Dear reader

On 12 February 2017, Swiss voters rejected the Corporate Tax Reform III as adopted by the Federal Parliament last summer. The need for a corporate tax reform is undisputed and the Swiss Federal Council will now prepare a revised bill.

Moreover, the Swiss Federal Council has decided to bring into force the changes to the Swiss Withholding Tax Act in connection with the application of the notification procedure on intra-group dividends as of 15 February 2017. Consequently, taxpayers can claim back late payment interest paid to the Swiss Federal Tax Administration provided the respective requirements are met.

In this issue of our quarterly newsletter we inform you about these important topics and some further very relevant tax developments.

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Swiss voters reject Corporate Tax Reform III in public referendum

Executive summary

On 12 February 2017, Swiss voters, in a popular vote, rejected the federal bill on Corporate Tax Reform III (CTR III) as adopted by the Federal Parliament last summer.\(^1\) The need for tax reform is undisputed in Switzerland and the Federal Council will now prepare a revised bill as quickly as possible. This means that the reform will not take effect in 2019 as planned, but may be delayed by one to three years depending on the further legislative procedure. The current tax legislation remains in force and the existing tax regimes remain available until a new law is passed.

Detailed discussion

CTR III was supposed to align the Swiss corporate tax system with international standards by replacing existing tax regimes with a new set of internationally accepted measures effective 1 January 2019. Disagreements on the scope of the new measures and the handling of the anticipated tax losses caused the rejection. Opponents argued that the tax revenue shortfall eventually would have to be borne by the Swiss population.

The need for a tax reform itself is undisputed and Switzerland remains committed to reform its tax system in order to retain its high attractiveness as business location for international companies. The preparation and adoption of a revised federal bill will result in a delayed implementation of the reform.

Key aspects of the current status are:

- Rejection of CTR III changes nothing for Swiss-based companies in the short term. The current corporate tax laws remain in force until a new law is passed. Current tax regimes should generally remain available until a revised tax reform is effectively enacted.
- The Federal Council announced that it will prepare as quickly as possible a revised bill on tax reform in close consultation with the cantons, communes, business community and the political parties. During its meeting on 22 February 2017, the Federal Council instructed the Federal Department of Finance to draw up the substantive parameters for a new tax proposals by mid-2017 at the latest following the vote on corporate tax reforms. Timing is currently unclear but a delay by one to three years may be expected considering the complexity of the reform and the fact that the cantons have two years for implementation at the cantonal level.
- It is assumed that the further legislative procedure, including the delay of the Swiss tax reform, will be discussed in an ongoing dialogue with the European Union and the Organisation for Economic Cooperation and Development (OECD).
- Cantons are sovereign to adopt unilateral changes to their cantonal tax laws within the framework of the federal tax harmonization law. In particular, they can unilaterally reduce their corporate tax rates in order to strengthen their fiscal competitiveness. Numerous cantons are already providing very attractive low statutory tax rates between 11.5 - 15% (including federal tax).
- Most cantons allow a tax-neutral disclosure of built-in gains upon a change of the cantonal tax status resulting in a comparable low cash tax rate during the subsequent amortization period (step-up). This would be relevant if a company decided to voluntarily exit a preferential tax regime before a revised version of CTR III is effectively implemented.

Despite of the referendum and the resulting delay of tax reform, Switzerland remains an attractive business location with its highly skilled workforce, excellent infrastructure, and the overall attractive tax environment. Companies engaged in business activities in Switzerland should analyze potential impact of future changes and consider potential alternative strategies, such as a voluntary exit from a tax regime with step-up or a tax-neutral move to another canton.

Future Alerts will report on developments in the tax reform process.

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Swiss Federal Council implements taxpayer-friendly changes to Swiss dividend notification procedure

Executive summary
The Swiss Federal Council has decided to bring into force the changes to the Swiss Withholding Tax Act in connection with the application of the notification procedure on intra-group dividends (withholding tax relief at source) as of 15 February 2017 after the referendum deadline has expired without action. Consequently, taxpayers can claim back late payment interest paid to the Swiss Federal Tax Administration (SFTA) provided the respective requirements are met.

