SWITZERLAND

Federal Tax Administration Circular Regarding Taxation of Service Companies

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1. INTRODUCTION

On 19 March 2004, the federal tax administration (hereinafter: FTA) published the new Circular 4 (hereinafter: the Circular) regarding the taxation of service companies (i.e. the determination of transfer prices for intra-group services).[2] The issuance of the Circular is the result of pressure by the OECD on Switzerland to follow the 1995 Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations as published by the OECD (hereinafter: OECD Guidelines). The Circular reads as follows:

> Taxation of service companies
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> This Circular replaces the circular letter of 17 September 1997, and reminds that the Director of the Federal Tax Administration has informed the cantonal tax administrations in its letter of 4 March 1997, that when taxing multinational enterprises they must take into account the OECD Transfer Pricing Guidelines.
> The mark-ups of service companies must be determined in accordance with the arm's length principle, on the basis of comparable uncontrolled transactions and with appropriate ranges of mark-ups for any individual case. The arm's length principle is also applicable when choosing the method for determining mark-ups, and for financial services or management functions this implies that the cost-plus

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2. The Circular is available under www.estv.admin.ch/data/dvs/druck/kreis/e/1-004-dv-2004-e.pdf.

method is not an appropriate method (or only in very exceptional cases).
Where a company is of the opinion that its current mark-up is too high, it must prove that a further application of that mark-up would be contrary to the aforementioned principles. The cantonal administrations are allowed to fix lower mark-ups only in exceptional cases.

With this Circular, the FTA expresses that, with respect to the taxation of service companies, Switzerland will adapt its transfer pricing practice to the OECD transfer pricing standards. The Circular has a direct influence on enterprises with service activities in Switzerland.

Swiss tax law does not mention the arm's length principle. Upon investigation, one will find in tax law neither a specific reference to transfer pricing nor a criterion like the comparison with actual or possible transactions between independent third parties or between the taxpayer and unrelated parties. In addition, it is rare to see court decisions on transfer pricing between a parent company and its subsidiary, or between companies under common control. In fact, there are only four basic court decisions regarding international dealings.[3] Transfer pricing rules therefore have mainly been developed in practice and as a result of negotiations between taxpayers and the FTA. Even though there are no explicit transfer pricing rules, the theoretical rules laid down in the OECD Guidelines should in future be applied when determining an arm's length transfer price under the Circular.

Transfer pricing has never been a highly developed science in Switzerland, as it is in countries such as the United States, Australia, Canada and Germany. The author regards this fact as an advantage to locating business in Switzerland. It is undoubted that in international dealings, every effort should be made to ensure that a correct income allocation is achieved. However, looking to third countries, it must be stated that the complicated, expensive and time-consuming transfer pricing requirements found in some of them should not be something the FTA seeks to replicate in Switzerland. While in other countries practitioners and scholars raise justified doubt about recent developments in transfer pricing practices,[4] it is the author's personal hope that the Circular will not serve as a basis for the introduction of excessive transfer pricing requirements. An entrepreneurial, friendly and uncomplicated administrative transfer pricing practice that adequately adheres to the OECD Guidelines would be preferable.

This article will summarize the principles laid down in the Circular, as well as the theoretical rules laid down in the OECD Guidelines that apply to the Circular.

2. NEW RULES FOR THE TAXATION OF SERVICE COMPANIES

The Circular describing the new rules on the taxation of service companies is composed of four sections and can be summarized as follows:

- it is confirmed that the existing safe-harbour rule (cost-plus-5%) will be abolished;
- the rules set forth in the OECD Guidelines will be followed;
- the profit margin must be determined in accordance with the arm's length principle, on the basis of comparable uncontrolled transactions;
- for financial services or management functions, the cost-plus method is normally not an appropriate method; and
- a lower profit margin than the determined one is accepted if a company proves that a further application of that profit margin would be contrary to the aforementioned principles.

