Xavier Oberson / Howard R. Hull

Switzerland in International Tax Law

Fourth Revised Edition

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Switzerland in International Tax Law (Fourth Revised Edition)

Why this book?
Switzerland has recently witnessed an unprecedented amount of tax treaty negotiations. Although this is a direct result of Switzerland's revised position regarding exchange of information, a number of Contracting States have taken this opportunity to modify tax treaty benefits and/or clarify certain aspects of tax treaty interpretation and application. These are developed extensively in this fourth revised edition.

As Switzerland has steadily aligned itself with the principles of international taxation, the self-imposed anti-abuse rules for the application of tax treaties have been modified significantly. Indeed, Swiss courts have become more creative in determining where there is and where there is not treaty abuse. As a result, the 1962 Abuse Decree is making way for a more complex basket of anti-abuse rules and regulations.

Switzerland in International Tax Law is designed for practitioners wishing to acquire a working knowledge of the Swiss tax issues involved in international cross-border investment. Whether Switzerland is the source or the destination of income, both domestic and international laws are explained in detail. Due to Switzerland's traditional role in international taxation, particular attention has been paid to the special tax relief granted to Swiss resident individuals and corporations as well as the complex rules for the avoidance of treaty abuse.

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International Allocation of Taxable Income

3.1. Business profits

3.1.1. Principles of taxation

International businesses are companies, partnerships or individuals which operate in more than one state. The principles of taxation for the international treaty allocation of taxable business profits are covered by Arts. 7(1) and 8 of the OECD Model Treaty.

3.1.1.1. General principle

Under the general principles, an enterprise of one contracting state is not taxable in the other state until it is considered to have set up a permanent establishment in the other state. Once it has been determined that there exists a permanent establishment in the other state, the other state may only subject the international enterprise to taxation on profits which are attributable to the permanent establishment. Therefore, the right to tax does not extend to profits that the enterprise may derive from that state otherwise than through the permanent establishment.

Most Swiss tax treaties have adopted a similar provision. Some Swiss treaties further allow the contracting state of a permanent establishment to levy a branch profit tax on the profit generated by such enterprise (in particular, *Australia*, *Canada* and the *United States*). Swiss domestic law allows for Swiss resident businesses to obtain relief on income which is attributable to a foreign enterprise or permanent establishment (Arts. 6(1), and 52(1) DTL). In addition, non-resident businesses are exempt from Swiss taxation unless their income is attributable to a Swiss enterprise or permanent establishment (Arts. 4(1) and 51(1) DTL).

Simple in appearance, this general principle raises two questions. First, it is necessary to define permanent establishments (see 3.1.2.). Second, where a permanent establishment exists, the rules of allocation of profits to the permanent establishment must be clarified (see 3.1.3.).

3.1.1.2. Shipping, inland waterways transport and air transport

Business profits in the field of shipping, inland waterways transport and air transport have special rules governing the place of taxation. These are laid down in Art. 8 of the OECD Model Treaty.

This article allows for the taxation of profits from shipping and air transport in international traffic as well as from transport on rivers, canals and lakes in the state in which the effective management of the enterprise is situated (Paras. 1 and 2). This is the case regardless of the fact that such profits may be attributed to various different beneficiaries on the basis of a pooling arrangement or other contract of a similar nature (Para. 4). Enterprises which are not exclusively engaged in this type of activity may take advantage of these rules of allocation with regard to profits arising to them from the operation of ships, boats or aircraft belonging to them (Art. 8, Para. 18 OECD Commentary). If the place of effective management of the enterprise is aboard a ship or a boat, tax will only be charged by the state where the harbour of the ship or boat is situated or, if there is no such home harbour, in the contracting state of which the operator of the ship or boat is a resident (Para. 3).

Most Swiss treaties, following the OECD Model, attribute the right to tax to the state in which the effective management of the enterprise is situated. There are some exceptions, however. In particular the tax treaties with Australia, Canada, Korea (Rep.), Finland, Japan, Malaysia, Portugal, Singapore and the United States grant the right to tax shipping, waterways transport and air transport in international traffic to the state of residence of the enterprise.[156] In addition, Switzerland has concluded separate bilateral reciprocal declarations in this area with many states.

