Tax News

April 2006

Dear Reader

Welcome to this edition of Tax News, in which you will find details of the latest national and international tax developments.

The choice of location is an important factor as far as tax is concerned. In February 2006, the Federal Department of Finance published a report on the international attractiveness of Switzerland as a business location from a tax standpoint, which went largely unnoticed by the public[1]. The report shows that international tax competition has intensified recently and Switzerland's traditional leading role has taken a bit of a hit. Ireland, Luxembourg and the new EU member states from Eastern Europe, in particular, have drawn level with Switzerland or even overtaken it (see Figure 1). The report looks at the tax burden on businesses, shareholders and employees. It is clear that a number of Swiss cantons are still in a strong position. In order to eliminate current weaknesses in the Swiss fiscal system compared with other countries, however, the Federal Department of Finance report puts forward a set of measures and assumes that Corporate Tax Reform II will be implemented ahead of time in order to achieve further improvements in corporate taxation in due course. It remains to be seen whether the rhetoric will result in concrete action.

On behalf of Ernst & Young, we hope that you find this edition of Tax News – and the latest expert knowledge that it brings together – of benefit. For further information on any of the topics covered in these articles or for a consultation, please contact one of our tax specialists.

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Table of contents

1 Editorial
2 Recent US tax developments
4 Tax reforms in Germany
5 Dynamic development of double taxation treaties (DTTs)
6 Off-shore questionnaire
7 Newly proposed transfer pricing regulation in Spain
8 Corporate tax reform II
10 Federal Stamp Duty Act (StG): simplified with effect from 1.1.2006, but not simpler
12 Frequent findings from tax due diligence reviews
13 Switzerland set to extend federal law on tax holidays
14 New national salary statement for Switzerland
15 Taxation of trusts in Switzerland, any news?
16 Announced changes to the VAT regime – a radical overhaul, cutting of red tape or simply tinkering with the existing system?

Comparative attractiveness of Switzerland as a business location from a tax standpoint

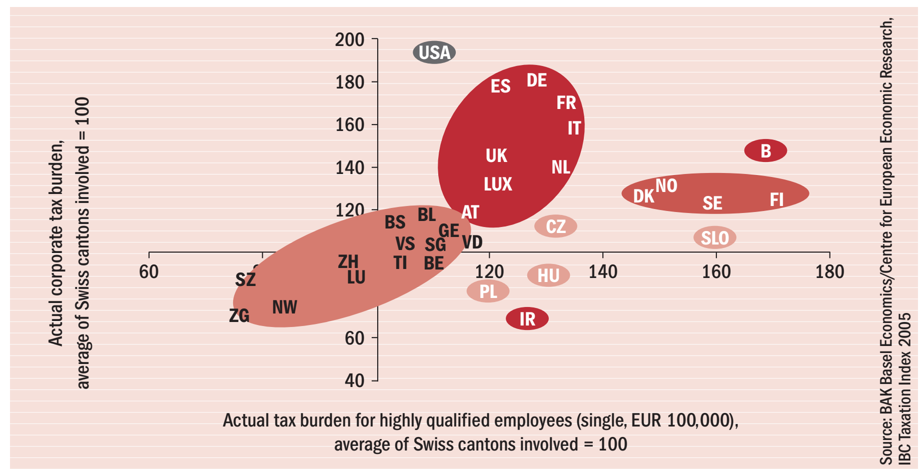

Figure 1: If one considers the tax burden on both businesses (vertical axis) and employees (horizontal axis), then a large number of Swiss cantons – with low rates of taxation – appear in the bottom left of the diagram, indicating that they represent an attractive business location by European standards[1].

www.ey.com/ch/tax

[1] Compare Report by the Federal Department of Finance on the International Attractiveness of Switzerland as a Location from a Taxation Point of View, February 1, 2006. http://www.efd.admin.ch/dokumentation/zahlen/00578/00878

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Recent US tax developments

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1. Protection for non-US corporations filing late US tax returns

In late January in a case before the US Tax Court, the court invalidated an IRS regulation that precluded foreign corporations from claiming deductions against gross income if the US tax return was not filed within a prescribed period (Swallows Holdings, Ltd.). The effect was to tax gross income earned by foreign corporations which was effectively connected with a US trade or business at normal graduated corporation income tax rates of up to 35%. The regulation in question had been issued in 1990 and had generally provided for an 18-month window in which the affected corporation had to file the US branch tax return. The IRS had claimed that the underlying statute which the regulation was interpreting had a «clear» time requirement. This was in contradiction of case law going back to 1938 that held that predecessor statutes to the relevant statute did not include a timely filing requirement. The court concluded that the timely filing requirement in the regulation was not in harmony with the plain language, origin, or purpose of the relevant statute. Further, it was unreasonable for the IRS and US Treasury to attempt to circumvent longstanding judicial decisions that had decided the issue decades before.

