COUNTRY NOTE

Arm's Length Principle from a Swiss Perspective: Profit Allocation to Inbound and Outbound Permanent Establishments

Céline Martin[*], Vikram Chand[**] & Natassia Burkhalter[***]

Switzerland continues to be one of the most preferred locations for many businesses when setting up a headquarters or permanent establishment (PE) structures. Thus, obtaining tax certainty and predictability is crucial for such structures. Swiss tax law does not provide for detailed rules for international profit allocation and particularly the arm's length principle (ALP) for the determination of an enterprise's profit. Therefore, the Swiss tax authorities and courts largely rely on general national tax law principles for their assessment of the allocation and calculation of the taxable profit of a company or a PE in Switzerland. They have developed a sophisticated system of profit correction in order to determine the relevant taxation basis, in particular when prices between related entities or within PE relationships are deemed to not be set at arm's length. This practice is continuously evolving, and the Authorized OECD Approach (AOA) is increasingly integrated in the assessment of each individual case. Against this backdrop, the present contribution discusses the application of the ALP from a Swiss tax treaty and Swiss national law perspective as applicable to transactions among separate entities as well as to head office and PE relations. With respect to the latter, the reader will find an overview of the profit allocation rules applicable in domestic and international cases. Moreover, for illustration, two case studies are developed and analysed for cross-border relations with fixed place PEs (inbound and outbound cases) and an example is provided for the interaction between international and domestic profit allocation.

Keywords: Switzerland, profit allocation, AOA, permanent establishment, arm's length principle, transfer pricing, international, intercantonal, developments, cases.

1 The Purpose and Structure of This Contribution

Switzerland continues to be one of the most preferred locations for many businesses when setting up headquarters or branch structures. Thus, obtaining tax certainty and predictability is crucial[1] for such structures.

Swiss tax law does not provide for detailed rules regarding international profit allocation and particularly the arm's length principle (ALP) for the determination of an enterprise's profit. Therefore, the Swiss tax authorities and courts largely rely on general national tax law principles for their assessment of the allocation and calculation of a company's or a permanent establishment's (PE's) taxable profit in Switzerland. They have developed a sophisticated system of profit correction in order to determine the relevant taxation basis, in particular when prices between related entities or within PE relationships are deemed to not be set at arm's length. This practice is continuously evolving, and the Authorized OECD Approach (AOA) is increasingly integrated in the assessment of each individual case.

Against this backdrop, the main objective of this contribution is to discuss the application of the ALP in Switzerland and its impact in cross border cases, in particular in cases that deal with inbound and outbound fixed place cross-border PEs. The latest court rulings seem to advocate the application of AOA principles in Swiss tax practice. Hence, the authors discuss the treaty framework applicable for cross-border cases. This is of particular interest because Swiss domestic profit allocation rules provide for an apportionment method based upon various formulae. This is a system that was allowed by Article 7(4) of the 2008 OECD Model but was later abolished with the 2010 version. The application of the AOA in Switzerland is then illustrated with the assistance of two concrete case studies. The analysis made in these illustrations could be also

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[*] Dr iur., Tax Advisor in Zurich and Expert Judge at the Administrative Court of the Canton of Aargau. She has also completed the Executive Program in Transfer Pricing (EPTP) offered by the University of Lausanne. Email: Celine.Martin@homburger.ch.

[**] Prof Dr iur., LL.M., Tax Policy Center, University of Lausanne. He is also the Program Director of the EPTP offered by the University of Lausanne. Email: vikram.chand@unil.ch.

[***] Dr iur., LL.M., Head of section Transfer Pricing & Rulings, Swiss Federal Tax Administration. She is also a former alumna of the EPTP and is currently a lecturer in the program. All views expressed are personal and do not reflect the views of the organizations to which the authors are affiliated. Email: natassia.burkhalter@gmail.com.

[1] S. Burger & D. Kälberer, *Rechts- und Planungssicherheit im Zeichen einer neuen Weltwirtschaftsordnung*, 11 IStR 411–417 (2020).

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relevant on a broader basis for other countries. To conclude, an example of the interaction between international and domestic profit allocation is discussed.

2 The arm's length principle in Swiss tax treaties and Swiss domestic law

2.1 *Swiss Tax Treaty Framework*

Switzerland has concluded double taxation agreements with over 100 countries[2] that are generally based on the OECD Model.[3] Switzerland has also signed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI) to implement the BEPS minimum standards vis-à-vis its tax treaties.[4] However, the number of Swiss treaties that have been modified pursuant to the MLI is rather limited.[5] This is primarily because Switzerland wishes to renegotiate treaties on a bilateral basis.[6] Moreover, the modified treaties (pursuant to the MLI or bilateral negotiations) will most likely include only the new preamble, the principal purpose test (PPT), and possibly mandatory binding arbitration provisions.

Switzerland adheres to a monistic system for which a treaty under international law becomes national law once it is ratified and becomes part of the Swiss legal system.[7] In the case of a conflict between an international agreement and unilateral provisions of the Swiss law, the international agreement will prevail.[8]

With regard to the questions of the ALP and profit allocation, the treaty provisions based on Article 9 (associated enterprises) and Article 7 (business profits) are important.

In this regard, to commence, it should be noted that Switzerland applies the principle of the separate entity approach.[9] All Swiss tax treaties generally adopt the content of Article 9(1) OECD MC. Moreover, the wording of Article 9(2) OECD MC that provides for a corresponding adjustment has also been widely adopted.[10] Moreover, the OECD transfer pricing guidelines are regularly being used as (not binding) an interpretation aid not only for the application of double taxation agreements but also for the interpretation of Swiss domestic law (as subsequently discussed).[11] Arguably, in the hierarchy of the law, the OECD TP Guidelines rank at the same level as the OECD Commentary on the Model Tax Convention. The OECD TP Guidelines play an important role in Swiss transfer pricing cases irrespective of whether the transaction takes place with a resident in a country that is a tax treaty partner of Switzerland.[12] Hence, the case law of the Swiss Federal Supreme Court and that from cantonal courts refers regularly to the OECD TP Guidelines.[13]

Furthermore, Switzerland has adopted the separate entity approach in its tax treaties vis-à-vis Article 7.[14] Article 7 of a majority of Swiss tax treaties are still based on the 2008 OECD Model. To reiterate, while Article 7 (2) of the OECD Model (2008) provided for the separate entity approach (by analogy, the application of the ALP to determine the profits of the PE[15]), some other provisions

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2 *See* Swiss State Secretariat for International Finance SIF, *List of Swiss Double Taxation Agreements* (10 Aug. 2021), www.sif.admin.ch/sif/en/home/bilateral/steuerabkommen/doppelbesteuerungsabkommen.html (accessed 30 Sept. 2021).

3 R. Matteotti & C. Horn, *Einleitung*, in *Kommentar zum internationalen Steuerrecht* 65 (M. Zweifel et al. eds, Helbing Lichtenhahn Verlag 2015).

4 *See* OECD/G20, *Multilateral Convention to Implement TaxTreaty Related Measures to Prevent Base Erosion and Profit Shifting* (24 Nov. 2016). For a general overview of the MLI, *see* R. Danon & H. Salome, *The BEPS Multilateral Instrument*, 3 FStR 197–247 (2017).

5 For a list of Swiss tax treaties that have been modified through the MLI, *see* Confédération suisse, *Statut de la liste de réserves et des notifications au moment de la signature* (2017), www.oecd.org/tax/treaties/beps-mli-position-switzerland.pdf (accessed 30 Sept. 2021).

6 In this regard, *see* the announcement of the Swiss State Secretariat for International Finance SIF, *BEPS Convention Enters into Force* (19 Nov. 2019), www.sif.admin.ch/sif/en/home/dokumentation/fachinformationen/archiv/mli.html (accessed 30 Sept. 2021).

7 CH: Federal Supreme Court Decision BGE 124 IV 23 cons. 4°, at 31; Matteotti & Horn, *supra* n. 3, at 174.

8 CH: Constitution, Art. 190 [Bundesverfassung der Schweizerischen Eidgenossenschaft (BV; SR 101)]; this is only different in the case of an explicit treaty overwriting (known as the *Schubert-Practice*, *see* CH: Federal Supreme Court Decision 2C_743/2011 dated 19 Sept. 2012, cons. 5.3.1; CH: Federal Supreme Court Decision BGE 136 III 168 cons. 3.3.4).

9 As opposed to a group view. On this matter, *also see* V. Chand, A. Turina & L. Ballivet, *Profit Allocation Within MNEs in Light of the Ongoing Digital Debate on Pillar I – A 2020 Compromise?*, 12 World Tax J. 3 (2020).

10 *See* for a full list of Swiss tax treaties Swiss State Secretariat for International Finance SIF, *supra* n. 2.

11 CH: Federal Act on Direct Federal Taxation (Bundesgesetz über die direkte Bundessteuer (DBG; SR 642.11)); *see infra* s. 2.2.1.

12 R. Stocker, *Potential Effects of the OECD Base Erosion and Profit Shifting Initiative on Swiss Transfer Pricing Rules and Swiss Companies*, 69(4/5) Bull. Int'l Tax'n 210 (2015); F. Duss, *Grenzüberschreitende Leistungsbeziehungen im Konzern*, FStR, 110 (2015); P. Brülisauer & M. Mühlemann, *Art. 58 DBG, n. 229*, in *Kommentar zum Schweizerischen Steuerrecht, Bundesgesetz über die direkte Bundessteuer (DBG)* (M. Zweifel & M. Beusch eds, Helbing & Lichtenhahn 2017).

13 CH: Federal Supreme Court Decision BGE 143 II 185 cons. 4.1; CH: Decisions of the Zurich Court SB.2018.94/95 dated 18 Dec. 2019, cons. 2.6; CH: DB.2015.166 dated 26 Mar. 2019, cons. 1.d.; Matteotti & Horn, *supra* n. 3, at 163 ss; M. Beusch, *Die Bedeutung ausländischer Gerichtsentscheide für die Auslegung von DBA durch die schweizerische Justiz*, at 401, in *Dogmatik und Praxis im Steuerrecht: Festschrift für Markus Reich* 395–408 (L. Utttinger et al. eds), Schulthess 2014) (also on characterization as a subsidiary interpretation means according to Art. 32 of the Vienna Treaty).