3.1.2. Permanent establishment defined

3.1.2.1. Legal basis

Due to the importance of permanent establishments for international enterprises, it is necessary to formulate a precise definition of what a permanent establishment is and is not. Indeed, it is now widely recognized that a permanent establishment is the minimal threshold which allows a state to tax a foreign enterprise conducting business activities within the territory of

156. Oberson (2009), p. 108; Locher (2005), p. 360.

that state. The definition of permanent establishments in Swiss tax treaties largely follows the rules of Art. 5 of the OECD Model Treaty, which reads as follows:

1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

2. The term "permanent establishment" includes especially:
a) a place of management;
b) a branch;
c) an office;
d) a factory;
e) a workshop, and
f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

3. A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.

4. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:
a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;
e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;
f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

5. Notwithstanding the provisions of paragraphs 1 and 2, where a person – other than an agent of an independent status to whom paragraph 6 applies – is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this

fixed place of business a permanent establishment under the provisions of that paragraph.

6. An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.

7. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

It follows from this definition that an enterprise which is a resident of one contracting state is considered to have a permanent establishment in the other contracting state either because it has a fixed place of business through which it operates in the other state (see 3.1.2.2.) or because there is a person acting for it in the other state (see 3.1.2.3.). There are special rules with regard to subsidiaries (see 3.1.2.4.).

3.1.2.2. Fixed place of business

3.1.2.2.1. *Treaty definition*

A *place* of business may be a facility, such as premises or, in certain instances, machinery or equipment. It is immaterial whether the premises, facilities or installations are owned or rented by or are otherwise at the disposal of the enterprise.

This place of business must be *fixed*, i.e. it must be established at a distinct place with a certain degree of permanence (Art. 5, Para. 2 OECD Commentary). However, if the place of business is not set up merely for a temporary purpose, it can constitute a permanent establishment, even though it exists, in reality, only for a very short period of time because of the special nature of the activity of the enterprise or because, as a consequence of special circumstances (e.g. death of the taxpayer, investment failure), it was prematurely liquidated (Art. 5, Para. 6.3 OECD Commentary). Para. 3 helps to determine whether a building site or construction or installation project is considered as being “fixed”, by characterizing such activities as permanent establishments only if they last more that 12 months.

The enterprise must carry on its *business* through the fixed place of business. This means usually that "persons who, in one way or another, are dependent on the enterprise (personnel) conduct the business of the enterprise in the State in which the fixed place is situated" (Art. 5, Para. 2 OECD Commentary). Treaty dispositions prevent activities of a purely preparatory or auxiliary character from being considered permanent establishments. It is often difficult to distinguish between activities which have a preparatory or auxiliary character and those which have not. The decisive criterion is whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole. Each individual case must be examined on its own merits. In any case, a fixed place of business whose general purpose is one which is identical to the general purpose of the whole enterprise, does not exercise a preparatory or auxiliary activity (Art. 5, Para. 24 OECD Commentary).

With regard to activities of a preparatory or auxiliary nature, on 17 September 1976[157] the Swiss Supreme Court had the occasion to confirm the application of Art. 5(3)(e) of the Spain–Switzerland tax treaty. A Spanish bank had set up a representation office in Geneva. Its mission was to explain to banks and Swiss businesses the services that the Spanish bank can render, to establish contacts with Swiss businessmen in view of Spanish business, and to provide the Spanish head office with information concerning the Swiss economy. The representation office had not negotiated or signed any contracts on behalf of the Spanish bank. The question had been raised as to whether the Geneva operations constituted a permanent establishment. The Swiss Supreme Court concluded that the mere fact of having an office in Switzerland was not sufficient to constitute a permanent establishment. It was moreover necessary to analyse the activity in Switzerland. Based on the above-mentioned facts, the Swiss Supreme Court judged that the bank did not conduct any of its banking business through the Swiss office and that the activities of the Swiss office could only be characterized as being of a preparatory or auxiliary nature. It was therefore not considered a permanent establishment.