The case is good news for those foreign corporations who determine they should have filed a US return, even as a protective measure, after the regulation prescribed due date. Two caveats: first, the IRS is likely to appeal the case. And second, the court upheld the regulation to the extent the IRS prepares a substitute return for the foreign taxpayer before the foreign taxpayer submits a return outside the 18-month period.

2. WTO Appellate Panel rules against the US in FSC/ETI dispute

In a proceeding sure to inflame trade tensions between the US and the EU, a WTO Appellate Body concluded in February 2006 that the transition and grandfathering rules provided for in the 2004 US tax legislation to repeal the US FSC export incentive regime and the ETI regime which replaced the FSC rules violate trade rules. The Appellate Body's ruling had affirmed a similar ruling by a WTO panel in July 2005.

The result is that the Appellate Body report will be adopted in 30 days, after which the US has 60 days to bring the relevant legislation into compliance with the WTO findings. The EU has indicated it will resume sanctions beginning May 14.

Already, certain US Senators have indicated they doubt Congress would revisit the issue. The two-year transition period ends at the end of 2006 and the grandfathering benefits are small. The view within the US is that the FSC/ETI dispute is seen as a tit-for-tat payback by the EU because of US accusations of unfair EU subsidies for Airbus.

3. US tax treaty developments

The US Senate Foreign Relations Committee held hearings in February on several pending US tax treaties. Of particular note was the discussion of the US-Sweden treaty. This noncontroversial protocol to the existing US-Sweden treaty provides for a 0% withholding tax rate on dividends from an 80% owned subsidiary to its parent shareholder, after a one-year holding period (among other requirements). This treaty continues a recent trend among certain US tax treaties to eliminate withholding taxes on parent-subsidiary dividends. Currently, only a few of the US tax treaties have this

provision in lieu of the more common 5% parent-subsidiary dividend withholding tax.

Of particular interest were comments by Treasury officials that the US would continue to make a priority of updating the few remaining US tax treaties which do not have a comprehensive limitation of benefits (LOB) article (such as Hungary, Iceland, Norway, Poland, among others). Further, it was indicated that treaty negotiations were continuing with several countries including Canada, Hungary, Iceland, Korea, Norway, and that new tax agreements were substantially complete with Denmark and Finland. (No mention was made of the old-style treaty with Poland but IRS officials have made comments elsewhere that negotiations with Poland «are just starting up».) As concerns the above-mentioned trend toward eliminating withholding taxes on parent-subsidiary dividends, a new upcoming draft of a US model treaty will not provide for zero dividend withholding taxes on intercompany dividends. Also, the «primarily traded» test added to the publicly traded test in the LOB article for the above-mentioned US-Sweden revised treaty was intended to function like the «substantial presence» test in the amended Dutch treaty and may be a feature of all US treaties going forward.

The US-Sweden protocol, along with a new US-Bangladesh treaty and two protocols to the US-France Income and Estate Treaty are expected to receive assent from the full Senate later this year, possibly as soon as this spring.

4. Proposed legislation tightening Sec. 163(j) Earnings Stripping Rules

In early February the Bush administration released its proposed FY 2007 Budget. There were only a handful of international tax-related provisions. Of particular interest was a provision proposing to tighten the Section 163(j) Earnings Stripping Rules. These rules limit the interest expense deductions that may be taken for interest payments to related persons, including interest on debt that is subject to a related party guarantee.

The proposed changes are as follow:

- Eliminate the current 1.5 to 1 debt to equity safe harbor. Under this rule, corporate taxpayers with less than a 1.5 to 1 D:E ratio are exempted from application of the Earnings Stripping Rules.
- Reduce the 50% of adjusted taxable income (ATI) threshold to 25%. Currently, related party paid, or guaranteed debt interest paid (disqualified interest) in excess of 50% of ATI is treated as disqualified interest.
- Limit the indefinite carryforward period for disqualified interest to ten years.
- Eliminate the three year carryforward period for excess limitation.