14 P. Brülisauer, *Art. 7 of the OECD Model Tax Convention*, in *Kommentar zum internationalen Steuerrecht* 268 ss (M. Zweifel et al. eds, Helbing Lichtenhahn Verlag 2015) with details regarding the application in the Swiss tax treaties. For both Arts 7 and 9 of the OECD Model Tax Convention, Switzerland has currently not imposed any reservations regarding their applicability (*see also* P. Eisenring, *Art. 9 of the OECD Model Tax Convention*, in *Kommentar zum internationalen Steuerrecht* 2 (M. Zweifel et al. eds, Helbing Lichtenhahn Verlag 2015)).

15 *See OECD Model Tax Convention (2008): Commentary on Art. 7,* para. N 14.

of Article 7 were considered to deviate from the ALP. For instance, it is argued that Article 7(3): (1) in some situations, restricts the head office from charging a profit mark-up to the PE for internal dealings relating to goods,[16] intangibles (and corresponding royalty payments),[17] and services[18] (especially, management services[19]) and (2) denies the recognition of internal loans and corresponding internal interest payments[20] (except for banks). This stated, in a number of other situations, a profit mark-up was considered appropriate. This is the case when there was a supply of goods (from the head office to a PE or vice versa)[21] or a supply of services (when the PE is usually in the business of providing services[22] or when the head office is in that business itself[23]). These statements surely lead to confusion.

Moreover, Article 7(4) of the 2008 OECD Model allowed states to allocate profits to a PE using an apportionment method based upon various formulae as long as the result was in accordance with the principles of Article 7. This provision is relevant for the current discussion because Switzerland actually provides for a formulary apportionment type system to allocate profits between a head office and PEs for domestic situations, to which the Swiss law explicitly refers for cross-border cases as well (see sections 2.2.3 *and 3*). On an international level, even though the application of the formulary system is recognized, the commentary emphasizes that:

> ***in general the profits to be attributed to a permanent establishment should be determined by reference to the establishment's accounts if these reflect the real facts.*** *It is considered that a method of allocation which is based on apportioning total profits is generally not as appropriate as a method which has regard only to the activities of the permanent establishment and* ***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 both by the taxation authorities and taxpayers generally there as being satisfactory.***[24]

While the Swiss formulary apportionment system continues to be widely applied in domestic situations, it is doubtful whether such a system will continue to be recognized in cross border cases when there is a tax treaty applicable based on the OECD Model (2008 or previous versions).[25] Considering the fact that Switzerland generally adopts OECD standards, it is questionable whether the application of the formulary apportionment system in cross-border cases will continue. Moreover, the Swiss Federal Supreme Court recently considered the application of the formulary apportionment system and in particular quota-based approach. It deemed amendments to this method not only to be appropriate, but actually necessary in order to effect an international profit allocation in line with the OECD Model Convention (*see discussion in* section 3.2.1).

Finally, the provision (Article 7(4)) was deleted in the 2010 treaty version, with the new version no longer providing for an apportionment method with a formulae-based approach. Switzerland, unlike other countries, did not record any observations or reservations to the new version of Article 7(4).[26] Some of the more recent tax treaties follow the wording of Article 7 of the 2010 OECD Model[27] with the new terminology being used in the latest tax treaties concluded by Switzerland with, for example, Belgium (updated), Cyprus, Hungary, Iceland, Kosovo, Liechtenstein and Slovenia.[28] The major differences between the 2008 and 2010 versions is that the latter: (1) explicitly recognizes internal dealings (including profit mark-ups)[29]; (2) eliminates the provision that authorized a state to use the formulary apportionment provisions as '*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*'[30]; and (3) recognizes that a purchasing office can be attributed a profit.[31]

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[16] *Ibid.*, para. N 33.

[17] *Ibid.*, para. N 34.

[18] *Ibid.*, para. N 37.

[19] *Ibid.*, para. N 38.

[20] *Ibid.*, paras N 41–42.

[21] *Ibid.*, para. N 33.

[22] *Ibid.*, para. N 36.

[23] *Ibid.*, para. N 35.

[24] *Ibid.*, para. N 52.

[25] However, for cases without a tax treaty in place, when domestic profit allocation rules apply exclusively, the formulary apportionment system based on the worldwide income of the entity in question may continue to apply (*see* CH: Supreme Court 2C_1116/2018 dated 5 Aug. 2020, *infra s.* 3.2.1).

[26] For observations and reservations *see OECD Model Tax Convention (2010): Commentary on Article 7,* paras N 82–98.

[27] As per Art. 7(2) OECD Model Tax Convention (2010 & 2017).

[28] *See* the latest version of Swiss tax treaties in Swiss State Secretariat for International Finance SIF, *supra* n. 2.

[29] *See OECD Model Tax Convention (2010): Commentary on Article* 7, para. N 40.

[30] *Ibid.*, para. N 41.

[31] *Ibid.*, para. N 43.

Accordingly, the majority of Swiss authors are currently of the opinion that, with the elimination of Article 7(4) OECD Model, the formulary apportionment system is no longer applicable in international circumstances.[32] This view is currently gaining additional importance in the context of the minimum taxation discussion because the OECD Pillar II project requires the determination of the Effective Tax Rate (ETR) of each constituent entity (including PEs) of a MNE Group that meets the Scope threshold and these determination rules will most likely need to adhere to the ALP (and consequently to the full AOA system) with separate financial statements of the PE.

Guidance on interpreting Article 7, in addition to the OECD Commentary, can be found in the AOA reports. Naturally, there are two versions of the OECD Commentary on Article 7 and AOA reports (2008[33] and 2010[34] versions). Similar to the OECD TP Guidelines, the authors are of the opinion that the OECD Commentary on Article 7 and the AOA reports can be used as nonbinding interpretation aids (to interpret Article 7(2) for their respective versions). Arguably, once again, in the hierarchy of the law, the AOA reports rank at the same level as the OECD Commentary.

The PE definition in the OECD Model was also updated as a result of the MLI. The question of whether the MLI or its Explanatory statement is to be used as an interpretation aid transcends beyond the scope of this contribution. This stated, additional guidance was issued by the OECD on allocating profits to the new type of PEs (post MLI PEs).[35] In the authors' opinion, the additional guidance can also serve as an interpretation aid to the extent that it clarifies the application of the separate entity approach reflected in Article 7(2).

When applying the treaty provisions, it must be borne in mind that the treaty provisions alone can never be a legal basis for any taxation by a national tax authority. The profit of an enterprise (separate legal entity or PE) is primarily determined from a unilateral view based on national law. The treaty provisions aim at avoiding international double taxation[36] and will restrict national law when necessary.[37]

2.2 *Swiss National Tax Law*

2.2.1 *Determination of Taxable Profit*

Each legal entity is considered to be a separate tax subject for Swiss corporate tax purposes (Article 50 s. DBG).[38] As a starting position and effectively in most cases, the taxable profit of a legal entity equals the balance of the income statement established under Swiss commercial law principles (Article 58(1)(a) DBG).[39] However, this balance will be corrected for tax purposes if necessary, i.e., if the accounting principles in commercial law were not adhered to or if there is a specific legal basis in tax law for an appropriate correction.[40]

In this regard, Article 58(1)(b) DBG states that corrections are possible when – inter alia – parts of the result were excluded before the balance of the income statement is calculated and were not used to cover business expenses.[41] This would include, in particular, open and hidden profit distributions,[42] non-business related benefits to third parties, or income not credited to the income statement. What is known as hidden profit distributions or, as the case may be, hidden capital contributions,[43] comes in the form of overpayments (when prices are too high) or reduced revenue (when prices are too low). Both variants represent transactions between related parties that are not at arm's length and

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[32] *See* P. Locher, A. Marantelli & A. Opel, *Einführung in das internationale Steuerrecht der Schweiz* 382 (Stämpfli 2019) with references in fn. 899.

[33] OECD, *Report on the Attribution of Profits to Permanent Establishments* (OECD Publishing 2008).

[34] OECD, *Report on the Attribution of Profits to Permanent Establishments* (OECD Publishing 2010).

[35] *See* OECD, *Additional Guidance on the Attribution of Profits to Permanent Establishments* (OECD Publishing Mar. 2018).

[36] Tax treaties allocate the right to tax to one of the contracting states, but they do not obligate the designated state to use its right to tax. This is known as the negative effect of double tax treaties. *See* among others, CH: Federal Supreme Court 2C/606/2016, 2C_607/2016, dated 25 Jan. 2017, cons. 3.5 and CH: Federal Supreme Court, 2C_436/2011 dated 13 Dec. 2011, cons. 4.1.1. In this regard, *also see* X. Oberson, *Droit Fiscal Suisse* 79–81 (Helbing Lichtenhahn Verlag 2020).

[37] This is the common view. For example, *see* J. Wittendorf, *Transfer Pricing and the Arm's Length Principle in International Tax Law* 190 (Kluwer Law International 2010) (with further references); Eisenring, *supra* n. 14, at 2; differences in the profit adjustments between two countries are to be resolved through bilateral MAP, Art. 25 of the OECD Model Tax Convention (2017).

[38] Defined as a corporately organized association of persons or institution dedicated to a special purpose that usually acquires the right of personality by registration in the commercial register [CH: Art. 52 Swiss Civil Code (Schweizerisches Zivilgesetzbuch [ZBG]; SR 210)]; for a differentiation from partnerships with tax liability of individual natural persons (Art. 10 s. DBG) which is not being discussed in this article *see* e.g., S. Hunziker & J. Mayer-Knobel, *Art. 10 and Art. 11 DBG*, in *Kommentar zum Bundesgesetz über die direkte Bundessteuer* (M. Zweifel & M. Beusch eds, Helbing Lichtenhahn Verlag 2017).

[39] According to the rules laid down in CH: Art. 957 ss. Code of Obligations [Bundesgesetz betreffend die Ergänzung des Schweizerischen Zivilgesetzbuches (Fünfter Teil: Obligationenrecht); SR 220].