Key elements of the revised regulations are:

- The notification procedure can still be applied even if the dividend is notified after the 30-day period provided the substantive conditions are fulfilled.
- No interest for late payment is imposed as long as the substantive requirements for the notification procedure are met and the dividend is declared and notified to the SFTA (regardless of the 30-day period).
- Late filing of the declaration and notification forms can be sanctioned by an administrative fine of up to CHF 5,000.
- New regulations will apply with retroactive effect to all cases where the claims for tax and/or interest on late payment have not passed the statute of limitations or have not been finally assessed prior to 1 January 2011.

Detailed discussion
Reclaim procedure
Due to the retroactive effect of the new regulations, unpaid invoices for late payment interest will be cancelled and late payment interest already paid to the SFTA can be reclaimed, if the respective requirements are met. The SFTA published an official announcement and outlined the procedural steps in connection with this amendment of the Swiss Withholding Tax Act. The official statement includes the following:

- Annulment of unpaid invoices for late payment interest
  Unpaid late payment interest invoices that were issued following a denial of the dividend notification procedure will be officially annulled by the SFTA as long as the respective Swiss company qualifies for the amended provisions (i.e., fulfillment of substantive requirements for the application of the notification procedure and conditions for retroactive effect are satisfied).
- Process for refund of late payment interest already paid
  Companies that were required to pay late payment interest on withholding tax (WHT), even though the substantive requirements for the application of the dividend notification procedure were met, can file a refund claim with the SFTA as of 15 February 2017. For this purpose, the SFTA has published a specific refund form on its website. Such claim for refund must be filed within one year of the entry into force of the new provisions (i.e., by 14 February 2018).

Even if the 30-day period is now officially redefined as a non-forfeiture deadline, it is critical that companies are compliant with the specific filing and notification requirements in order to avoid administrative fines.

Companies with unpaid invoices for late payment interest due to omission of the 30-day notification deadline should receive a written confirmation from the SFTA that the respective invoices are officially cancelled. Alternatively, action is required for companies which already paid late payment interest to the SFTA and are eligible for a refund based on the new law. Refunds must be claimed with the official form (1 RVZ) within one year of the entry into force of the new provisions (i.e., by 14 February 2018).

Next steps
Swiss Federal Tax Administration issued final guidelines on Automatic Exchange of Information

The Swiss Federal Tax Administration (SFTA) recently issued the final guidelines on the Standard for the Automatic Exchange of Information (AEOI). Under the AEOI, Swiss financial institutions will start collecting information as of 1 January 2017 and report such information to the SFTA. The SFTA will then exchange this information with its partner countries as of 1 January 2018.

Consequently, the Swiss bank secrecy provisions will remain applicable only in domestic circumstances going forward. Furthermore, Swiss and foreign entities might face compliance duties as well as reporting obligations under this standard. Therefore, as a new instrument for international tax transparency, the AEOI will have an important impact on both private individuals and entities in Switzerland that have an international structure with respect to their financial assets. For example, it is expected that an increased number of non-punishable voluntary disclosures will be filed prior to the exchange of information as of 1 January 2018.

In general

In January 2017, the SFTA published its final guidelines on the AEOI on its homepage. The document is available in German, French and Italian. The guidelines as well as the AEOI Act and the respective ordinance entered into force retroactively on 1 January 2017.

The AEOI and the Organisation for Economic Cooperation and Development’s (OECD’s) Common Reporting Standard (CRS) are the international standard that govern how tax authorities in the participating countries will exchange data relating to financial information of taxpayers. To date, approximately 100 countries, including Switzerland, have committed themselves to introducing this global standard. Under the AEOI, financial information – in particular regarding bank and safekeeping accounts – will be reported to the domestic tax authorities by their local financial institutions. The domestic tax authorities, in turn, will then exchange the information with the tax authorities in their respective AEOI partner countries (i.e., the tax authorities of the bank client’s country of residence or incorporation).