Similar restrictions on Section 163(j) legislation have been proposed in the past but were not approved by the US Senate. It is unclear how strong support will be for these proposals when the FY 2007 Budget goes through the legislative process. ■

Tax reforms in Germany

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1. Tax reforms for 2006, 2007 and 2008

The German government is currently working on a spate of legal amendments. Important decisions were made in December 2005 and implemented on *January 1, 2006.* These include:

– The abolition of the allowance for owner-occupied property
– The restriction of the loss set-off used by tax-saving schemes (media funds, shipping funds, etc.)
– The partial abolition of the deduction of special expenses for private tax consultancy
– The abolition of declining-balance depreciation for rental property

The comprehensive reform of the German tax system is going forward. The federal cabinet approved a *draft law on the fiscal promotion of growth and employment* at its meeting on January 18, 2006. The legislative procedure is expected to be finalized before the summer recess and the amendments should enter into force retroactively with effect from *January 1, 2006.* The following amendments, among others, are scheduled:

– Increasing the declining deduction for wear and tear on moveable fixed assets purchased or manufactured after December 12, 2005, and before January 1, 2008, to three times the linear depreciation rate, not to exceed 30%
– Tax breaks for child care costs incurred for employment-related or personal reasons
– The extension of the scope of Sec. 35a para. 2 of the German Income Tax Act (EStG) to apply to renovation, maintenance and modernization measures (services by craftsmen) and to the costs of looking after persons in need of care

The federal government also introduced the key elements of the *2006 accompanying budget law,* which will apply from *January 1, 2007:*

– Introduction of a so-called *tax on the wealthy* («Reichensteuer»), i.e., the increase of the top income tax rate by 3%, from 42% to 45%. The increase will not apply to commercial income and will only apply to noncommercial income of more than EUR 250,000 (EUR 500,000 for married couples)
– Increase of *value added tax* and insurance tax from 16% to 19%
– General settlement tax of approx. 20% on private sales transactions, irrespective of the trading period
– Abolition of the kilometer allowance for the first 20 kilometers
– Reduction of the savers' tax-free amount

However, according to the latest reports it is possible that the general settlement tax on private sales transactions will not be implemented until January 1, 2008. Another big task is a law on the tax measures to accompany the introduction of the European Company and the amendment of other tax-related provisions, known in short as the *«SEStEG»*. A preliminary draft bill has been prepared, but some parts are still incomplete or have already been revised. The aim of the law is to bring the tax provisions for company reorganizations into line with current developments and EU law. These include, for example, the regulations for the European Company (SE), the European Cooperative Society (SCE) and the amendment guidelines for the EU merger directive. This law is intended to introduce uniform principles for domestic and cross-border reorganizations. The coming months will show which formulations legislators have chosen for the individual provisions (global vs. European approach). It can already be said today that the transformation tax law as well as parts of the income tax and corporate tax laws will be changed permanently. The amendments are expected to be implemented on *January 1, 2007.*

The federal government also plans to draft the key elements of a comprehensive corporate tax reform by autumn 2006. This reform should enter into force on *January 1, 2008.*

2. ECJ issues decision regarding foreign losses from private rentals

On February 21, 2006, the European Court of Justice issued a decision in the Ritter-Coulais case (C-152/03) finding that the failure to take account of foreign losses of rental income (negative progression) for the purpose of determining the tax rate of married couples who are fully liable for tax in Germany is a violation of EU law. The ECJ found this to be an unjustifiable violation of the principle of the free movement of workers (Art. 39 EC Treaty). Prior to the decision, the trial was seen as important because it concerned the treatment of foreign losses when calculating income, however – in the face of the first point of law referred to by the Federal Finance Court and the final arguments of the advocate general – the ECJ refrained from answering this question, as the plaintiffs in this case only asked the court to decide their tax rate, taking account of foreign losses. ■

Dynamic development of double taxation treaties (DTTs)

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As part of the Bilateral II agreements, Art. 15 of the Savings Agreement between Switzerland and the European Community (EC) entered into force on July 1, 2005. This provision provides for the abolition of withholding tax on cross-border payments of dividends, interest and royalties made between affiliated corporations. At the same time Switzerland concluded a Memorandum of Understanding with the EC and its member states under which it was agreed to include provisions in the various bilateral double taxation agreements (DTTs) regarding the granting of administrative assistance in the form of exchange of information on request in cases of tax fraud and the like. This development more or less started the ball rolling, and led to the renegotiation of the DTTs with various European states: negotiations with Spain, Austria, Finland, Norway and the UK have already been finalized, while the protocols on the revisions to the treaties with the Netherlands, France and Italy are still to be initialed. In addition to the introduction of zero tax rates on payments of dividends, interest and royalties, the revisions focus in particular on the granting of reciprocal administrative assistance in cases of tax fraud and the like as well as in cases that involve holding companies.