[40] For example, regarding investment costs, amortizations, and depreciations or the tax treatment of equity positions (known as the 'Massgeblichkeitsprinzip' regarding the decisiveness of the profit established according to commercial law rules for tax purposes and what is referred to as 'Legalitätsprinzip' regarding the need for a legal basis for any taxation (*see* E. Blumenstein & P. Locher, *System des schweizerischen Steuerrechts* 325 s., 14 ss (Schulthess 2016).

[41] Original wording: 'charges justifiées par l'usage commercial'/'geschäftsmässig begründeter Aufwand'.

[42] Original wording 'Distribution dissimulée de bénéfice'/'geldwerte Leistung' or 'verdeckte Gewinnausschüttungen'.

[43] For example, the disputed case in a recent Zurich decision (CH: Zurich Tax Appeal Court DB.2015.166 dated 26 Mar. 2019).

need to be corrected, i.e., any difference added to the taxable profit as per the statutory accounts.[44]

In the lack of detailed legal provisions, hidden profit distributions according to Article 58(1)(b) DBG are defined by case law. In this regard, the Swiss Federal Supreme Court has always adhered to the ALP by referring, in some cases, to the OECD TP Guidelines as an interpretation aid to this principle.[45]

As a third party approach, this is understood as a comparison of the actual figures with what should be, i.e., which price unrelated parties would have agreed on in a market situation.[46] According to the longstanding case law of the Swiss Federal Supreme Court, a hidden profit distribution occurs when the following four cumulative conditions are satisfied: (1) the company gives away a benefit without receiving a corresponding consideration; (2) this benefit is granted to a shareholder or to a person closely related to the shareholder; (3) the benefit would not have been granted to a third party under the same conditions; (4) the disproportion between the benefit and the consideration is manifested in such a way that the organs of the company could have been aware of the advantage that was granted.[47,48]

It is the condition mentioned above regarding the giving away of a benefit without receiving a corresponding consideration (*prestation sans contre-prestation correspondante*) that refers directly to the arm's length approach in the strict sense. As it requires an identification and a valuation of the performance in question, and Swiss law does not provide for any rules on that question, transfer prices are assessed by the application of the case law regarding Article 58(1)(b) DBG and the relevant OECD principles.[49]

In addition, Article 58(1)(c) DBG states that any profit not accounted for in the income statement established under Swiss commercial law principles is added to the taxable profit. This correction rule is of particular interest when it comes to the profit allocation in internal dealings or PE relationships.

2.2.2 *Transactions Among Separate Legal Entities*

For transactions between different separate legal entities of the same group, due to the given shareholder-related connection of the companies and the transactions in question, the assessment of a hidden profit distribution will always evolve around condition, i.e., the arm's length character of a transaction, as described above.

The arm's length character of any transactions between separate entities of the same group is relevant not only in an international context but also in domestic cases. As each canton has its tax sovereignty,[50] and cantonal and communal tax rates can differ significantly,[51] this is a relevant subject for companies and tax administrations within Switzerland.

For example, in the case of a Swiss regional principal company with distribution companies in several countries and also one in Switzerland, albeit in another canton, the prices charged to the Swiss distribution company must rely on the group's – verified – transfer pricing principles. The overall profit margin of the Swiss distribution company must correctly reflect its functions, assets, and risks assumed. If it differs from the profit margin of other distribution entities in third countries, the group's transfer pricing documentation needs to show the basis for these differences in an internal comparison analysis (for example: the Swiss distribution company has a lower profit margin than another related European distribution company as the latter performs activities of entrepreneurial nature which could be loss making in the first few years). The tax administration of the canton of the Swiss distribution company will assess the arm's length requirement of the pricing between the domestic distribution company's transactions with the Swiss principal company just as it would in an international context. The same is valid for service fees, licence fees, and any other intragroup transactions.

In the context of transfer pricing and potential hidden profit distributions by Swiss legal entities, it must be considered that potential Swiss tax consequences not only concern the determination of the taxable profit for corporate income taxes. They also concern a deemed flux of distributions to the company receiving the benefit without corresponding consideration.

With a Swiss company being the entity giving away a deemed benefit, the value equivalent is, in principle,

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[44] CH: Federal Supreme Court 2C_11/2018 dated 10 Dec. 2018, cons. 7.2; CH: Federal Supreme Court 2C_644/2013 dated 21 Oct. 2013, cons. 3.1; CH: Federal Supreme Court 2C_834/2011 dated 6 July 2012, cons. 2.1; CH: Zurich Tax Appeal Court DB.2015.166 dated 26 Mar. 2019, cons. 1.b. with further references.

[45] N. Burkhalter-Martinez, *Transfer Pricing Aspects of Intragroup Financial Guarantees in Light of the Recent OECD TP-Guidance on Financial Transactions*, IFF Forum für Steuerrecht, 354 (2020). For a recent case of the Swiss Federal Supreme Court referring to the OECD TP Guidelines as a means of interpretation of the arm's length principle, *see* CH: Federal Supreme Court 2C_1073/2018, 2C_1089/2018 dated 20 Dec. 2019, cons. 11.2; *Also see* P. Eisenring & F. Regli, *National Report – Switzerland*, in *Future of Transfer Pricing*, IFA Cahiers Vol 102B, 755–758 (IFA 2017).

[46] Rather than a 'what should be taxed' approach; *see* CH: Zurich Tax Appeal Court DB.2015.166 dated 26 Mar. 2019, cons. 1.c.; CH: Zurich Tax Appeal Court DB.2011.50/ST.2011.77 dated 29 June 2015, cons. 3.c.bb (CUP as preferred method).

[47] Recently (instead of many), CH: Federal Supreme Court 2C_11/2018 dated 10 Dec. 2018, cons. 7.2 with further references; CH: Federal Supreme Court 2C_1082/2013 and 2C_1083/2013 dated 14 Jan. 2015, CH: Federal Supreme Court cons. 5.1; 2C_834/2011 dated 6 July 2012, cons. 2.1; fundamental CH: Federal Supreme Court BGE 140 II 88 cons. 4.1 with further references; recently on a cantonal level e.g., CH: Zurich Tax Appeal Court DB.2015.166 dated 26 Mar. 2019, cons. 1.c.

[48] J. Eckert & J. Benoit-Gonin, *Switzerland*, in *The Transfer Pricing Law Review*, The Law Reviews 248–249 at 247 (Law Business Research July 2020).

[49] CH: Federal Supreme Court 2C_11/2018 dated 10 Dec. 2018, cons. 7.2.

[50] CH: Art. 3 BV.

[51] *See* e.g., Swiss State Secretariat for International Finance SIF, *Steuerbelastung in den Kantonshauptorten* (12 July 2021), www.estv.admin.ch/estv/de/home/allgemein/steuerstatistiken/fachinformationen/steuerbelastungen/steuerbelastung/steuerbelastung-in-den-kantonshauptorten-2020.html (accessed 30 Sept. 2021).

subject to Swiss withholding tax at 35% (Articles 4(1)(b), 13(1)(a) VStG[52]). This must be paid by the said Swiss company (Article 10(1) VStG) and has to be rolled over to the receiving company (Article 14 (1) VStG). Without such a rollover, the benefit provided is considered at its net value as the basis for the calculation of the withholding tax, i.e., the effective tax on the equivalent value of the deemed benefit amounts to 53.84%.[53]

In domestic cases, it is possible – if the conditions are met – to apply a notification procedure leading to a 0% tax burden. In cross-border cases,[54] if there is a tax treaty applicable and the conditions for its application are met, the Swiss withholding tax on the deemed profit distribution is arguably subject to the treaty provisions regarding dividends (Article 10 OECD MC).[55] This allows for a partial refund of the Swiss withholding tax to the receiving foreign entity. However, if the receiving company does not hold a qualifying participation in the Swiss company, the residual, non-refundable Swiss withholding tax will often amount to 15% of the gross benefit.[56]

2.2.3 *Internal Relationships (Head Office and PE)*

In order to proceed, a difference needs to be made between domestic and international situations.

In domestic situations, Swiss tax law, in principle, does not treat different parts of same legal entity as 'separate entities' (i.e., a head office in one canton[57] and PE(s) in another). The entire company is considered to be one taxpayer. Otherwise stated, from a civil law perspective, a PE cannot legally be separated from its headquarters, i.e., all parts of a company belong to the same legal subject.[58] As a result, there cannot be any legal transactions (internal dealings) between the head office and a PE or vice versa. Accordingly, transfer pricing principles may not be applied, and it is not possible to account for 'hypothesized' internal licence fees, lease payments, service fees, or any cost-plus mark-up for tax purposes.[59]

Moreover, in such domestic cases, Swiss tax law and practice allocates the total profit of the legal entity to the cantons involved based on quotas that allow each of them to tax a certain percentage of the total profit of the company. In principle, each canton effects its own profit allocation based on its cantonal legal basis. The total profit is assessed by each canton as if the activities of the company were only located in that particular canton.[60] In practice, the allocation of the profit is usually effected by the canton of the headquarters as the responsible location[61] and usually taken over in the (separately effected) assessments of the PEs in the other cantons. Albeit rarely occurring, the latter can object and amend the domestic profit allocation in their own tax assessments. However, in the absence of any 'internal' dealings and transfer pricing rules, this will always concern a question of allocation of profit (and not its calculation). Double taxation is avoided by limitation of the earnings to be allocated to the total profit of the company. In particular, case law has developed a cascade of loss absorption by the various locations which avoids a situation in which, in the worst case, a company would have to pay tax on profits at one location even though the overall company had incurred losses.[62] In intercantonal conflict cases, the constitutional principle of the prohibition of an intercantonal double taxation will serve as a legal basis to avoid double taxation.[63]

From a technical perspective, the quotas per location are determined on the basis of the accounting results of

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[52] Swiss Federal Act on Withholding Tax [Bundesgesetz über die Verrechnungssteuer (VStG; SR 642.21)]. *Also see* K. Honold & R. Stocker, *National Report – Switzerland*, in *Cross-Border Business Restructuring*, IFA Cahiers, Vol 96A, 700–701 (IFA 2011).