3. TAX PRINCIPLES APPLIED PRIOR TO THE CIRCULAR

When supplying services to affiliated companies, it is difficult to determine and allocate taxable profits, namely to define that part of the total group profit that should be taxable in Switzerland for example. It often happened that the FTA would allocate deemed income to Swiss service companies. As a safe-harbour rule, the net profit of such companies was defined as 5% of the total business expenses (i.e. cost-plus-5%). The determination of the arm's length price by applying this cost-plus-5% profit margin was generally accepted in Switzerland. This practice was not codified in the formal tax law, but was practiced by the FTA and confirmed by the Federal Supreme Court.

4. NEW RULES UNDER THE CIRCULAR

The rules laid down in the Circular will apply when a Swiss company supplies services to affiliated companies. The Circular makes clear that it is the intention of the FTA to give up its safe-harbour practice (i.e. cost-plus-5%). It is confirmed that the OECD Guidelines will serve as a basis for the determination of transfer prices in Switzerland. Due to the fact that domestic law does not provide for any transfer pricing rules, the OECD Guidelines, especially the special provisions regarding intra-group services under Chap. 7 of the OECD Guidelines, must be taken into consideration when determining the arm's length price of an intra-group service. The considerations noted below focus on the determination of the transfer price for intra-group services under the OECD Guidelines.

As Chap. 7.5 of the OECD Guidelines points out, there are two issues in the analysis of transfer pricing for intra-group services, such that it must be determined:

- whether intra-group services have in fact been provided (the benefit test); and
- if such services have in fact been provided, what the intra-group charge for such services for tax purposes should be in accordance with the arm's length principle.

3. See *The Tax Treatment of Transfer Pricing* (Amsterdam: International Bureau of Fiscal Documentation, loose-leaf), Switzerland chapter, Sec. 2.3.

4. In this regard, there was a panel discussion between Guglielmo Maisto, Deloris Wright, Wally Hellerstein, Theo Schmit and Jeffrey Owens during Prof. Hubert Hamaekers' farewell symposium on 6 May 2004 in Amsterdam, titled "Income Allocation in the XXIst Century. The end of transfer pricing?"

4.1. Benefit test under Sec. 7.6 of the OECD Guidelines: Providing economic or commercial value

Under the arm's length principle, the question of whether an intra-group service has been rendered when an activity is performed for one or more group members by another group member should depend on whether the activity provides a respective group member with economic or commercial value to enhance its commercial position.[5] An activity provides a respective group member with economic or commercial value if an independent enterprise in comparable circumstances (i) would have been willing to pay for the activity if performed for it by an independent enterprise or (ii) would have performed the activity in-house for itself. Only in these cases would a group company make use of such offered services and be willing to pay a price for such services. If the activity is not one for which an independent enterprise would have been willing to pay or perform for itself, the activity ordinarily should not be regarded as an intra-group service under the arm's length principle.

The benefit test depends on the actual facts and circumstances of the case, and it is not abstractly possible to set forth categorically the activities that do or do not constitute the rendering of intra-group services. The test is complex where an intra-group activity may be performed relating to group members even though those group members do not need the activity, such as shareholder activities. A shareholder activity is an activity that a group member (usually to the parent company or a regional holding company) performs solely because of its ownership interest in one or more other group members (i.e. in its capacity as shareholder). Examples of shareholder activities include the following:

- costs of activities relating to the legal structure of the parent company itself, such as meetings of shareholders of the parent, issuing of shares in the parent company and costs of the supervisory board;
- costs relating to reporting requirements of the parent company, including the consolidation of reports; and
- costs of raising funds for the acquisition of the parent's participations.