DTT Spain

(initialed on April 27, 2005)
The partial revision of the DTT with Spain is very important in light of the proviso contained in Art. 18 para. 3 of the Savings Agreement. Under this article, Art. 15 of the Savings Agreement (zero tax rates) will only enter into force with respect to Spain if a bilateral agreement on the exchange of information upon request in cases of tax fraud and the like has been concluded. Given the delays experienced in connection with the translation of the agreement, the revision protocol is not expected to enter into force before the second half of 2006.

DTT Norway

(in force since December 20, 2005)
The federal parliament approved the protocol on the revision to the DTT with Norway, and the revised DTT entered into force on December 20, 2005. Corporations holding at least 20% (new) of qualified share capital in the company paying the dividends can benefit from the exclusive right to impose taxes on dividends in the country of residence (zero rate) with effect from January 1, 2005. Norway has also amended the method for eliminating double taxation and now applies the tax credit method instead of the exemption method. Finally, expanded administrative assistance is one of the new elements introduced by the partial revision.

DTT Austria

(initialed on April 28, 2005)
The special provision applying to cross-border commuters was deleted with the revision of the DTT with Austria. In the future, income from employment can be taxed in full at the place of work. In return, Switzerland will make offset payments to Austria amounting to 12,5% of the tax revenue earned with respect to commuters resident in Austria. Other revisions include the introduction of zero tax rates for interest and royalty payments and expanded administrative and judicial assistance. Austria introduced a new tax relief ordinance on July 1, 2005, that has the same purpose as the Swiss reporting procedure (option of tax relief at source).

DTT United Kingdom

(initialed on January 18, 2006)
The most significant proposed amendments include full relief from withholding tax on dividend payments if a corporation holds at least 10% of the share capital of the company paying the dividends as well as expanded administrative assistance (comparable to the new provisions included in the DTAs with Spain and Norway). The revision protocol also contains measures pertaining to the taxation of pensions and the tax deductibility of social security and pension fund contributions.

Ongoing negotiations with the Netherlands, France and Italy

The DTT with the Netherlands from 1951 should be modernized and brought into line with the OECD model agreement. Negotiations should be finalized this coming summer. Negotiations with France center on the abolition of the provision regarding abusive practices in Art. 14 of the current DTT. The negotiations with Italy focus on the exchange of information and the «black list». ■

Off-shore questionnaire

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In the past many Swiss groups took advantage of the attractive tax regimes that are provided by some offshore locations. Thus numerous groups have one or more companies in off-shore locations like the Channel Islands, BVI, the Cayman Islands etc. acting as finance companies, intellectual property companies and the like. However, such structures are increasingly scrutinized by the Swiss tax authorities.

In this connection the Swiss Federal Tax Administration (SFTA) recently sent a questionnaire to a number of companies regarding their off-shore structures. This questionnaire gives an insight of the aspects that are examined by the SFTA. It results in a thorough check-up of the off-shore structure.

The issues at hand are:

– the effective place of management of the off-shore company respectively the place of supply of services
– tax avoidance
– transfer pricing

Companies whose substance at the off-shore location is deemed to be insufficient and are effectively managed out of Switzerland may be considered Swiss tax residents for corporate income tax purposes (see EY Tax News, edition of March/April 2005). Services provided by Swiss companies to such off-shore companies are deemed as being provided to their Swiss parent companies, falling within the scope of Swiss VAT. Likewise services provided by the off-shore companies with insufficient substance may also be subject to VAT (see EY Tax News, edition of June 2004). Furthermore, such companies may be subject to Swiss withholding tax for dividend payments, interest payments on bonds, etc.

Should the effective place of management at the off-shore location be accepted, conducting the business over the off-shore company might still be considered as a tax avoidance scheme. This could for instance be the case, if an off-shore finance company provides financing to Swiss group companies. In case of tax avoidance the profit of the off-shore company would be allocated to the Swiss parent company and taxed in Switzerland. In case the off-shore company issued bonds, the current practice would treat these bonds like Swiss-issued bonds subject to Swiss stamp duties and withholding tax, if the bonds are guaranteed by a Swiss company and the funds are used to finance Swiss group companies.

Still even in case the off-shore company has enough substance and the use of the off-shore structure is based on sound business reasons the profit realized off-shore could be questioned for transfer pricing reasons.

