving a real benefit in the framework of the existing tax credit rules would arise from a different definition of income by the source country and the domestic tax authority, i.e. the source country qualifying certain payments as management fees, while the domestic tax authorities qualified the same income as licence fees for which a source tax would be allowed to be levied in the source country based on the applicable double tax treaty and therefore a tax credit to the amount of the residual source tax could be granted. Hence, since the most countries follow the definitions set forth in the OECD model tax convention, in practice there are not many such situations.

3.4. Compatibility with applicable international commitments

As already mentioned at the beginning of this report, Switzerland follows an exemption system only for income from landed property, and from fixed places of business, whereas any other income is taxed on a worldwide basis, as long as no double tax treaty limits the right to tax. Therefore, the Swiss double tax treaties mostly follow the tax credit system. Should Switzerland shift to a tax credit system for all types of income, i.e. including income of foreign landed property and foreign fixed places of business, such income would "automatically" fall under the tax credit method according to the existing double tax treaties. In the opposite case, if any income from foreign sources already being exempt under domestic Swiss tax legislation, no double tax treaty would need to be applied in this situation and therefore no amendment would need to be made. Currently, it is not expected that such changes will be made in the near future.

3.5. Impact on economic decisions

Whether or not the Swiss system to avoid international double taxation has an economic impact on any particular activities of a company or of a group, it is difficult to say. But due to the exemption of any income from foreign fixed places of business and due to the fact that Switzerland does not follow a consolidated taxation of group income, this may be a reason for Switzerland being a head office jurisdiction, allowing multinational groups to establish their head office activities in Switzerland and allocate their operating activities and the income derived therefrom to any other country which appears suitable for tax and business reasons.