Shareholder activities and corresponding costs do not pass the benefit test. As a consequence, a charge of costs to affiliated companies is not justified. On the other hand, activities that should pass the benefit test under the OECD Guidelines include:[6]

- raising funds on behalf of another group member that uses such funds to acquire a new company;
- cost of managerial and control (monitoring) activities related to the management and protection of the investment if, under comparable facts and circumstances, the activity is one that an independent enterprise would have been willing to pay for or to perform for itself;
- debt-factoring activities, where a multinational group decides to centralize the activities for economic reasons (limitation of currency, debt risks and administrative burdens);[7]
- contract manufacturing as a contract manufacturer normally bears low risk and, subject to the fulfilment of its contractual obligations, is assured that its entire output will be purchased;[8]
- contractual research as intra-group service;[9] and
- administration of licences.

Accordingly, the costs for such activities may be charged to affiliated parties. No intra-group service should be deemed to take place with regard to activities undertaken by one group member that merely duplicates a service that another group member is performing for itself, or that is being performed for such other group member by a third party. An exception may be where the duplication of services is only temporary, for example where a multinational group is reorganized to centralize its management functions or where the duplication is undertaken to reduce the risks of a wrong business decision.[10]

4.2. Determination of arm's length charge

Once it is determined that an intra-group service has been rendered, it is necessary to determine whether the amount of the charge, if any, is in accordance with the arm's length principle.[11] Accordingly, the charge for intra-group services should be that which would have been accepted between independent enterprises in comparable circumstances. To determine the arm's length charge, the OECD Guidelines anticipate the following two steps:

- identification of the actual arrangements for the charging for intra-group services;[12] and
- calculation of the arm's length consideration.

Regarding the calculation of the arm's length consideration, the Circular is again drafted rather briefly. It reads as follows:

> The mark-ups of service companies must be determined in accordance with the arm's length principle, on the basis of comparable uncontrolled transactions and with appropriate ranges of mark-ups for any individual case. The arm's length principle is also applicable when choosing the method for determining mark-ups, and for financial services or management functions this implies that the cost-plus method is not an appropriate method (or only in very exceptional cases).

5. Chap. 7.6 OECD Guidelines.
6. It is understood that the examples are provided for illustrative purposes only and when dealing with an individual case, it is necessary to explore the actual facts and circumstances to judge the applicability of any transfer pricing method.
7. Chap. 7.39 OECD Guidelines.
8. Id., Chap. 7.40.
9. Id., Chap. 7.41. However, the research company itself is often insulated from financial risk because it is normally agreed that all expenses will be reimbursed regardless of whether the research is successful. In addition, intangible property deriving from research activities is generally owned by the principal company and so risks relating to the commercial exploitation of that property are not assumed by the research company itself. In such a case, the cost-plus method may be more appropriate.
10. Chap. 7.7-7.10 OECD Guidelines.
11. Id., Chap. 7.19-7.37.
12. The OECD Guidelines in this regard distinguish between different arrangements (i) for direct charging to specific enterprises for specific services, (ii) that are readily identifiable but not based on a direct-charge method and (iii) that are not readily identifiable and either incorporated into the charge for other transfers, allocated amongst group members on some basis, or in some cases not allocated amongst group members at all. Chap. 7.20-7.28 OECD Guidelines.

As the Circular does not contain any specific rules, the principles under the OECD Guidelines should apply and be taken into consideration when determining the arm's length charge for an intra-group service. When doing so, both the perspective of the service provider (what are the costs and profits for the provider) and of the service recipient (how much would a comparable independent enterprise be willing to pay) should be taken into consideration.

Where comparable services are provided between independent enterprises in the recipient's market or by associated enterprises providing the services to an independent enterprise in comparable circumstances, the OECD Guidelines recommend the application of the comparable uncontrolled price (hereinafter: CUP) method. On the other hand, the cost-plus method would likely be appropriate in the absence of a CUP where the nature of the activities involved, assets used and risks assumed are comparable to those undertaken by independent enterprises.[13] Thus, the profit margin for intra-group services must be determined in accordance with the arm's length principle on the basis of comparable uncontrolled transactions and with appropriate ranges of profit margins for the individual case. For the determination of the profit margin, a taxpayer should first try to compare the price charged for services transferred in a controlled transaction to the price charged for services transferred in a comparable uncontrolled transaction under comparable circumstances. If there is any difference between the two prices, this may indicate that the conditions of the commercial and financial dealings between the affiliated enterprises are not at arm's lengths and that the price in the uncontrolled transaction may need to be substituted for the price in the controlled transaction.