Being aware of the above, the question arises what a group with an off-shore structure can do to manage the tax risks inherent to such structures. Based on the questionnaire of the SFTA Ernst & Young designed a health check for off-shore structures. Such a health check will include a thorough analysis of the current structure, an assessment of the Swiss tax risks involved, and a recommendation of concrete measures in order to reduce the risks. ■

Newly proposed transfer pricing regulation in Spain

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On December 30, 2005, the Spanish government issued a draft legislative proposal that would, if enacted, significantly reform the transfer pricing legislation of the country. If approved, these new rules will be written as law and made effective as of the financial year beginning January 1, 2007.

The draft is proposing to introduce, amongst other things, the obligation of taxpayers to prepare transfer pricing documentation that supports the arm's length price for affiliated transactions. If accepted, Spain would be the first country within the EU to adopt the EC Code of Conduct on transfer pricing documentation. The basis of the EC code is the concept of a single master file approach that allows taxpayers to avoid documentation-related penalty if they comply in good faith and within reasonable manner and time. It is imperative to note that the proposed draft does not differentiate transactions that occur internally between two Spanish affiliates and those between a Spanish entity and a foreign affiliate. In short, transactions occurring between two Spanish affiliates will also need to be documented.

Under the current legislation, the burden of proof lies with the tax authorities, and this is made more onerous by the fact that taxpayers are under no obligation to prepare documentation and there are no penalties in Spain for transfer pricing adjustments. The draft proposes that the burden of proof be shifted partly to the taxpayers, which also grants the tax authorities the power to impose penalties of up to 150% of an adjustment. The draft also states that it is not necessary for taxpayers to have documentation for all transactions. Taxpayers only need to have documentation prepared for transactions that are of importance in nature.

The proposed draft talks about updating the current rule of acceptable transfer pricing methods, i.e., traditional methods like CUP, cost-plus or resale minus are no longer applied on a «hierarchical» basis, instead on a «best method» rule. In the case where none of the traditional methods can be used, the application of TNMM or profit split methods may be applied. However, the proposed draft also suggests that in order to apply CUP, cost-plus, resale minus or TNMM, it is vital that there is comparability. In the absence of close comparability, taxpayers should consider the possibility of either accounting or capital adjustments.

There is a section within the proposed draft on secondary adjustments that will allow retroactive application of those terms in advance pricing agreements of prior years.

The proposed regulation also touched the topic on service fees. It states that the extent of deductions for expenses relating to services provided would now be dependent on how much economic benefit taxpayers have gained from receiving such services. The taxpayers will have the task of proving that to the tax authorities. With respect to cost-sharing arrangements, the proposed draft now extends its scope to all areas of cost-sharing contracts and not limiting it to only research and development projects. When there is a change in circumstances or participants, then the arrangement must be modified accordingly – «buy-in» concept.

Given all the points mentioned above, it is highly anticipated that the number of APAs will rise with time. That being the case, the proposed draft includes a clause which states that the APA period be increased from three to four years. A roll-back scheme is also allowed so long as the deadline for submitting the tax return has not elapsed. ■

Corporate tax reform II

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Introduction

At the end of June 2005, the Federal Council approved the draft law and its Message concerning the second corporate tax reform. Among others, the reform will introduce the following significant amendments (cf. Tax News, September 2005):

- Easing of the economic burden constituted by double taxation of dividend distributions
- Legal provisions regarding indirect partial liquidation
- Legal provisions regarding transfers of assets
- Legal provisions regarding commercial securities trading
- Crediting of income tax to capital tax
- Relief regarding the deduction of shareholdings
- Abolition of job creation reserves

The draft law was then submitted for preliminary review to the Council of States Committee for Economic Affairs and Taxation (WAK-S), which discussed the individual chapters during its 2005 winter session. The following is a brief commentary of the individual decisions and the results arising from these discussions.

Legal provisions regarding indirect partial liquidation

In view of the scale and complexity of the corporate tax reform, the Committee came to the conclusion that the draft law cannot be discussed in totality during parliament's 2006 spring session. However, in light of the business community's uncertainties about the application of indirect partial liquidation and transfers of assets, these two areas are in urgent need of regulation. The Committee has therefore separated the issues of indirect partial liquidation and transfers of assets from the rest of the draft law, and these topics will be discussed separately in the 2006 spring session.

Indirect partial liquidation

In accordance with the rulings of the Federal Supreme Court, an indirect partial liquidation is deemed to have taken place if all of the following criteria have been met:

- Participation rights subject to the nominal value principle (private assets) are sold to a person who is subject to the book value principle (business assets).
- The acquired company suffers the withdrawal of funds or asset erosion.
- The funds withdrawn from the company are used to finance the purchase price.
- The buyer initiates the withdrawal of the company funds in the knowledge that the funds will not be returned to the company.