3.1.2.2.2. *Swiss domestic law*

Under Swiss domestic law, at the *federal* level, Arts. 4(2) and 51(2) of the DTL define permanent establishments as being fixed places of business which are wholly or partially engaged in the business activities of an enter-

157. Supreme Court judgement of 17 September 1976, ATF 102 Ib 264, Archives 45,602.

prise or an independent profession. They include, in particular, branches, manufacturing plants, workshops, sales offices, permanent agencies, mines and other plants for the extraction of mineral resources and building or installation projects with a duration of at least 12 months. As per leading opinion, this definition does not necessarily exclude activities that are preparatory or auxiliary.[158]

At the *cantonal* level, the concept of permanent establishment, even if it is not defined in the THL, should correspond to the usually applied definition at the intercantonal and international levels.[159] In a long-standing series of cases, the Supreme Court has defined permanent establishment for the intercantonal allocation of profits as a fixed place of business with which an enterprise engages in an essential qualitative and quantitative part of its technical or commercial activity.[160] Under Swiss practice, a piece of equipment could be regarded as *a place of business*. The presence of human personnel is in particular not a requirement for the definition of a place of business. For instance, even though this case was rendered in an intercantonal situation, the Supreme Court judged in a 1903 case that vending machines (*Automaten*), which distributed goods against payment at the place of location, must be characterized as permanent establishments of an enterprise whose registered office was in another canton.[161]

Swiss legislation governing *VAT* requires taxable persons without domicile or place of business within Swiss territory to appoint a representative for the fulfilment of their obligations (Art. 17, 67 NVATL). However, this does not give rise to a permanent establishment with regard to direct taxation (Art. 67(3) NVATL).

3.1.2.3. Representatives

Although an enterprise in one contracting state may not have a fixed place of business in the other contracting state through which the business of an enterprise is wholly or partly carried on, there may nevertheless be a permanent establishment in the other state if a person habitually acts on behalf of the enterprise and concludes contracts in the name of the enterprise.

158. Oberson (2009), p. 123.
159. See Message of the Federal Council pertaining to the DTL and THL, 25 May 1983, FF 1983 III, p. 87.
160. See Supreme Court judgement of 2 November 1984, *L A.G.,* ATF 110 Ia 190, 193.
161. Supreme Court judgement of 25 March 1906, ATF 29 I 8.

This is confirmed by Art. 5(5) of the OECD Model Treaty. Persons concerned by this provision are so-called dependent agents (Art. 5, Para. 32 OECD Commentary). They may be either individuals or companies.

There is no permanent establishment if the representative is an independent broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business (Art. 5(6) OECD Model Treaty). In addition, activities undertaken by a dependent agent of a purely preparatory or auxiliary character (as defined by Para. 4) shall not constitute a permanent establishment.

Under Swiss domestic law, however, a dependent permanent agent may be characterized as a permanent establishment only to the extent that it exercises its activity in a fixed place of business. [162]

3.1.2.4. Subsidiaries

It is mentioned in Art. 5(7) of the OECD Model Treaty that the existence of a subsidiary company does not, of itself, constitute a permanent establishment.

A subsidiary is an independent legal entity and does not usually constitute a permanent establishment. However, the OECD Committee on Fiscal Affairs specifically mentions that a subsidiary company will constitute a permanent establishment for its parent company under the same conditions stipulated in Para. 5 as are valid for any other unrelated company, i.e. if it cannot be regarded as an independent agent in the meaning of Para. 6, and if it has and habitually exercises an authority to conclude contracts in the name of the parent company (Art. 5, Para. 41 OECD Commentary).

3.1.2.5. The impact of e-commerce

A very important question, which has caused a lot of discussion and controversy, is to what extent a "web site" or an Internet server could constitute a permanent establishment.[163] The OECD has somewhat clarified this

162. Oberson (2009), p. 126; Athanas/Widmer in: *Kommentar DBG*, Art. 51 N 29.
163. Literature on the subject is extremely broad. See among many others, Doernberg/Hinnekens (1998); Hinnekens (1999), p. 3; Skaar, A., "Erosion of the Concept of Permanent Establishment: Electronic Commerce", *Intertax* (2000), p. 188.

issue.[164] As a general rule, Switzerland follows the OECD recommendations in this field.