Content of the AEOI guidelines

The final AEOI guidelines of the SFTA describe and formalize the duties which result from implementing the AEOI standard for Swiss Financial Institutions (FI) and other Swiss entities, and also describe the consequences for private individual taxpayers. Although the guidelines are now officially in force, the SFTA may amend the AEOI guidelines at any time if needed. It is therefore important for all Swiss taxpayers to monitor any future developments very closely.

Under the AEOI guidelines, Swiss entities will have to declare their classification either as an FI (reporting, non-reporting) or as a passive/active Non-Financial Entity. Swiss FIs are obliged to comply with certain commitments regarding the implementation of AEOI. It is recommendable for every Swiss entity that does not yet have certainty with respect to its AEOI status to perform a respective assessment as soon as possible. In application of the OECD standards, the actual beneficial owner of securities (bank accounts, safekeeping accounts, custody account, etc.) must be identified and reported to the tax authority of the state of residence of this entity or person. Thus, the Swiss bank secrecy provisions will remain applicable only in domestic circumstances.

If a Swiss entity classifies as a Swiss FI, the entity has – among other duties – the following obligations:

- Registration with the SFTA
- Compliance with the due diligence in relation to the identification of reportable accounts
- Information obligation towards clients
- Report information with respect to reportable accounts (identifying information, account information, financial information)

On the other hand, an entity classifying as a Non-Financial Entity might, under certain circumstances, be obliged to disclose its ultimate beneficial owner.

Partner countries of Switzerland regarding AEOI

As of 1 January 2017, Switzerland intends to collect data and will start exchanging this information as of 1 January 2018 with all the countries which have already concluded a corresponding agreement with Switzerland. To date, Switzerland has signed an agreement for AEOI with the following partner countries: Australia, Canada, European Union (EU) Member States, Guernsey, Iceland, Isle of Man, Japan, Jersey, Norway and South Korea. Additionally, Switzerland has signed joint declarations with approximately 40 additional partner countries, whose approval in local parliaments is still pending.
Impact of AEOI on the non-punishable voluntary disclosure

With the non-punishable voluntary disclosure introduced in Switzerland in 2010, the Swiss legislator seeks to encourage taxpayers who have either accidentally or intentionally not disclosed all taxation factors to report such undeclared income or assets. If all required conditions for the non-punishable voluntary disclosure are met, the cantonal tax authority will reassess the last ten tax periods and determine the "back taxes" and the late payment interest for those last ten years, but refrain from penal prosecution and the related monetary fine. As an important condition, the exemption from prosecution and from monetary fines is only available if the tax authority has no knowledge yet of the undeclared income or assets. It is important to note that the non-punishable voluntary disclosure is a one-time allowance. As the SFTA and subsequently the cantonal tax authorities will receive the first data on financial information from partner countries based on the AEOI by mid-2018 at the latest (based on 2017 figures), it is important that taxpayers who wish to benefit from a non-punishable voluntary disclosure submit their request promptly. Once the Swiss tax authorities have received the financial information through the AEOI, they will consider the information as "known" and therefore refuse the non-punishable voluntary disclosure (the exact time as to when the information is considered as "known" will depend on the practice of the respective cantons).

How EY can help

Our tax professionals at EY will be happy to support you with respect to the implementation of the AEOI in Switzerland, such as the question of entity classification according to the AEOI-guideline, assistance in compliance matters or for potential non-punishable voluntary disclosures.
The Swiss Administrative Court rules on withholding reclaims in securities lending cases - and SFTA is close on its heels with proposed changes of guidelines

Executive summary

On the 20 December 2016, the Swiss Federal Administrative Court (“SFAC”, or “Court”) issued a ruling that affected the claims for refund of Swiss withholding tax levied on dividends paid on Swiss shares that had been subject to a securities lending agreement between two non-Swiss / foreign parties. It ruled that the claim for refund of the Swiss withholding tax lodged by a Luxembourg company acting as a borrower of those securities must not be honoured by the Swiss Federal Tax Authorities (“SFTA”) due to lacking beneficial ownership of the dividend payment. The court ruling as well as some modifications that the Swiss Federal Tax Authorities propose for their circular letter no. 13 of 1 September 2006 (governing securities lending and repo agreements) – and which appear to be ensuing directly from the court ruling - are likely to influence the lending market in Swiss securities to a substantial extent.