[53] M. Reich & M. Bauer-Balmelli, *Art. 14 VStG*, in *Kommentar zum Bundesgesetz über die Verrechnungssteuer* 17 ss (M. Zweifel et al. eds, Helbing Lichtenhahn Verlag 2012).

[54] Swiss practice also treats a deemed benefit from (inter alia) a Swiss entity to a Swiss PE of a foreign entity as a cross-border case (the Swiss PE itself not being a withholding tax subject; *see* Th. Jaussi & F. Duss, *Art. 9 VStG*, in *Kommentar zum Bundesgesetz über die Verrechnungssteuer* 28 ss (M. Zweifel et al. eds, Helbing Lichtenhahn Verlag 2012)).

[55] According to Art. 10(3) of the OECD Model Tax Convention (2017), the qualification as a dividend in the meaning of the OECD Model Tax Convention is determined 'by the laws of the State of which the company making the distribution is a resident', i.e., Switzerland. The Swiss Federal Tax Authority operates on the principle of what is known as the direct-beneficiary theory (Direktbegünstigtentheorie) for domestic and international cases which treats hidden profit distributions as 'income from shares' according to the treaty provision (S. Oesterhelt & R. Heuberger, *Art. 10 of the OECD Model Tax Convention*, in *Kommentar zum internationalen Steuerrecht* 237 (M. Zweifel et al. eds, Helbing Lichtenhahn Verlag 2015)); *see* e.g., CH: Federal Supreme Court 2C_726/2009 dated 20 Jan. 2010.

[56] Further implications such as an intragroup refund and/or compensation obligations, tax adjustment issues, etc. might be encountered that are not discussed in this article.

[57] Switzerland has twenty-six so-called 'cantons' for which each have their own tax legislation and jurisdictions for cantonal and communal taxes (in addition to direct federal tax).

[58] CH: Federal Supreme Court 4A_129/2014, cons. 2.5; Art. 109 ss. of the Swiss Ordinance on the Register of Commerce [Handelsregisterverordnung (HRegV); SR 221.411] regarding branches of legal entities; on international level OECD, *supra* n. 34, e.g., Part I at 33 ss.

[59] *Also see* S. Collomb, *Etablissement d'une repartition intercantonale: Est-il encore possible d'éviter d'utiliser des methodes de prix de transfert?*, 88 Archiv fur Schweizerisches Abgaberecht 185–198 at 195 (2019/2020), *see* Brülisauer & Mühlemann, *supra* n. 12, at 499.

[60] *See* SSK, *Circular Letter no. 34 Dated 15 January 2020 Regarding the Intercantonal Tax Allocation of Companies Making Use of the Tax Reform Deductions*, n. 2.1, available in German, French and Italian at, www.steuerkonferenz.ch/?Dokumente:Kreisschreiben (accessed 30 Sept. 2021).

[61] CH: Art. 105 al. 3 DBG, Art. 22 al. 1 StHG.

[62] *See* SSK, *Circular Letter no. 27 Dated 15 November 2018 Regarding the Avoidance of Allocation Losses*, n. 1 s., available in German, French and Italian at, www.steuerkonferenz.ch/?Dokumente:Kreisschreiben (accessed 30 Sept. 2021).

[63] CH: Art. 127 al. 3 BV.

the different locations of the company (if there is separate accounting, known as direct method) or by means of auxiliary factors (indirect method).[64]

The direct quota-based method calculates the profit quota for each location based on the earnings actually recorded separately in the books of the company. As long as each location shows an overall gain for the year, the profit quota for each location will equal the recorded profit as per the books of the company. However, this is different if there is a loss at one or several locations or if the enterprise itself was loss-making while, at the same time, there was a capital gain at a property location. The allocation of the overall remaining profit follows a sophisticated system that prioritizes special tax domiciles (in particular connected to real estate) and ensures that there are no allocation losses overall.[65]

The indirect quota-based method relies on auxiliary parameters. Depending on the industry and the particular enterprise, these parameters are weighted differently contingent upon their importance for the business activity. They largely represent production factors such as the location of personnel expenses, assets, etc. and thus – together with their weighting – stand for a certain functional analysis similar to that provided for in step 1 of the AOA.[66] This is valid even if it has neither been called that nor been linked to the AOA in the past.[67] Depending on the character of the industry, further parameters such as the turnover per location may also be taken into account (thus the system goes beyond the functions and assets logic). Often, the tax administration and the taxpayer work out a hybrid calculation mechanism with several of these parameters and different multiples which best suits the company's activity and division of functions and earnings between the company's locations.[68]

Having stated that, it is only in particular circumstances when a profit is attributed to a defined part of the company, i.e., the headquarters or a specific location. The latter may apply for a taxable gain on real estate that is directly linked to its location.[69] In other cases, the practice of the Swiss Federal Supreme Court denies the cantons of the PE of what is known as object-based taxation of income generated in their tax jurisdiction, i.e., a taxation of the profit as recorded in the books of the PE; rather, one of the quota-based methods will have to be applied. A direct allocation of profit to the headquarters may possibly apply in connection with certain defined tax objects such as participations or IP income. However, Swiss practice usually reflects such a 100% allocation of certain profit components in a higher praecipuum/quota for the headquarters rather than a direct allocation of the profit concerned.[70]

Concerning cross-border cases, there is interaction between Article 58(1)(a), (b), and (c) DBG regarding the determination of the taxable profit (calculation) and Article 52 (1), (2), (3), and (4) about the allocation of profit.[71] Both provisions are systematically embedded in the legal provisions of the definition of the tax object. The latter will allocate all relevant external transactions between head offices and PEs according to legal, economic, and functional criteria. The former is the basis for the determination of the relevant profit[72] and will function as a correction provision with regard to the internal relationships.[73] Based on these two provisions, all profits deriving from activities contributing to the value chain of the enterprise have to be divided between Switzerland and the foreign PE. For this allocation, the functional analysis and an ALP approach is decisive.[74] One crucial element of step one of the AOA in hypothesizing a PE as a separate and independent enterprise – in order to effect such a functional analysis – is the principle of a recognition of dealings within the same legal entity. Due to the lack of legal consequences for such dealings,

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[64] *See* For an overview of these methods, *see* P. Brülisauer, *National Report – Switzerland*, in *The Attribution of Profits to Permanent Establishments*, IFA Cahiers, Vol 91B, 642–644 (IFA 2006); for example calculations, *see* Collomb, *supra* n. 59. Moreover, although the Swiss Federal Supreme Court favours the application of the direct method, the indirect method remains the most commonly used, *see* D. de Vries Reilingh, *La double imposition intercantonale* 279 (Stämpfli 2013); Oberson, *supra* n. 36, at 605; H. Teuscher & F. Lobsinger, *§ 31 on Tax Allocation of the Profit of an Enterprise*, in *Kommentar zum interkantonalen Steuerrecht* 1 (M. Zweifel et al. eds, Helbing Lichtenhahn Verlag 2021).

[65] SSK, *supra* n. 62, n. 1 s., Examples 4 and following.

[66] *See supra* s. 2.3.

[67] *See* e.g., CH: Federal Supreme Court, dated 23 Jan. 2020, cons. 8.4, referring to the company headquarters' functions and performances or CH: Federal Supreme Court 2P.340/2006, dated 10 Sept. 2007, cons. 3, where the court discusses the connection between the headquarter's management function and their reflection in the intercantonal profit allocation in the personnel costs, making an additional praecipuum for the headquarters redundant.

[68] As an example of a unified approach in a specific industry, *see infra* s. 3.4.

[69] What is known as a 'special tax domicile' (*Spezialsteuerdomizil*); CH: Federal Supreme Court 2C_41/2012, dated 12 Oct. 2012, E. 3.2; CH: Federal Supreme Court, 2C_312/2010, dated 11 Mar. 2011, E. 2.5.

[70] *See* e.g., CH: Federal Supreme Court 2C_57/2018, dated 23 Jan. 2020, in particular cons. 8.4., in which the Swiss Federal Supreme Court has explicitly referred to the functions and activities performed in connection with a certain IP whereby, based on these, the attribution of a deemed profit realization on such IP was to be determined. Such an attribution was the basis for a subsequent intercantonal allocation of the profit by way of a correction of the praecipuum of the headquarters (rather than a direct profit allocation to the income statement established under Swiss commercial law principles.

[71] *See infra* s. 3.1 re Art. 52 DBG.

[72] Due to the commercial balance sheet being the basis for taxation, only the profit generated through external transactions may be accounted for; *see* Brülisauer & Mühlemann, *supra* n. 12, at 447.

[73] Brülisauer & Mühlemann, *supra* n. 12, at 439 s.; P. Brülisauer, A*bgrenzung nach dem «Dealing-at-Arm's Length-Prinzip» im internationalen Einheitsunternehmen* (2. Teil), IFF Forum für Steuerrecht 336 ss. at 339 (2014).

[74] Brülisauer & Mühlemann, *supra* n. 12, at 472, 448.

there is greater scrutiny, and a certain threshold needs to be passed before a dealing is accepted as an equivalent to a legal transaction that would have taken place between independent companies acting at arm's length.[75,76] In particular, they must be relevant for the profit allocation in terms of a functional analysis. Hence, ongoing internal relationships regarding services and other performances (e.g., contract R&D and delivery of goods) between the different international locations may be accepted as 'dealings' for Swiss tax purposes if they relate to third party transactions realized and reflected in the company's commercial P&L.[77] The practical treatment of these internal dealings then further depends on the tax liability in Switzerland.

In the case of a Swiss headquarters with unlimited personal tax liability, the profit of the enterprise is determined without any internal dealings based on its worldwide net income. Subsequently, the overall earnings may be allocated according to the role of each location. For this profit allocation, internal dealings may serve as a calculation basis to determine: (1) the allocation of a proportionate praecipuum for the Swiss headquarters' activity and (2) the allocation of the remaining profit quota to the headquarters and the PEs based on each location's books (which include said internal dealings).[78,79] For example, a praecipuum of the taxable profit (e.g., 10%) may be attributed to the Swiss headquarters for the performance of administrative functions that are not charged to the PEs before the remaining profit (e.g., 90%) is allocated according to the books of the headquarters and the PEs.