The time at which the assets are withdrawn from the company is immaterial. The cantons often apply a blocking period of five years, but the Federal Supreme Court does not allow this principle to be applied to direct federal taxes.

The Message of the Federal Council contains a «replacement dividend» proposal, according to which capital gains on the sale of a significant shareholding of at least 20% held as part of a taxpayer's private assets to a buyer who is not subject to the nominal value principle will be subject to income tax to the extent that the sold company holds distributable assets that are not required for operational reasons.

The Committee does not agree with this concept and proposes the taxation of the actual distribution of funds not required for operational reasons within five years of the sale. In the debate of March 14, 2006, the majority of the Council of States consented this model.

Transfers of assets

As far as the provisions on transfers of assets (sale of participation rights to a company controlled by the seller) are concerned, the Committee mostly endorsed the proposals of the Federal Council. According to these, the proceeds from a transfer of participation rights from a private portfolio to the assets of a business is taxed as a transfer of assets if, after the transfer, the seller owns at least 50% of the company purchasing the rights. However, the Committee formulates the proposal of the Federal Council more precisely by proposing that proceeds should only be taxed if the sale involves at least 5% of the share capital of a limited company or cooperative.

Legal provisions regarding commercial securities trading

According to the practice of the Federal Supreme Court, quasi securities trading is also taxed within the sphere of private wealth if it goes beyond what can be considered mere asset management. Under the reform proposed by the Federal Council, this principle will continue to apply, but the current uncertainties about the criteria should be removed by clearly defined and identifiable conditions.

The opinion of the Committee for Economic Affairs and Taxation differs from this, and the Committee proposes the following amendment to the draft law:

«Gains on the sale of securities and other financial investments that do not form part of the business assets which are functionally related to the business operated by the taxpayer do not represent income from self-employment.» (New Art. 18 par. 2 bis of the Federal Law on Direct Federal Taxation and new Art. 8 par. 2 of the Federal Law on Tax Harmonization.) The Committee therefore

believes that capital gains on movable private assets should not be taxed.

Replacement of the nominal value principle by the contribution of capital principle

Currently, the Confederation and most cantons tax private assets under the nominal value principle. According to this principle, only share capital can be repaid without incurring any tax liability. However, the owner of the participation rights is liable for tax on the repayment or distribution of reserves and gains by a limited company or a cooperative.

In this regard, the WAK-S champions the introduction of the contribution of capital principle proposed under the reform. In future, the premium paid directly by the owner of the participation rights should be treated in the same way as the repayment of share capital, thus going directly to domestic and foreign shareholders without any tax liability.

Economic double taxation

Economic double taxation refers to the fact that the earnings of a limited company or cooperative are taxed twice when a dividend is paid out – once at the level of the corporation (corporate income tax) and once at the level of the owner of the participation rights (private income tax).

According to the proposal by the Federal Council, holders of participation rights that constitute part of their personal wealth must in future pay tax only on 80% of the resulting income instead of on 100%. Capital gains should continue to be tax-exempt. Income from participations held as part of the business assets (including capital gains) should be taxed at 60%. Here, the Committee in principle endorsed the proposal of the Federal Council.

Summary

Given the current uncertainties in the business community, it is a good thing that the issues of indirect partial liquidation and transfers of assets were separated from the rest of the draft law and will be discussed during the 2006 spring session. We await the results and their implementation with great interest.

As far as the rest of the reforms are concerned, it is too early to say when initial results can be expected. ■

Federal Stamp Duty Act (StG): simplified with effect from 1.1.2006, but not simpler

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The amendments to the Stamp Duty Act that took effect on January 1, 2006, relate to the amount that is exempt from the new issues tax and the qualification as securities trader for the purposes of turnover tax.

The legislator did not comply with the demand to abolish stamp duty and in particular turnover tax.

In the year 2004 alone the Confederation earned approximately CHF 2.7 billion in stamp duties, and the budget for 2005 made projections for stamp duty revenues of as much as CHF 3.3 billion. The income from stamp duty therefore exceeds even the income from withholding tax, budgeted at just over CHF 3 billion. While amendments to the new issues tax are welcomed and will provide relief in particular to small and medium-sized enterprises, the amendments to the turnover tax have produced a complex system of rules and exceptions. We therefore cannot speak of a simplification of the turnover tax system, and it is clear that certain forms of relief – as politically intended – will only be granted to parties that can otherwise avoid turnover tax.