Detailed analysis

The SFAC ruled against a Luxembourg based company (“Lux Co”, or “Borrower”) which is part of a UK based banking group and which acted as a borrower of the Swiss securities. The shares (blue chip listed Swiss equities) had been borrowed from a UK resident company (“UK Co”, or “Lender”), a regulated stock broker that belongs to the same banking group. The lending transactions were based on a General Master Stock Lending Agreement (GMSLA) and partially extended over the dividend dates of the shares. Borrower had filed claims for refund of Swiss withholding taxes of 35% under the Luxembourg – Swiss tax treaty for several past years. The SFTA had rejected these claims stating, amongst others, that Lux Co had not been the beneficial owner of the dividends received on the mentioned shares. More concretely, Lux Co had been required to pass on all received dividends to UK Co. In addition, most of the lending agreements had a very short term (the court ruling mentions 9 up to 13 days). Finally, the SFTA claimed that, although a claimant for refund is obliged to provide factual information that the SFTA deems relevant to ascertain the beneficial ownership Borrower refused to disclose some of these information. This particularly related to the identity of the counterparties which Borrower claimed it could not reveal. The SFTA, in turn, held that in the absence of such information the economic motivation of the transactions could not be determined and, hence, beneficial ownership could not be ascertained. The following graphic depicts the transactions:
Proposed changes for SFTA’s circular letter no. 13

The SFTA has promulgated proposed changes to its circular letter no. 13 for consultation which had been published in its original version in September 2006 (likely to be evaluated in April 2017). The original version of the circular letter provided that in case of a “long borrowing” by a foreign borrower, the latter could file a claim for refund (under the applicable tax treaty, if any) of Swiss withholding taxes. Albeit not explicitly mentioned, the SFTA saw this regulation as a “pragmatic” approach where foreign borrowers “inadvertently over-borrowed” Swiss securities past their dividend date.

The SFTA wrote that practice had shown (and the above-mentioned court case may have contributed to this as, arguably, also the results from numerous recent enquiries in the form of questionnaires lodged by the SFTA) that certain market participants had used this set-up in a targeted way to realize “treaty shopping”. Hence, the new proposed regulations contain substantial procedural changes which mainly affect the situation of a foreign borrower of Swiss equity over the dividend date:

a. Foreign Borrower enters into a “long borrowing”

In this scenario, a foreign borrower keeps the borrowed Swiss securities (i.e. enters into a “long borrowing” transaction).

This borrower either contracts with the original lender directly or is the last borrower in a chain of borrowing transactions. Upon dividend date, the Swiss company pays the net dividend to this foreign borrower. The lender will require a compensatory payment of 65%. Only if the Swiss or foreign lender receives proof that it actually received the original dividend it can file a claim for refund of 35% withholding tax (in case of a Swiss resident lender) or of the applicable treaty rate (in case of a non-Swiss lender). The proposed wording of the circular letter does not give any details in which form this proof must be given. It is conceivable though that the borrower might need to produce a copy of the original payment advice that it received from the Swiss company or its paying agent upon receipt of the original dividend. Under the proposed scenario the foreign borrower would no longer be able to lodge a claim for refund of Swiss withholding tax. Only the original lender would be able to lodge the claim. In the same context it is worth noting that the amended circular letter also requires the disclosure of the entire lending chain; this is a new onus on the lender that has not existed before and may present a substantial obstacle to the refund procedure.
b. Foreign borrower sells or delivers the shares to a third party

In the second scenario, the foreign borrower had sold or delivered (e.g. to satisfy its obligations following a short sale) the borrowed securities to a third party. That is, the shares have now left the lending chain.