If a PE of a foreign company in Switzerland is concerned, services or any other performances rendered from the Swiss PE to a foreign location must be remunerated at cost with an additional profit component.[80] From an international perspective, this approach seems to be accepted in the 2008 OECD Commentary[81] and is obvious for the 2010 version. For services rendered from a foreign location to the Swiss PE, the practice to accept a remuneration above cost, i.e., with a mark-up, has been rather strict under unilateral law.[82] In fact, it has been argued that services should be charged at cost.[83] With the increasing integration of international transfer pricing standards within Switzerland, it is to be expected that such a remuneration to a foreign location above cost if properly justified and documented should be accepted.

In addition, for one-time transactions, Article 61b DBG[84] explicitly aims at internal transactions and includes the transfer of assets, a business or part of a business, or functions from Switzerland to a foreign PE. It begins from the principle that anything of value (for example, fixed, current, or intangible assets, business activities and functions) leaving the Swiss tax sphere will be taxed.

Typical examples may include the transfer of IP, client relationships, distribution activities, or other business activities that are attributed a goodwill value.[85] Any such 'exit' is treated as a deemed realization of hidden reserves or goodwill for the purpose of Swiss taxation. Hence, a cross-border transaction or transfer when something of value is shifted – from a Swiss PE to the foreign headquarters or from the Swiss headquarters to a foreign PE – will indeed be recognized as a 'dealing' for national tax law purposes.[86] Transfer pricing rules will apply as the dealing has to be at market value. When the value of a transfer of functions has to be assessed, the value of the functions performed by the Swiss transferring entity before and after the transfer will be compared, taking into account the risks assumed and the profit potential connected therewith.[87] This will be assessed based on the

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[75] OECD, *supra* n. 34, Part I at 33 ss.

[76] For Swiss dividend withholding tax, dealings within the same entity cannot be subject to taxation due to the lack of a distribution or a dividend income respectively (concept of limitation of the Swiss dividend withholding tax to domestic companies [Inländerbegriff], Art. 9(1) VStG; *see* C. Martin & P. Riedweg, *§ 10 on Emigration*, in *Kommentar Umstrukturierungen* 147 ss (M. Zweifel et al. eds, Helbing Lichtenhahn Verlag 2021) for details).

[77] *See* also Brülisauer & Mühlemann, *supra* n. 12, at 453 (also on the timing of taxation in relation to external dealings that is not further elaborated on in this contribution). The separate financial statement of the PE (including internal dealings) is likely to gain importance in an international context as we because the OECD Pillar II project requires the determination of the Effective Tax Rate (ETR) of each constituent entity (including PEs) of a MNE Group that meets the Scope threshold for minimum taxation based on the AOA.

[78] CH: Art. 52(1) and (2) DBG; Brülisauer, *supra* n. 14, at 176 ss.

[79] The practice is also recognized by the OECD. *See* OECD Model Tax Convention (2008): Commentary on Art. 7, paras N 39–40.

[80] *See* Brülisauer, *supra* n. 64, at 653; P. Brülisauer, *Art. 7,* in *Kommentar zum internationalen Steuerrecht* 181 (M. Zweifel et al. eds, Helbing Lichtenhahn Verlag 2015); Locher, Marantelli & Opel, *supra* n. 32, at 393.

[81] Depending on the specific case, this requirement may derive from the OECD principles regarding the remuneration of services (*see* e.g., discussion in OECD Model Tax Convention (2008): Commentary on Art. 7, para. N 35 s.).

[82] If the foreign location is the headquarters, a proportionate up-front praecipuum may be accepted; Brülisauer, *supra* n. 14, at 183.

[83] *See* Brülisauer, *supra* n. 64, at 653.

[84] In power since 1 Jan. 2020 as part of the 2020 tax reform (STAF).

[85] *See also* examples in P. Brülisauer & St. Kuhn, *Allokation und Reallokation von betrieblichen Funktionen und Risiken im multinationalen Konzern,* 2 FStR 81 ss (2002); Martin & Riedweg, *supra* n. 76, at 18; Brülisauer & Mühlemann, *supra* n. 12, at 472.

[86] *See* CH: Art. 61b DBG, in power since 1 Jan. 2020, which explicitly mentions the transfer of assets, a business or part of a business, or functions from Switzerland to a foreign entity or to a foreign headquarter/establishment, Martin & Riedweg, *supra* n. 85, at 6.

[87] *See also* P. Hinny, *Neue steuerliche Behandlung des Zuzugs in die Schweiz und des Wegzugs aus der Schweiz (einschliesslich Funktionsverlagerung) im Rahmen des STAF*, 4 IFF Forum für Steuerrecht 347 ss (2019).

separate entity approach and, accordingly, the ALP.[88] This practise is also reflected in the 2010 OECD Commentary[89] which prescribes that an internal dealing needs to be at arm's length.[90]

The new Article 61b DBG is to be welcomed and provides both the tax authority with an explicit legal basis for the taxation of internal emigration transactions and the taxpayers with a clear guideline. The integration of such an explicit rule for ongoing internal transactions in PE relations as well would have the benefit, on the one hand, to be the basis for taxation without having to resort to the general profit determination and distribution norms of Articles 58 and 52 DBG. On the other hand, it would explicitly incorporate the ALP into domestic law. Taking a step back, such an autonomous regulation would also be welcome for relationships within a group of legally separate entities. This would allow a directly applicable profit adjustment standard based on the ALP instead of resorting to the instrument of a deemed dividend (*geldwerte Leistung)* based on the relationship with the participation holder.[91]

3 Profit allocation to permanent establishments in cross-border situations: Swiss perspective

3.1 *Legal Basis*

Whereas the profit of an enterprise is primarily determined from a unilateral point of view (Article 58 DBG), the allocation of profits in cross-border situations is, in principle, effected from an international perspective. However, starting from that of the Swiss, domestic rules of international profit allocation play a crucial role in the effective allocation of profit.

The domestic rules form the basis of the international profit allocation and hence taxation in Switzerland whereas tax treaty provisions as bilateral law can only restrict the unilateral law but not replace it. Therefore, from a Swiss position, it would also not be possible to base an allocation of losses to a PE on a treaty provision such as Article 7 OECD MC. Rather, this requires an explicit norm in domestic law as provided for in Article 52(3) DBG.[92]

Swiss Domestic Law, on the one hand, provides for an unlimited personal tax liability of a company if their registered offices or their effective place of management is located in Switzerland. However, this tax liability does not extend to PEs abroad (Articles 50, 52(1) DBG). Stated differently, profits attributable to foreign PEs are unilaterally exempt from taxation in Switzerland. On the other hand, for companies with their registered offices abroad and a PE in Switzerland, the tax liability in Switzerland is limited to the PE's profit earned in Switzerland (Articles 51(1)(b), 51(2), 52(2), and (4) DBG).

In principle, the concept of a PE[93] (which is quite similar to the fixed place PE provisions in the OECD Model) and its profit determination according to domestic law should be applied in the same manner for outbound and inbound cases alike (*einheitliche{r} Begriff*).[94]

Nevertheless, Swiss practice is differentiating between the assessment of outbound and inbound PE cases. The Federal Supreme Court held in the past that, as far as the definition of a PE of a foreign company in Switzerland is concerned, it should be regulated when and to what extent Switzerland may use part of the operating result for taxation purposes.

Conversely, the definition of a foreign PE of a Swiss company regards determining when and to what extent the operating results of a Swiss company that are attributable to a foreign PE must be excluded from taxation in Switzerland.

These different objectives of the unilateral profit allocation rules must be taken into account in particular in connection with double taxation questions that very often result from the allocation of taxation rights through double tax treaties. Hence, the unilateral provisions aiming at avoidance of unilateral double taxation tend to be interpreted in favour of Switzerland's right of taxation. If this is overly extended, the rules of the tax treaty in general – i.e., insofar as a tax treaty is applicable – will intervene to correct it.[95]

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[88] *See* Brülisauer, *supra* n. 64, at 651–653.

[89] *See* OECD Model Tax Convention (2010): Commentary on Art. 7, para. N 40.

[90] Honold & Stocker, *supra* n. 52, at 704–705. Additionally, due to the unilateral allocation of profits to a foreign PE, in the case of a transfer from the foreign location to the Swiss headquarters/permanent establishment, any hidden reserves built in the foreign location are exempt from taxation in Switzerland; if necessary, a correction needs to be booked in the accounts of the company (P. Brülisauer, *Gewinnabgrenzung zwischen Stammhaus und Betriebsstätte im internationalen Steuerrecht der Schweiz*, 2 IFF Forum für Steuerrecht 225 (2007); Brülisauer, *supra* n. 14, at 142). *Also see* Honold & Stocker, *supra* n. 52, at 705.

[91] *See* e.g., DE: § 1 Aussensteuergesetz regarding « *Berichtigung von Einkünften* ».

[92] Locher, Marantelli & Opel, *supra* n. 32, at 417.

[93] In general, a PE is defined as a fixed place of business in which the commercial activity of an enterprise is wholly or partly performed. PEs are, in particular, branches, factories, workshops, sales outlets, permanent representations, mines and other sites for the exploitation of mineral resources, as well as construction or assembly sites of at least twelve months' duration (Art. 51(2) DBG; *see* e.g., M. Vogelsang, *Der Begriff der Betriebsstätte im schweizerischen und internationalen Steuerrecht* 305 ss (2015); R. Danon, *Bénéfice 'offshore' et exemption au sens de l'art. 52 al. 1 LIFD, analyse de l'arrêt rendu par le Tribunal Fédéral le 5 octobre 2012*, at 355 ss, in *Dogmatik und Praxis im Steuerrecht, Festschrift für Markus Reich* 355–370, at 364 ss (L. Uttinger et al. eds, Schulthess 2014)). Arguably, the definition is quite similar to the concept of a fixed place PE found under Art. 5(1) and Art. 5(2) of the OECD Model.

[94] CH: Federal Supreme Court Decision BGE 139 II 78 cons. 2.3 ss; *also see* discussion in Danon, *supra* n. 93, at 369 s.

[95] CH: Federal Supreme Court BGE 139 II 78, cons. 3.1.2; confirmed in CH: Federal Supreme Court 2C_738/2014 and 2C_739//2014 dated 21 Aug. 2015, cons. 2.4.