Amendments to new issues tax

One of the most important amendments regarding the new issues tax: where a company is incorporated or share capital increased, the tax-exempt amount – often inaccurately called the «free quota» – has been substantially increased from CHF 250,000 to CHF 1 million when shares in public limited companies, limited stock partnerships and limited liability companies are issued against payment. This is likely to provide administrative and financial relief to small and medium-sized companies in particular as well as promoting corporate restructuring.

Amendments to the turnover tax

The amendments to turnover tax affect tax-liable securities traders based in Switzerland and investors as well as transactions that are generally exempt from turnover tax.

Confederation, cantons and municipalities

In addition to banks, traditional brokers and intermediaries, the following entities can also become securities traders as defined by the stamp duty act: limited companies with taxable securities on their balance sheets in excess of CHF 10 million, as well as the Confederation, the cantons and the political municipalities and their institutions. If an entity qualifies as a tax-liable securities trader, a turnover register of all taxable transactions must be kept and a statement on the turnover tax due must be filed with the Federal Tax Administration. In transactions with domestic banks or brokers, these limited companies, the Confederation, cantons and municipalities can delegate their tax liability to the domestic bank or broker. However, this cannot be done if a foreign bank or broker is used to buy or sell securities. In such cases the limited company or public-sector entity is required to deliver turnover tax for itself and for its counterparty (unless the latter qualifies as a securities trader or a tax-exempt investor).

This has been changed with effect from January 1, 2006: like limited companies, the Confederation, cantons and political municipalities and their institutions will only qual-

ify as securities traders if they have taxable securities on their balance sheets in excess of CHF 10 million. As a result, the number of securities traders among public-sector entities will likely decrease significantly, which will bring administrative relief for many municipalities. At the same time the number of securities traders will fall, as the AHV compensation offices and unemployment offices will no longer be deemed to be domestic securities traders. These entities will then no longer have to pay turnover tax on purchases and sales of taxable securities. All they need to do is to mandate a foreign bank or broker to carry out the transaction.

Foreign companies

On the other hand, the intention is to give foreign companies an incentive to use domestic banks and brokers for securities transactions. To this end the group of investors exempt from turnover tax has been expanded: foreign companies, whose shares are listed on registered domestic or foreign stock exchanges (including their foreign group companies), can now mandate a foreign bank or broker to carry out a securities transaction without being charged turnover tax.

Trade with foreign banks or brokers

To date, only trades in foreign securities via foreign banks/brokers were exempt from turnover tax («foreign bank/broker exemption»). Since January 1, 2006, this exemption also applies to trades in domestic securities, provided that the counterparty of the Swiss securities trader is a foreign bank or a foreign broker. As a result, the preconditions for what is known as a «triangle transaction» also ceased to apply. A triangle transaction is assumed when a foreign bank or a foreign broker claims to trade in domestic securities for a «tax-exempt» investor. This transaction – which in principle would be subject to turnover tax – had been exempt from turnover tax under one condition only: if the foreign bank or foreign broker was prepared to disclose the identity of its (tax-exempt) client to the Federal Tax Administration. Since January 1, 2006, this disclosure is no longer required, as all securities transactions between a Swiss securities trader and a foreign bank/foreign broker are exempt from the payment of turnover tax payable for the foreign party. ■

News regarding stamp duties

As of January 1, 2006, a number of changes to the legislation governing stamp duty came into effect. As far as stamp duty on the issue of securities is concerned, the tax allowance for company start-ups/capital increases has been raised to CHF 1 million. With regard to stamp duty on the transfer of securities, the changes relate to the qualification of Swiss residents as securities dealers and general exemption from this duty for certain transactions and investors. (For further details, see: «Insight – for Executives in Financial Services», Winter 2005/2006).
The article is downloadable at:
http://www2.eycom.ch/library/items/2006_insight_stempelabgaben/en.pdf

Frequent findings from tax due diligence reviews

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To protect themselves against unpleasant surprises when buying a company, the acquirers will often carry out a due diligence review in advance. Due diligence reviews are generally not just confined to tax aspects but also include other areas such as the company's financial and legal situation, etc.

The intention and purpose of a tax due diligence review are to analyze past tax risks and identify future tax risks and tax optimization possibilities. A due diligence review will also supply acquirers with important information to help them structure the planned acquisition.