Here, none of the parties involved in the lending transaction is allowed to lodge a claim for refund. Only the third party holding the original shares and receiving the original dividend can ask for a refund (again, 35% if such party is resident in Switzerland, or according to the applicable treaty rate). The lender can no longer file a claim for refund. Consequently, the lender is likely to ask being recompensed with a manufactured payment of 65% up to 100% (depending on its individual status as a Swiss resident or resident in a treaty country). This requires the lender to be aware if its lent securities had been kept within the lending chain (i.e. the securities remained with a “long” borrower) or if they had been sold or delivered to a third party. Arguably, the lender will be aware of this situation if its borrower(s) fail to produce the proof that an original dividend has been passed on to the lender (as mentioned in sect. a above). In other words: unless the lender receives proof that the payment it receives from the borrower is an “original dividend” it may not file a claim for refund. The circular letter also provides that the changes mentioned above are equally applicable to repo transactions.

Hence, in summary, the proposed changes in the circular letter would ascribe the right to claim a refund for the Swiss withholding taxes either to the lender, if – after disclosure of the entire lending chain – it is clear that the borrower retained a long position in the borrowed securities and proved that it passed on the original dividend. Alternatively, if the securities had been sold or transferred to a third party by the borrower, only such third party can lodge a claim for refund and all members within the lending chain are barred from lodging a claim for refund.
Revision of Swiss Customs Tariff and introduction of Registered Exporters (REX)

1 January 2017 saw the entry into force of the revisions announced last year in connection with the Swiss Customs Tariff and the Generalized System of Preferences (GSP) with Registered Exporters (REX). The amendments made are extensive and are of importance for both importers and exporters as well as for logistics providers. The resulting impacts on companies needed or need to be analyzed and appropriate measures are to be implemented in due time.

Revision of Swiss Customs Tariff

For customs clearance purposes, goods require an eight-digit number that is assigned according to national and international provisions (e.g., bicycles: 8712.0000). Customs tariff numbers provide the basis to determine customs duty levels, the applicable value added tax and any other additional taxes (e.g., motor vehicle tax, beer tax, etc.). Tariff numbers can also be used to compile national and international statistics and analyses for interest groups. Correct classification is therefore crucial not only for levying duties, but also for monitoring and enforcing further provisions, so-called non-customs related legislations, which are applied in areas such as food inspections, dual-use goods, species protection (CITES-convention) etc.

In line with the revised nomenclature used by the World Customs Organization (WCO) and the Information Technology Agreement II (ITA II) implemented by the World Trade Organization, the Swiss Customs Tariff was subject to a broad-based adjustment effective on 1 January 2017. In addition, since January 2017 goods of several customs tariff numbers can be imported duty-free without a preferential proof of origin (primarily, Chapters 85 and 90). The amendments take account of the latest technological developments, concerning in particular the tariff numbers of chapters 84, 85 and 90. The new customs tariff is also intended to ensure better monitoring by the relevant authorities with respect to international trade in marine animals and chemical products. The more precise classification permitted by the newly created tariff numbers should also improve the quality and evaluability of statistics. The comprehensive amendments, including new tariff numbers and notes pertaining a more detailed classification, amendments to wording and notes, etc., concern almost 50 sections of the harmonized system.

Consequences

International companies are inevitably affected by the amendments due to their cross-border activities. Among other tasks, the revision of the Swiss Customs Tariff requires the review of stored product master data, the application of the new provisions of the customs tariff for correct classification and the communication of the new tariff numbers to suppliers, customs agents and clients. It is therefore recommended that companies examine their situation on an individual basis and implement any necessary measures in good time, provided that they have not been implemented already. It may also make sense to use these amendments as an opportunity to conduct a fundamental review of the product portfolio, since there may be untapped savings potential from customs duties following the reclassification of individual products.