As we have seen above, a permanent establishment requires premises or, at least, machinery or equipment located in Switzerland. The simple fact that customers access an *Internet web site* cannot be deemed to be a fixed place of business. As such, a web site is not tangible property, but a combination of electronic data[165] and cannot constitute a place of business.

The situation is more difficult in the case where a foreign enterprise uses *servers* located within Switzerland. A *server* could be treated as a place of business, since under Swiss practice, the presence of human personnel is not a requirement in the definition of place of business. It is not relevant whether this equipment is owned or rented (wholly or partly) by the foreign resident company, provided it is at the disposal of the company. Nevertheless, only in rare situations can a server be qualified as a permanent establishment. First, in order to be treated as a *fixed* place of business, the server should effectively remain in the same place for a certain period of time. Second, and more importantly, assuming that a server is considered to be fixed, the functions fulfilled by the equipment located in Switzerland must fulfil all or part of the *core business* of the enterprise. As a consequence, in most cases this condition can disqualify the server from being a permanent establishment because its functions are limited to the transfer of data. Third, the treaty definition of permanent establishment would disqualify all servers whose scope is limited to services which are considered to be *preparatory and ancillary*. We therefore tend to believe that a server can only exist as a permanent establishment when the equipment fulfils all the main elements of a contract (conclusion, payment, and delivery of digitized goods).[166]

Finally, in most cases, the presence of the Internet service provider (ISP) in Switzerland will not be regarded as an agent of the foreign enterprise. Indeed, among other considerations, the ISP will have no authority to conclude contracts on behalf of the foreign enterprise operating the web site.

164. OECD Commentary on Art. 5.
165. See OECD, revised draft of 3 March 2000, of a proposed clarification of the Commentary on Art. 5 of the OECD Model.
166. Oberson (2009), p. 122; OECD Commentary.

3.1.3. Allocation of profits

3.1.3.1. Principles of international treaty law

3.1.3.1.1. *In general*

Once it has been ascertained that a business has a permanent establishment in another jurisdiction, it is necessary to determine the amount of taxable income which is to be allocated to that permanent establishment. The main methods used for the allocation of profits are the direct and the indirect methods. The third method, called the force-of-attraction principle, is nowadays clearly rejected (C(7), Para. 12 OECD Commentary).

Under the *direct method*, profits which are to be attributed to each permanent establishment are those which it would have made if the permanent establishment had been a separate, unrelated and distinct enterprise engaged in the same or similar activities under the same or similar circumstances. Income is therefore determined on the basis of separate accounts pertaining to the permanent establishment.

Under the *indirect method*, the income of the permanent establishment is calculated as a fraction of the total profits earned by the enterprise. The permanent establishment's participation in the total income is quantified by applying coefficients based on a comparison of assets, turnover, number of hours worked or other appropriate factors.

The fundamental difference between the direct and indirect methods is that, under the direct method, a permanent establishment is treated as an independent entity. As a consequence, in a loss situation it does not participate in the allocation of the total net income. Under the indirect method, on the other hand, a permanent establishment running at a loss may very well participate in the total net income. This is due to the fact that the permanent establishment is treated as a part of the enterprise as a whole and that the latter may not be taxed more than on its global profits.

In order to ensure a more consistent interpretation and application of the rules governing the allocation of profits between head offices and permanent establishments, the OECD Committee on Fiscal Affairs issued a report in 2008 titled "Attribution of Profits to Permanent Establishments".[167] The report deals with the attribution of profits both to permanent establishments

167. Attribution of Profits to Permanent Establishments, OECD, Paris, 2010.

in general (Part I of the Report) and, in particular, to permanent establishments of businesses operating in the financial sector, where trading through a permanent establishment is widespread (Part II of the Report deals with permanent establishments of banks; Part III deals with permanent establishments of global trading; and Part IV deals with permanent establishments of enterprises carrying on insurance activities)(C(7), Para. 9 OECD Commentary).