Despite this more refined definition of a PE by the Swiss Federal Supreme Court, Swiss authors predominantly argue for the need of an identical approach in inbound and outbound cases.[96] Having stated that, the definition of a PE and the substance/functional threshold remains an important element of cross-border cases. Next to the arm's length pricing between related separated companies, it is around this very question that quite a few disputes between taxpayers and the Swiss tax authorities evolve.

3.2 *Swiss Resident Company With a Foreign PE (Outbound Case)*

3.2.1 *Introduction and Recent Developments*

With the unconditional unilateral exemption from taxation for profits attributed to foreign PEs of Swiss companies provided for by law,[97] the Swiss tax law adheres to a strict territorial principle.[98] Even though the provision does not intend to result in double non-taxation, such an outcome would, as such, not infringe the applicability of the provision.[99] The strict territorial principle is broken by the provision that losses allocated to a foreign PE may be provisionally taken over by the Swiss headquarters as long as they were not already recognized for tax purposes in the country of the PE. If the PE does not have enough profits within the next seven years to recover its losses, the taking over of the losses will become definite.[100]

The law directly links the profit allocation of outbound cases to the principles of Swiss federal law prohibiting double taxation between two or more cantons in Swiss domestic cases (Article 52(3) DBG). Without further guidance by the law, these principles are based on Article 127(3) of the Swiss Constitution regarding the prohibition of intercantonal double taxation and the corresponding case law.

As discussed previously, for intercantonal enterprises,[101] the Swiss courts apply a quota-based approach to allocate the total profit of a company between the canton of domicile and those with a PE. The relevant quotas may be determined based on accounting (directly) or, if that is not possible, through auxiliary parameters (indirectly).[102]

In principle, the same allocation principles are to be applied for an international profit allocation (Article 52(3) DBG). However, the quota-based methods developed for the intercantonal profit allocation can have inappropriate effects if they are applied to a cross-border relationship without modifications. While the practice of the Swiss Federal Tax Administration usually works with the direct method based on the headquarters' and the PE's accounting (that is, if there is a relative autonomy and independence of the PE with separate accounting[103]), some Swiss authors still defend the application of the quota-based methods.[104] The Swiss Federal Supreme Court is also upholding the permissibility of the quota-based methods as such. However, the court has clearly stated that there must be amendments to these methods to effect an international profit allocation under the current version of the OECD Model Convention taking into account the economic, legal, and social circumstances in international cases.[105]

In two recently decided cases regarding an international profit allocation between the Swiss headquarters and the foreign PEs of an enterprise, the Swiss Federal Supreme Court had the opportunity to assess the application of the unilateral profit allocation rules.

The first case concerned (inter alia) the international allocation of profits of a Swiss international airline company. It was the first time that the Swiss Supreme Court had the opportunity to set a standard for an international profit allocation of a company with its headquarters in Switzerland.[106] At the same time, the circumstances of the case were rather particular due to the special activity of the company raising questions in relation to the allocation of personnel costs, capital (airplanes), etc. The use of the quota-based approach, as such, was not disputed between the parties, even more so as there was no separate

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[96] Vogelsang, *supra* n. 93, at 303 s.; S. Oesterhelt & S. Schreiber, *Art. 51 DBG*, in *Kommentar zum Bundesgesetz über die direkte Bundessteuer* 16 (M. Zweifel & M. Beusch eds, Helbing Lichtenhahn Verlag 2017) with further references: *Also see* D. de Vries Reilingh, *The Concept of Permanent Establishment: A Comparative Analysis of Tax Treaty and Swiss Domestic Tax Law*, 38(11) Intertax (2010).

[97] CH: Art. 50, 52(1) DBG.

[98] Danon, *supra* n. 93, at 357, 363.

[99] Recently discussed in CH: Federal Supreme Court 2C_151/2017 et al. dated 16 Dec. 2019, cons. 3.5.1 s.; e.g., in CH: Federal Supreme Court BGE 139 II 78 (discussion in Danon, *supra* n. 93, at 358 ss). In this last decision, interestingly, the Swiss Federal Supreme Court came to the conclusion that a PE located in a low-tax jurisdiction with the aim of being exempt from taxation in Switzerland was against the spirit of the law.

[100] CH: Art. 52(3) DBG.

[101] *See supra* s. 2.2.3.

[102] *See supra* s. 3.1.1.

[103] CH: Federal Supreme Court Decision 2C_1116/2018 dated 5 Aug. 2020, cons. 7.3.2.

[104] *See* Locher, Marantelli & Opel, *supra* n. 32, at 381 with references.

[105] CH: Federal Supreme Court Decision 2C_1116/2018 dated 5 Aug. 2020, cons. 7.2; CH: BGE 146 II 111 dated 16 Dec. 2019 (2C_151/2017 et al.), cons. 3.5.3. *Also see* C. Martin, *Swiss Supreme Court Restates Principles of International Profit Allocation Under Swiss Domestic Law*, Kluwer Tax Blog (9 Oct. 2020), http://kluwertaxblog.com/2020/10/09/swiss-supreme-court-restates-principles-of-international-profit-allocation-under-swiss-domestic-law/ (accessed 30 Sept. 2021).

[106] CH: Federal Supreme Court BGE 146 II 111, cons. 3.2.

accounting for the PEs. Based on the indicated quota-based approach with auxiliary factors, in particular personnel costs, capital and turnover allocated to the headquarters and abroad, the company concluded on a foreign (tax-exempt) quota of 35%. The tax authority did not include the turnover in their calculation and concluded on a different allocation of personnel costs and capital, resulting in a foreign (tax-exempt) quota of only 6.729%. In a detailed *obiter dictum*, the Swiss Supreme Court considered that the application of the quota-based methods are deemed to no longer be admissible under the current version of the OECD Model Convention, in particular after Article 7(4) of the 2008 OECD MC was abolished.[107] Furthermore, it mentioned the general tendency in Swiss literature and from the Swiss Federal Tax Administration to apply the direct object-based method (i.e., a pure separate entity approach based on the accounts of the company) that prevails in international law or at least a proportional allocation by the direct method.[108] Due to the particularities of the case and in the absence of an existing standard for international airline companies in domestic law, the judges did not decide in this case whether the quota-based indirect methods can (generally) still be applied at all in international cases. Rather, they held it to be imperative that profit allocation for an international airline company had to follow the object-based method with a direct calculation of the profit of the foreign PEs to be exempt from taxation in Switzerland.[109] The case was remanded to the tax authority for a new tax assessment.[110]

The second case involved two international companies with their headquarters in Switzerland providing supply services for military troops and civilian emergency forces in various crisis areas of the world, in particular in Afghanistan. While there were no separate PE accounts as such, the companies maintained detailed country analyses comparable to accounting. As there were no double taxation treaties with any of the countries concerned, the taxation and particularly the international tax allocation in relation to PEs was completely governed by Swiss domestic profit allocation rules. Tax rulings were issued by the cantonal tax administration with regard to the international profit allocation. In the course of an audit by the Swiss Federal Tax Administration, the application of said tax rulings was disputed. It was specifically concerning the principle of the protection of confidence (*Vertrauensschutz*) in the rulings which could only be invoked if they are in accordance with the applicable law or, if not, an incorrectness of the tax rulings was not easily recognizable by the company.[111] While the companies invoked the protection of the *Vertrauensschutz* in the rulings, the Swiss Federal Tax Administration wanted to proceed with a discretionary assessment. The judges focused on the question of whether the profit allocation method stated in the rulings was covered by the domestic principles on the international allocation of profit. For this purpose, they restated the principles on the international profit allocation in Swiss domestic law as initiated in the first case described above. The Swiss Supreme Court reconfirmed its general position that certain amendments to these methods are appropriate and necessary in order to effect international profit allocation taking into account the economic, legal, and social circumstances in international cases.[112] It took a firm stance, however – due to the explicit reference in Article 52(3) DBG – stating that the fundamental principles of the intercantonal methods still have to be applied, especially that the total world income of the company in question must be the basis for any profit allocation.[113] Hence, the Swiss Supreme Court concluded that the tax rulings were not in accordance with the Swiss domestic profit allocation rules. They were deemed to technically operate the wrong way around: instead of basing the calculation on the world income of the companies and then exempting a foreign profit, they rather started with a purely Swiss figure (local cost approach) and calculated the taxable profit in Switzerland without taking into account the results of the PEs. To that extent, it confirmed the decision of the lower court and remanded the case to it for a new decision on whether the companies could have easily recognized this incorrectness of the rulings. Should it be deemed to have been easily recognizable, this would result in a denial of *Vertrauensschutz* in the rulings and the need of a new allocation of the taxable profit in Switzerland.[114]

These cases clearly represent the trend that a PE should be treated as a functionally separate entity and profits should be allocated to it on that basis. In light of this discussion, the authors present an illustration on how the mechanism would work from a Swiss standpoint.

Notes

[107] *Ibid.*, cons. 3.5.3.

[108] *Ibid.*, cons. 3.5.3 with references; Oesterhelt & Schreiber, *supra* n. 96, at 17 with further references; explicit instruction by the Swiss intercantonal tax conference for the international tax allocation of banks, CH: CSI *Circulaire no.* 5, para. 2.1. *Also see* Brülisauer, *supra* n. 14, at 644–645.

[109] CH: Federal Supreme Court BGE 146 II 111, cons. 3.9.

[110] *Ibid.*, cons. 6.2.

[111] CH: Supreme Court 2C_1116/2018 dated 5 Aug. 2020, cons. 5 f.

[112] *Ibid.*, cons. 7.2.

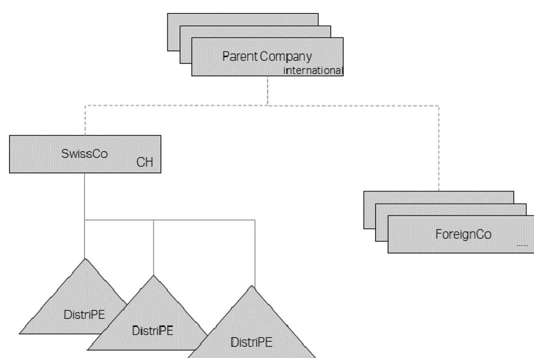
[113] *Ibid.*, cons. 7.4.