Introduction of REX

Goods from developing countries can benefit from reduced customs duties if a valid proof of origin can be presented on import to a contracting state. Proofs of origin have until now been issued in various forms (e.g., declaration of origin with value limit of CHF 10,300, certificate Form A). The aim of REX is to replace the proofs of origin used today with a standardized statement of origin (SoO) on a commercial document. Exporters in developing countries need to newly register for REX to issue certificates of origin. Once the application for registration has been accepted, the exporter can issue SoOs by specifying the assigned REX number. Developing countries have been given a transition period until 30 June 2020 by which REX has to be implemented. After this date, SoOs will only be accepted in the defined standard.
Due to the amendments made to the transport regulations, consignments can now be split and stored in transit countries other than EU member states, Norway and Switzerland. In addition, it is permitted to affix labels, trademarks, seals or additional documentation insofar as this is required to meet provisions in the respective destination country. Certain manipulations to the goods are also allowed, but only to preserve the condition of the goods. In order to maintain GSP status, shipments must be transported and stored under customs supervision at all times. Switzerland, Norway and the EU have already implemented the amendments with regard to REX. As a result, Swiss companies must register for REX and issue an SoO if they are sending goods originating from Switzerland with a value higher than CHF 10,300 to a developing country for outward processing or if replacement certificates of origin (e.g. when goods are relocated from a customs warehouse) have to be issued (application form at: https://www.ezv.admin.ch/ezv/en/home/information-companies/exemptions-reliefs-preferential-tariffs-and-export-contributio/exportation-from-switzerland/free-trade-preferential-origin/REX.html).

**Conclusion**

The REX system will simplify customs processes through the issuance of SoOs on commercial documents and reduce bureaucracy in developing countries. New transport regulations allow certain processing steps in a third-party country and thus extent the range of possibilities. Swiss companies are therefore advised to encourage their suppliers in concerned developing countries to register for REX as soon as possible or at the latest by the end of the granted period in order to ensure a smooth transition and to be able to benefit from preferential origin in the future.
Germany plans restriction on deductions for royalty payments (“royalty restrictions”)

A draft bill submitted on 25 January 2017 is set to introduce a new section (SEC. 4j ITA) into the German Income Tax Act. The purpose is to restrict the deductibility of royalties if these are taxed at a lower rate or treated as tax free income. However, this only applies if the royalties and similar payments are made to related parties and if such payments are subject to a harmful preferential tax regime in the jurisdiction of the recipient, and therefore, effectively taxed at a rate below 25%. Exceptions are to be made for payments to OECD compliant IP-Boxes with significant business activities (nexus approach). The royalty restriction regulation is scheduled to take effect for the first time for expenditure incurred after 31 December 2017 (under discussion).

Details of new stricter rules
The tax deduction of cross-border royalties may be wholly or partially denied if the following conditions are cumulatively met:

- Payments made to related parties.
- The (direct or indirect) recipient of the royalty benefits from a preferential tax regime related to the royalty income.
- The preferential tax regime is not limited to income for which sufficient underlying economic activities are required, i.e., the exploitation of self IP creation (unqualified preferential IP regime); hence, a fully OECD compliant IP regime should not be caught by the deduction limitation.
- The effective taxation of the royalty income is less than 25%.
- Royalties should not be deemed as taxable income according to the German CFC-rules

If all preconditions of the royalty restrictions are met, the percentage of nondeductible royalties is calculated as follows:

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\frac{(25\% - \text{effective tax rate IP-Regime})}{25\%} = \text{non deductible IP expense in } \%
\]

For example, if the effective tax rate of the recipient was 0%, then 100% of the licensor’s expenses would be nondeductible. According to the wording of Sec. 4j ITA the application of the rule shall not be limited by any existing double tax treaties (treaty override regarding the settlement laid down in DTTs that stipulate the identical treatment of royalty payments to domestic and foreign licensors).

Preferential regime and Swiss privileges
The new regulation shall be applicable if the low taxation in the jurisdiction of the recipient is caused by a preferential IP tax regime. The unqualified preferential tax regime must provide for the taxation of the royalty income at an effective rate of less than 25% accompanied by simultaneous discrimination of income from other sources. The new rules thus primarily target so called foreign IP, license and patent boxes. To cover all conceivable iterations of the various preferential regimes as far as possible, the effective tax rate has to be determined based on German tax accounting principles, and follows in general the determination rules of “low taxed income” under the German CFC-rules. This also applies in particular to the Swiss tax regimes (management, holding and mixed companies) and the IP-box regime in the canton of Nidwalden, where royalty income is not subject to standard taxation but is taxed at a preferential rate. However, it does not apply to Swiss companies subject to standard taxation but whose tax rate for all income is similarly lower than 25%.