The OECD Model Treaty of 22 July 2010 reflects the approach developed in the 2008 report. The allocation of profits between head offices and permanent establishments is now covered by Art. 7, Paras. 2 to 4 of the OECD Model Treaty as follows:

> 2. For the purposes of this Article and Article (23A)(23B), the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.
>
> 3. Where, in accordance with paragraph 2, a Contracting State adjusts the profits that are attributable to a permanent establishment of an enterprise of one of the Contracting States and taxes accordingly profits of the enterprise that have been charged to tax in the other State, the other State shall, to the extent necessary to eliminate double taxation on these profits, make an appropriate adjustment to the amount of the tax charged on those profits. In determining such adjustment, the competent authorities of the Contracting States shall if necessary consult each other.
>
> 4. Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.

Para. 2 attributes the profits to a permanent establishment that it might be expected to make if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed. There is therefore a fiction that the permanent establishment is a separate enterprise acting independently from the rest of the enterprise of which it is a part – which corresponds to the arm's length principle, which is also applicable, under the provisions of Art. 9, for the purpose of adjusting the profits of associated enterprises (C(7), Para. 16 OECD Commentary).

This very clearly advocated the application of the direct method of allocation. As a consequence, if the enterprise as a whole is in a loss situation, profits may nevertheless be allocated to the permanent establishment, as it does not participate in the allocation of total net losses. Conversely, if the enterprise as a whole is profitable, there may be no profits allocated to the permanent establishment that is in a loss situation.

Prior to 2010, the OECD Model Treaty read as follows:

> 2. Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.
>
> 3. In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere.
>
> 4. Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.
>
> 5. No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.
>
> 6. For the purposes of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.

The pre-2010 OECD Model Treaty therefore included wording about the indirect method of allocation, stating that it is not forbidden, but that it is applicable only if it is "customary" in a contracting state. Thus, countries which did not habitually attribute profits on the basis of separate accounts, but by apportioning the total profits of the enterprise by reference to various formulae (indirect method), may do so. The OECD Committee on Fiscal Affairs nevertheless had previously mentioned that this method should be used only where, exceptionally, it has as a matter of history been customary

in the past and is accepted in the country concerned by both the tax authorities and taxpayers generally there as being satisfactory (C(7)-12, Para. 25 OECD Commentary before 22 July 2010). In the 2010 version, the Committee has wholly deleted any reference to the indirect method because "its application had become very exceptional and because of concerns that it was extremely difficult to ensure that the result of its application would be in accordance with the arm's length principle" (C(7), Para. 41 OECD Commentary).

The 2008 Report provides a detailed guide as to how the profits attributable to a permanent establishment should be determined using a two-step approach. The first step is to undertake a functional and factual analysis. The second step is to price any transactions with associated enterprises attributed to the permanent establishment by means of the OECD Transfer Pricing Guidelines (see Chapter 6).

Under a principle commonly known as the "*force of attraction*" of permanent establishments, states in which there is a permanent establishment levy taxes on all income sourced in that state. In other words, the permanent establishment "attracts" all income sourced in the state in which there is a permanent establishment. This principle is not accepted by the OECD Model Treaty or Swiss treaty policy. Indeed, business profits are only taxable in a state if they are effectively connected to that permanent establishment. This is confirmed by the special provisions in the OECD Model Treaty covering dividends (Art. 10(4)), interest (Art. 11(4)) and royalties (Art. 12(3)), whereby such income which is paid by a person in one contracting state to a resident of the other contracting state, shall be subject to the articles concerning dividends, interest and royalties, respectively, unless it is "effectively connected" to a permanent establishment or fixed base in the state of which the paying entity is a resident.

Therefore, on the one hand, if not effectively connected to a permanent establishment or fixed base in the state of which the paying entity is a resident, such income shall be considered dividends, interest or royalties for the application of the tax treaty. On the other hand, if effectively connected to a permanent establishment or fixed base in the state of which the paying entity is a resident, such income shall be considered business profits or independent personal services for the application of the tax treaty.

While the OECD Guidelines ensure a more consistent interpretation and application of the rules of allocation of profits to permanent establishments, it is the domestic law of each contracting state that determines how

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