[114] *Ibid.*, cons. 7.6, 7.7, and 8; for this, the lower court had originally given certain instructions based on an indirect quota-based method approach (decision of CH: Administrative Court of the Canton of Glarus VG.2017.00088 dated 8 Nov. 2018, E. II / 7.2; no instruction on this was given by the Swiss Supreme Court as it did not decide on the validity of the tax rulings but rather remanded the case back to the lower court which has).

3.2.2 *Illustration*

A Swiss company (**SwissCo**) is part of a group of companies that – following a start-up and development phase – began manufacturing and distributing its products. It has distribution centres (**DistriPEs**) in several foreign countries (countries with which Switzerland has concluded tax treaties based on the OECD Model). The employees of the **DistriPEs** take care of the distribution of the group's products to the local companies of existing international customers of the group and also to newly acquired local customers. While some DistriPEs have extended their activities to several small countries (regional centres), others are only active in their particular country.

Separate accounts are being established in the form of a per country analysis. In several countries, after initial losses, the distribution activities of the DistriPEs have been very successful, and the group is now planning on transferring the distribution activities to several new related (local) legal entities (**ForeignCo**).



For profit allocation before the restructuring, the profits of SwissCo allocated to its foreign PEs (the DistriPEs) are exempt from taxation in Switzerland insofar as they meet the PE criterium. A proportional profit allocation method is being applied based on the intercantonal principles of tax allocation referred to by the law (Article 52 (3) DBG).

In particular:

- The basis for Swiss taxation is the worldwide profit of SwissCo established according to Swiss commercial law (accounting) rules.
- A quota of the worldwide profit of SwissCo is then allocated to the DistriPE and hence exempt from taxation in Switzerland.
- In this particular case, per country reports have been established based on the AOA approach. Specifically, the profit and loss as well as the balance sheet of each DistriPE is drawn up based on its functions, assets and risks. Beginning with the assumption that there is an overall commercial law profit, it is the basis for a profit allocation based on the direct method (preferably, the direct object-based method).
- In theory, as a complementary method based on Swiss domestic rules, an auxiliary value such as the turnover per PE may be taken as the basis for the profit allocation with a pre-allocation of a praecipuum for the headquarter functions that are allocated (indirect method). However, even though this reflects a methodology of the Swiss unilateral profit allocation rules, when a OECD model based tax treaty exists between the states involved, such auxiliary methods should no longer be applied.

For the restructuring, there will be a partial correction of the profit of SwissCo established according to Swiss commercial law (accounting) rules for the year in question. This will reflect the deemed realization of hidden reserves or goodwill that respectively results from the transfer of the distribution activities to ForeignCo. This correction will be based on a separate entity approach and a functional analysis with regard to the distribution activities in question and the goodwill connected therewith, the legal basis for taxation being Article 61b DBG. In particular:

- It must be analysed which part of the activities and customer relationships are to be attributed to the DistriPE – this may include all of the activities and customer relationships that were locally acquired during the first years of the DistriPE's activities. The DistriPEs are therefore the economic owners of these 'assets';
- a transfer of such activities and the goodwill connected therewith, in particular the economic ownership of the customer relationships allocated to the DistriPEs, will be exempt from taxation in Switzerland;
- as far as customer relationships concern existing customers of the group, the functional analysis may show that the goodwill attributable to these customer relationships and (auxiliary rather than real value-adding) activities has remained with the SwissCo headquarters' in Switzerland. The PE has not taken any decisions but is merely following the instructions of the headquarters.[115] Accordingly, a transfer of this

Notes

[115] *See* e.g., Decision of CH: Zurich Tax Appeal Court DB.2015.166 dated 26 Mar. 2019, cons. 2.a.

goodwill may be qualified as a realization for tax purposes and added to the taxable profit of SwissCo in Switzerland;
– the remuneration for the transfer of the goodwill related to the activities and the customer relationships attributed to SwissCo's Swiss headquarters is to be determined according to the ALP.

3.3 *Non Resident Company With a Swiss PE (Inbound Case)*

3.3.1 *Introduction and Recent Developments*

A non-resident company with a Swiss PE will be liable for taxation in Switzerland based on the profit it has earned in Switzerland.[116] Based on the wording of the law[117] and in contrast to outbound cases of Swiss companies discussed above, it has been established for such inbound cases that the profit allocation always has to be effected based on the direct method, i.e., directly based on the separate accounts of the Swiss PE.[118]

This principle was already established by the Swiss Federal Supreme Court in the year 1947[119] and very recently confirmed in a case regarding a PE of a Luxembourg based customer relationship management and debt collection company with a PE in the canton of Zurich. While the dispute mainly concerned depreciation on receivables from royalties for the use of patents related to the organization of call centres and its periodicity, the basis for the discussion was the separate accounts of the Swiss PE as a taxation basis according to Article 52(4) DBG.[120]

This application of the direct method is sensible not only because it is in accordance with international standards that refer to the separate entity concept. It is also because Swiss tax authorities (and often even the management of the Swiss PE) will only have limited or no information about the foreign headquarters and/or any information available does not correspond to Swiss accounting standards etc. This would make a determination of the profit of the Swiss PE impossible.[121]

As a consequence of the direct method, a loss within Switzerland may be carried forward according to the general rules[122] whereas an overall loss of the company will not reduce a taxable profit earned by the Swiss PE.[123] Should the latter result in double taxation due to differing rules in the resident country of the company, any tax treaty provision would prevail.[124]

In light of this discussion, the authors present an illustration on how the mechanism would work from a Swiss standpoint.

3.3.2 *Illustration*

Company R from State R (**RCo**) has a Finance branch in Switzerland (**SwissFin**) that is registered in the Swiss register of commerce as a foreign branch.[125] State R and Switzerland have entered into a tax treaty based on the OECD Model. RCo is part of a larger European group of companies that provides investment advisory and management services to various customers worldwide. SwissFin provides loans (mainly in EUR) as well as management and administrative services to different group companies (**GroupCo**). It has rented offices in Switzerland and currently employs two managers and three administrative assistants. These employees: (1) perform loan management functions with respect to the loans provided to group companies and (2) perform management and administrative functions concerning group finance.

Notes

[116] CH: Art. 51(1)(b), 51(2), 52(2) and (4) DBG; '*Taxpayers domiciled and effectively managed abroad must pay tax on profits earned in Switzerland*'. [Art. 52(4) DBG, underlining added by the authors].

[117] CH: Art. 52(4) DBG.

[118] *See* CH: Federal Supreme Court 2C_972/2018 dated 2 Oct. 2019, E. 5; CH: Federal Supreme Court 2P.140/2005 dated 28 Nov. 2005, cons. 4.3; Oesterhelt & Schreiber, *supra* n. 96, at 15, 61; P. Locher, *Art. 52 DBG*, in: *Kommentar zum Bundesgesetz über die direkte Bundessteuer* (M. Zweifel and M. Beusch eds, Helbing Lichtenhahn Verlag, 2017), at 24; Locher, Marantelli & Opel, *supra* n. 32, at 381 with further references; *Also see* Brülisauer, *supra* n. 14, at 646–647.

[119] CH: Federal Supreme Court BGE 73 I 191 dated 23 Oct. 1947, E. 3.

[120] CH: Federal Supreme Court 2C_972/2018 dated 2 Oct. 2019, E. 5.

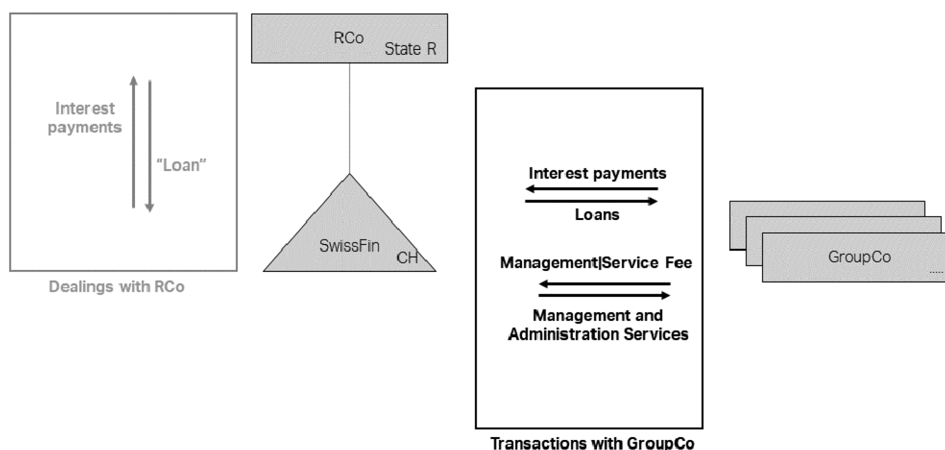
[121] Brülisauer, *supra* n. 14, at 166, has made the same statement.

[122] CH: Art. 67 DBG.

[123] This was the case disputed in CH: Federal Supreme Court 2P.140/2005 dated 28 Nov. 2005; *see also* F. Lampert, *Die Verlustverrechnung von juristischen Personen im Schweizer Steuerrecht* 321 ss (Helbing Lichtenhahn Verlag 2000).

[124] However, double taxation is to be avoided primarily by the country of residence of the company (M. Simonek, *Art. 23 A, B of the OECD Model Tax Convention*, in *Kommentar zum internationalen Steuerrecht* 2 (M. Zweifel et al. eds, Helbing Lichtenhahn Verlag 2015); Oesterhelt & Schreiber, *supra* n. 96, at 64).

[125] 'ausländische Zweigniederlassung'/'succursale étrangère'.



According to the Swiss tax allocation rules described above, RCo is subject to taxation in Switzerland for SwissFin's profits. These profits will depend on: (1) the transactions with GroupCo, (2) corresponding dealings with the headquarters of RCo in State R, and (3) its proper costs incurred in Switzerland.