Only payments made to related parties affected
Only payments between related parties are affected. According to the definition provided in the German Foreign Tax Act, a party is related to another person if it owns a direct or indirect equity participation of at least 25% or owns the possibility of a controlling interest and a vested interest in the realization of income by the other party. Accordingly, the regulation generally does not apply between independent parties. The same rules would apply for a permanent establishment to which the IP or right is attributed for income tax purposes.

Substantial business activity and trademarks
To differentiate between harmful and non-harmful preferential tax regimes, the German bill refers to the nexus approach outlined in the final report of the OECD/G20 BEPS Project, Action 5. According to this approach the tax deduction of license payments should not be limited if the low taxation in the jurisdiction of the recipient is caused by a preferential IP tax regime that only applies to rights which are based on substantial business activities. Substantial business activities are not deemed to exist if the recipient of the payments did not or did not predominantly develop the right in the course of its ordinary business activities. In particular, no substantial business activities shall exist if the right was acquired or if it was developed by another related party. Since the affected Swiss companies with special tax status do not necessarily require such substance, the scope of application of the new regulation would be extended to privileged Swiss companies.
Conversely, the restriction on deductions would not be applicable if income in the target state were subject to a preferential regime comparable to the nexus approach. The proposed Swiss Corporate Tax Reform III, which was recently rejected by Swiss voters, provided for the abolition of Swiss companies with special tax status and the introduction of a patent box regime compliant with OECD and thus aligned with the nexus approach. According to the current proposal of the German Federal Council a patent regime structured in this way would have given Swiss royalty right holders a way out of the German royalty restrictions.

The planned increased maximum deduction of 150% of costs for R&D, which was also contained in the rejected draft proposal, would likely not have extended the scope of application of the royalty restrictions and thus would not have been harmful.

Regarding the OECD BEPS report on Action 5, the substantial business activities exception does not apply to licensing of trademarks (or product or umbrella brands); hence, such rights would not be covered by the nexus approach.

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A Swedish Court has held that a German company has a permanent establishment (PE) in Sweden despite the fact that the company’s activities were limited to short-term testing functions and the company had no physical office or storage facility in Sweden. The case reflects a trend of evolving and increasingly strict PE regulations around the world. This article explains why multinationals should take note of this case and what they can do to protect themselves from potential PE risks.

Case summary
The German company develops and sells software for tire inflation pressure systems to automotive suppliers in Germany which then ultimately sell to car manufacturers. The development, production, marketing and sales activities are carried out in Germany. However, as it was important to test the software in a winter environment, the company sent its testing equipment and a limited number of employees to Sweden each year for about 3-4 months to perform these tests and collect data. The tests are then performed on cars (owned by the car manufacturers) which the company’s employees bring with them to Sweden. The company had been doing this activity since 2008. The data is then analyzed back in Germany. The company had no permanent building or storage facility in Sweden, although it rented a garage, office and test track for the relevant time periods (see EY Global Tax Alert of 18 January 2017).

Based on the above facts, and referring to the Organization for Economic Cooperation and Development’s (OECD’s) most recent PE guidance, the Swedish Administrative Court of Appeal (the Court) concluded the following:

• Although the 6 months threshold was not met, the annually recurring presence and nature of the German company’s business in Sweden was such that it had a “fixed place of business” in Sweden; and

• The German company’s activities in Sweden formed part of the company’s core business and as such could not be of a preparatory or auxiliary character. In other words, the German company could not rely on the PE exemption under Article 5(4) of the Sweden-Germany tax treaty.

In arriving at their decision, the Court analyzed the German company’s activities in Sweden in light of the company’s overall business. Moreover, the Court noted that these recurring annual short-term visits to Sweden involved the same specialized employees that were instrumental in the design and testing of the product in Germany.

The Court was of the opinion that the winter testing of the software (which required Sweden’s harsh winter climate and which was performed by the same employees as when the activity was conducted in Germany) was of such significance to the overall business of designing, testing and manufacturing the tire inflation software system that these activities could not be seen to be preparatory or auxiliary in character. As such, the Court deemed that the recurring visits to Sweden created a fixed place of business PE for the German company, notwithstanding their short-term nature.