An uncontrolled transaction is comparable to a controlled transaction for purposes of the CUP method if one of the following conditions is met:
- none of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions could materially affect the price in the open market; or
- reasonably accurate adjustments can be made to eliminate the material effects of such differences.

Where it is possible to locate comparable uncontrolled transactions, the CUP method is the most direct and reliable way to apply the arm's length principle.

Often it may be difficult to find a transaction between independent enterprises that is similar to a controlled transaction such that no differences have a material effect on the price. When this is the case, some adjustments will be appropriate. It is understood, however, that the extent and reliability of such adjustments will affect the relative reliability of the analyses under the CUP method. Due to the relatively small Swiss market, an enterprise will often have the problem of finding independent comparable enterprises in Switzerland. In practice, it is therefore necessary to make use of available data of comparable enterprises located across Europe.[14]

In some cases, it will be possible to apply the arm's length principle to determine a single price or margin that seems to be the most reliable to establish whether the conditions of a transaction are at arm's length. However, as transfer pricing is not an exact science, there will always be situation where the application of the most appropriate method or methods produces a range of figures, all of which seem to be relatively equally reliable. It is understood that the different figures in a range represent the fact that independent enterprises engaged in comparable transaction under comparable circumstances may not determine exactly the same price for a specific transaction. As a consequence, there is no reason not to use prices that deviate from the range of figures.[15]

5. CONCLUSION

With the issuance of the Circular, the FTA reacted to the pressure of the OECD arising from the OECD view that the Swiss safe-harbour rule (cost-plus-5%) breached the OECD Guidelines. Accordingly, Switzerland will take care that its transfer pricing practice is in line with the OECD Guidelines, i.e. that transfer prices will be set at arm's length, on the basis of comparable uncontrolled transactions. The old cost-plus-5% rule will not breach the rules laid down in the OECD Guidelines if it is in accordance with the arm's length principles as defined by the OECD. With the Circular, the FTA reflects its intention that Switzerland will adapt its transfer pricing practice with respect to the taxation of service companies, so that such practice is in line with the OECD transfer pricing standards.

Even though the practice of determining transfer prices for intra-group services will be corrected by the Circular, the Circular does not specify any new rules on documentary or administrative requirements, nor on possible analysis for the determination of arm's length transfer prices. Taxpayers and practitioners should be appreciative that the FTA did not use the issuance of the Circular as a means of implementing burdensome documentation requirements, but has rather kept the administrative requirements uncomplicated and taxpayer-friendly by requiring consideration of the specific requirements of each individual case.

The author is of the opinion that the brief and general Circular issued by the FTA fulfils the obligations towards the OECD, as well as the needs of the business world. As the Circular confirms that prices for intra-group services are to be determined based on the arm's length principle, and on the basis of comparable uncontrolled transactions, Switzerland has expressed its commitment to the recognized standards defined in the OECD Guidelines. On the other hand, the Circular is flexible and friendly towards entrepreneurs, as it does not set forth rigid, complex procedures and rules, but allows an appropriate procedure to be examined for each individual case.

13. Chap. 7.31 OECD Guidelines.
14. In this regard, for example the database AMADEUS (Analyse Major Databases from European Sources) could be consulted. See also *Steuer-Revue* 5/2005, Urs Brügger/Nicolas Bonvin, at 343.
15. In practice, the accepted range is between 25 and 75% of the average range (50%) of the compared transactions. See *SteuerRevue* 5/2004, Urs Brügger/Nicolas Bonvin, at 344.