The basis for Swiss taxation will be the financials of SwissFin established according to Swiss commercial law (accounting) rules. In particular, the primary components of the balance sheet of SwissFin on the 'liability' side will consist of loans payable to RCo whereas, on the 'assets' side, the balance sheet will consist of loans receivable. In terms of the profit/loss account, the main components on the income side will consists of interest income from granting loans to group companies and service fees for rendering services. On the expense side, in addition to the actual expenses of the PE (such as personnel costs, rent, other administrative expenses, etc.), internal dealings could be recognized. The internal dealing relates to provision of loans from the head office to the PE and corresponding notional interest payments.

To be more specific, a direct profit allocation method will apply taking into account 'transactions' and 'dealings' alike. For both, a separate entity approach with an at arm's length requirement is applied. In particular:

- The granting of the loans to GroupCo must be remunerated with a minimum interest rate according to the Swiss Federal Tax Administration Circular Letters providing safe harbour interest rates for loans to and from related parties;[126]
- Domestic practice based on unilateral law will allow internal interest payments to RCo for the internal 'loans' insofar as they correspond to the interest income from external loans. The interest payments to RCo may not exceed a maximum interest rate according to the SFTA Circular Letters providing safe harbour interest rates for loans to and from related parties;[127]
- A minimum equity based on the Swiss thin capitalization rules will be taxed with Swiss capital tax;[128]
- The finance-related management and administration services to GroupCo must be remunerated at an arm's length price to be determined according to the OECD TP Guidelines;[129]
- If the PE receives certain services from its head office (another internal dealing), then their price must be determined according to the OECD TP Guidelines. A cost plus amount could possibly be accepted as an expense of the PE insofar as it is related to the business and the external transactions of the PE.[130]

Notes

[126] *See* Swiss Federal Tax Administration (SFTA), *Circular Letter Steuerlich anerkannte Zinssätze 2021 für Vorschüsse oder Darlehen in Schweizer Franken* (28 Jan. 2021), and SFTA, *Circular Letter Steuerlich anerkannte Zinssätze 2021 für Vorschüsse oder Darlehen in Fremdwährungen* (29 Jan. 2021).

[127] *See ibid.* In some scenarios, if the rates based on the arm´s length principle are higher, then this rate could possibly be taken into account; while the charging of interest is usually not allowed for the capital account for the books of the PE, in this particular case, it is allowed to charge interest as SwissFin is a financial branch (*see* Locher, Marantelli & Opel, *supra* n. 32, at 396 s. with further references).

[128] *See* SFTA, *Circular no. 6 Verdecktes Eigenkapital, minimum (hidden) equity for cash 0%, for loans 15%* (6 June 1997). Circular no. 6 provides a safe haven list of maximum amounts of debt per type of asset. The limits established in Circular no. 6 should be applied on the book value with a possibility for the taxpayer to apply them on the market value if the latter is higher than the book value of its assets. Circular no. 6 allows the taxpayer to demonstrate that financing exceeding the maximum amounts provided is at arm's length. For more details, *see* Burkhalter-Martinez, *supra* n. 45, at 356.

[129] *See* Locher, Marantelli & Opel, *supra* n. 32, at 393 s. regarding the permissibility to charge for specific services.

[130] *See* Locher, Marantelli & Opel, *supra* n. 32.

3.4 *Interaction of International and Domestic Profit Allocation*

In the case of an international enterprise with several PEs in Switzerland (or, as the case may be, with its head office and several PEs in Switzerland), different methods of profit allocation may be applied to determine (1) the taxable profit in Switzerland and (2) the taxable profit per Swiss location.

An illustrative example for this interaction is the profit allocation for Switzerland-based banks for which the Swiss tax conference has issued a circular letter.[131] There are different divisions such as private banking, retail banking, asset management, and investments banking that are contrasted by specialized units at the head office or at local service centres. Therefore, the establishment of PE accounting for the purpose of a national tax allocation would require a very significant level of administrative effort and a need for continuous change. Hence, many banks in Switzerland do not even establish accounts for each Swiss PE.

The standard of the Swiss tax conference details the two steps (1) and (2) of the profit allocation as follows[132]:

- First, in order to determine the taxable net profit in Switzerland, the overall profit is reduced by those of the foreign PEs based on the PE accounting (direct method);
- Second, the taxable profit remaining in Switzerland is allocated to the headquarters and the PEs:
  - Participation income is directly allocated to the headquarters;
  - Real estate income and capital gains from real estate investments are directly appropriated to the location of the real estate;
  - The remaining business profit is apportioned to the domestic PEs based on the indirect/quota-based method applying appropriate auxiliary factors. In practice, for most banks, the allocation is based on the gross salary costs per location.

This example illustrates that the Swiss profit allocation rules are very versatile and thus adaptable to individual cases.

4 Summary and conclusion

Switzerland has a lean but stable framework of domestic rules for the international allocation of profits to a company with cross-border activities. It once relied on the rules of the intercantonal allocation of profits in domestic cases. Such rules provided for an apportionment method based upon various formulae. However, the Swiss practice has developed considerably and is increasingly oriented towards international standards.

While the Swiss court practice has, in principle, adopted the OECD TP Guidelines as an interpretation basis for the ALP since their first version in the 1990s, the latest decisions by cantonal appeal bodies and the Swiss Federal Supreme Court show a substantiated discussion of the Swiss law in light of the latest international standards. Not only are they applied in international tax treaty cases in which Switzerland has implemented Article 7 and Article 9 OECD MC in its tax treaties practice but also – in particular the functional analysis approach – in domestic cases and international settings without applicable tax treaties.[133]

In summary:

- For transactions between **separate legal entities of the same group**, the arm's length standard according to domestic law, Article 9 OECD MC and the OECD TP Guidelines is thoroughly applied in domestic and international cases. If transactions are not effected at arm's length, there will be a profit correction involving what is known as a hidden profit distribution based on Article 58(1)(b) DBG.
- For the profit allocation between a **Swiss headquarters with foreign PEs**, Swiss law follows a strict territorial principle – if the substance threshold for a PE is satisfied, profits from foreign PEs are exempt from Swiss taxation regardless of their effective taxation abroad (Article 52(1) DBG).[134] As one of the remaining core principles of the intercantonal profit allocation rules to which the law refers, the worldwide income of the company must be the basis for any subsequent allocation of profit. Preference is given to a proportionate allocation method directly based on the accounts of the headquarters and the PEs. Under certain conditions, losses incurred by the foreign PEs may be taken over by the Swiss headquarters. Dealings between the Swiss headquarters and the foreign PEs may be recognized in certain circumstances and will be assessed based on the AOA and a realization fiction for tax purposes. Any corrections for tax purposes will be based on the general rules of Article 52 and Article 58 DBG (ongoing transactions) or Article 61b DBG (one-time transactions).

Notes

[131] SSK, *Circular Letter no. 5 Dated 14 November 2018 Regarding the Profit Allocation of Banks* (2018), available in German, French and Italian at, www.steuerkonferenz.ch/?Dokumente:Kreisschreiben (accessed 30 Sept. 2021).

[132] *Ibid.*, at no. 2 ss.

[133] The practice is thus confirming the position of some Swiss authors: Stocker, *supra n. 38,* at 210; Duss, *supra* n. 12, at 110; Brülisauer & Mühlemann, *supra* n. 12.

[134] *See* CH: Supreme Court 2C_498/2014 dated 29 Apr. 2014, cons. 4.2 considering that there is no international standard to avoid double non-taxation and for a more nuanced approach CH: Federal Supreme Court BGE 139 II 78, cons. 3.2.2.

– In the case of **non-resident companies with a Swiss PE**, the profit allocation is directly based on the accounts of the Swiss PE (Article 52(4) DBG). Dealings with the headquarters or other PEs of the same entity are, in principle, accepted if properly recorded in the PE's P&L. Their pricing needs to adhere to the AOA.

Proceeding forward, the OECD standards and the ongoing international developments will continue to play a crucial role in Swiss international tax practice. To obtain legal certainty, it is advisable to consult with the tax administration in advance (through an advance ruling procedure) about the methodology of profit allocation and documentation requirements in complex international cases. One such case could represent a situation wherein a Swiss principal operates with a sales and/or marketing services entity overseas. It could well be possible that the overseas jurisdiction classifies the local entity as a dependant agent (DA) and argues that a dependant agent PE (DAPE) is effectuated for the Swiss principal (even for treaties based on the OECD Model versions before the BEPS Project). Examples are the approach adopted by the Spanish Supreme Court in the *Roche* and *Dell* cases[135] and the French Supreme Court in the recent *Conversant/Value Click* case.[136] In such cases, depending on the status of tax proceedings, the use of bilateral dispute prevention/resolution mechanisms could also be considered.[137]

In conclusion, the Swiss domestic methods interplay with the changing international standards and continue to evolve. While Swiss domestic law and practice is increasingly integrating international standards, in particular a direct profit allocation in international PE settings, the indirect domestic profit allocation methods based on auxiliary factors may return to the spotlight (in the near future) with the latest developments surrounding the digitalization of the economy. This is because measures beyond the arm´s length principle are currently being contemplated in a Pillar I context. However, at the same time, it should be noted that the AOA could become a global standard for determining the profits allocable to a PE due to the rules for the determination of the Effective Tax Rate (ETR) of each constituent entity under the Pillar II project.

Notes

[135] On this matter, *also see* A. M. Jiménez, *The Spanish Position on the Concept of a Permanent Establishment: Anticipating BEPS, beyond BEPS or Simply a Wrong Interpretation of Article 5 of the OECD Model?*, 70(8) Bull. Int'l Tax'n 461–467 (2016). In the Roche case, the provisions of the Swiss-Spanish tax treaty were discussed.

[136] For an overview of this case, *see* H. Levit & N. Duboille, *Conseil d'Etat Recharacterises the Existence of a PE in the Digital Economy*, ITR (2 Feb. 2021), www.internationaltaxreview.com/article/b1qd2yxxchxjym/conseil-detat-recharacterises-the-existence-of-a-pe-in-the-digital-economy (accessed 30 Sept. 2021).

[137] Taking a step back in time, in order to avoid disputes in this area, MNEs can transform their business settings from sales and marketing structures to buy-sell structures. In fact, many MNEs have already implemented this structure.