Impact on global operating models
Rules dictating what constitutes a PE in jurisdictions around the world are constantly evolving. The problem for multinationals with global operations is that these rules are being implemented not only on a bilateral treaty basis but also on a country-by-country basis with many tax authorities interpreting the PE definitions in a broader manner or the PE exemptions in a stricter manner than was previously the case. This Swedish case illustrates that multinationals can no longer assume that short term visits to a country to do non-sales related activities will not create any PE issues. Given that the judiciary in many countries often refer to other international cases for persuasive guidance, it is not unreasonable to assume that tax authorities and courts in other countries will take note and may rely on this judgment to support their arguments for the existence of a PE in their countries.
The finding of a PE will have implications on the sustainability of existing centralised operating models and the design of new operating models. It will become more challenging for multinationals to find the right balance between risk management and control versus creating dependency in seeking to design an efficient operating model. Also, it will become more and more important to know not only how many days employees spend in another country, but also what activities they perform while there. The management of cross-border teams will need to be more rigorous in future as it becomes more important to implement strict guidelines for how employees of both the principal and the local entity should act under the centralised model.

The creation of a PE does not only create a corporate tax liability and related compliance work for the company but also triggers other obligations such as employer reporting for the company as well as registration and compliance obligations for the employees (e.g. personal income taxes and social security). If a multinational sends many (e.g. several hundred) employees to a country (e.g. Sweden) on short-term business travel, then the administrative compliance work can become very burdensome. The effect is particularly negative where the corporate tax liability is small in proportion to the relatively larger amount of administrative costs incurred by the multinational to comply with its tax obligations resulting from the PE.

Other PE developments worldwide

This Swedish case is not a one-off incident. More and more countries around the world are increasingly focusing on PE risk when conducting tax audits. They are also becoming more sophisticated in gathering data. For example, the Indian tax authorities used the LinkedIn profiles of GE Group expatriate employees (that were sent to India to provide marketing and sales support activities to local GE Group entities) to determine whether their activities had created a PE in India. The LinkedIn information was accepted by the Income Tax Appeal Tribunal (ITAT) as admissible evidence and subsequently, the ITAT held that the activities of such employees had indeed created both a fixed place of business and agency PE for their respective GE Group employers (see EY Tax Alert of 8 July 2014; EY Mobility Tax Alert of February 2017) because they were regularly involved in the negotiation of prices and securing of orders from Indian customers for their GE Group entities outside of India and they did this work from the Indian GE affiliates’ offices.

Although each multinational’s situation and organization is likely to be unique, the following trends are more or less equally applicable to all multinationals:

Tax authorities are increasingly

- monitoring the activities of short term business travelers into their country in cooperation with their local immigration authorities;
- reviewing the activities of employees working under a non-resident employer arrangement, e.g. if you are using an offshore representative office or a non-resident employer structure to conduct your business activities - even with a limited number of employees - beware that your operations may come under scrutiny;
- scrutinizing foreign-based multinationals that are using cost-plus subsidiaries to assist with marketing and support activities in-country. They may challenge that the in-country activities constitute a greater proportion of the business than mere “support” activities and therefore trigger a PE.

What should global multinationals do to protect themselves

Thanks to the spotlight on Base Erosion and Profit Shifting (BEPS), many countries around the world are tightening their PE rules and stepping up on their tax audits such that PE challenges are arising more frequently. Multinationals should start by performing a sustainability review of their operating models for PE risks.

This means re-evaluating the necessity of centralising certain key processes and functions, reviewing the roles and responsibilities relating to the management of those key processes and performance of those functions, as well as checking where those roles are being performed and whether they need to be moved. This can be a challenging exercise given that each country has its own evolving laws, but taking the time and effort to identify and manage the risks can also present opportunities for improving the operating model from a business perspective.

As the PE rules and enforcement practices continue evolve over time, it may be sensible to consider establishing a monitoring process that employs the use of tax technology tools which can analyse travel and activity data to regularly scan for potential PE risk. Improvements to the oversight, data collection and documentation of where people are, what they are doing and who they are doing it for will be key to assessing whether the existing operating model is robust enough to withstand PE risk challenges and whether there are opportunities for improvement.
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