As a result of our many years of experience in due diligence, we have identified certain risk groups that typically need to be analyzed as part of a due diligence review and – as experience has shown – often entail specific risks, the main risks being intragroup services (transfer pricing) and VAT.

When acquiring a group or spinning off individual group companies, intragroup relationships such as transfer prices, management and license fees, hidden profit distributions and capital contributions may constitute possible tax risks. While a due diligence review can usually identify these risks and sketch out certain solutions, more detailed studies are required if the solutions suggested are to be implemented in individual cases – especially in the area of transfer pricing.

With regard to VAT, there are often tax risks for potential buyers in connection with group taxation, real estate, input tax reduction and the import/export of goods and especially services. In addition, it is important to check the sales reconciliation and the formal requirements for invoicing. Our experience shows that VAT often entails the greatest risks at the moment. This is mainly also due to the fact that VAT is calculated on the basis of sales revenue where often considerable sums are involved.

Furthermore, checks are generally performed to test whether tax provisions are sufficient to cover all owed and as yet unpaid taxes. Particularly with real estate companies and companies that prepare their accounts on the basis of IFRS or US GAAP, checks must also be performed to ascertain whether deferred taxes have been calculated using appropriate methodology and measured correctly. Intragroup restructuring measures also need to be examined to check whether they might contain possible restrictions for future buyers (e.g. blocking periods). Restrictions may also arise if the seller is a natural person who holds his or her equities as private assets (indirect partial liquidation).

The extent of a due diligence review is dependent on the type of transaction, the time available and not least on the acquirer's financial exposure. With regard to the type of transaction, the key question is whether what is being acquired are assets and liabilities or shares. The extent of a due diligence review can also be dependent on the buyer or seller. In the case of a seller listed on the stock market, for instance, the disclosure of information is partially restricted.

It is often the case that buyers wish to ensure the following procedure. Initially, the available documents are simply examined for the existence of the risks already mentioned as well as any other risks (so-called red flag due diligence). If the negotiations continue, attempts are then made not only to identify the possible risks but also to quantify their influence on the purchase price or the exchange ratio (so-called confirmatory due diligence).

It may not be possible to definitively evaluate many of the named risks solely on the basis of an examination of the available documentation. Being able to speak to the company's tax representative is therefore essential if the due diligence is to be meaningful. It is only after having talked to the tax specialist that an experienced consultant can paint a detailed picture of the company's tax situation. However, it is nevertheless very difficult to quantify these risks exactly due to the lack of information or the difficulty in estimating the likelihood of their occurring.

Due diligence can either result in the purchase price being adjusted or warranty clauses being added to the sales contract. However, hedging risk by means of contractual clauses is only to be recommended with financially strong sellers. When selling a company on the stock market or as part of an insolvent group, hedging by means of contractual clauses is not possible or advisable. With tax warranty clauses, particular attention must be paid to ensuring that the terms and amounts involved are adjusted appropriately and to taking account of the very long limitation periods – particularly with VAT. ■

Switzerland set to extend federal law on tax holidays – urgent action may be needed

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On March 7, 2006, the Swiss Council of States unanimously accepted the extension of the federal law granting tax holidays to newly established businesses. This is very encouraging for multinationals intending to establish headquarters and principal companies in Switzerland. It should be noted, however, that this extension must still be approved by the Swiss National Council this summer. A possible reconsideration of qualifying geographical areas must also be undertaken.

1. Federal tax holidays

For some years, tax relief has been granted to new businesses as an incentive for investments in Switzerland. While nearly all cantons encourage the establishment of new industries within their territories by granting partial or complete exemption from cantonal and communal taxes for a limited period of time, relief from Swiss federal tax may also be granted to qualifying companies in certain predetermined geographical areas.

New businesses must be in the interest of the economy in order to qualify for relief from federal corporate income tax. This depends on the determination of the competent authorities. The following criteria are, inter alia, taken into consideration:

- Location (municipality)
- Headcount
- Activity
- Investments
- Ratio between tax relief and impact on the local economy
- Availability of a cantonal and communal tax holiday

Tax relief includes exemptions from income taxes for periods of up to ten years after inception of business. The amount of relief depends on the above-mentioned criteria. With the right profile and negotiation leverage, multinational companies establishing themselves in Switzerland can expect up to ten years without paying any corporate income tax.

2. Changes to Swiss legislation

Federal tax holidays are currently granted on the basis of the so-called «Bonny Law», which legally expires on June 30, 2006. The intention is for the Bonny Law to be replaced by a «New Regional Policy», which grants similar relief, but which would only enter into force on January 1, 2008.

In order to bridge the gap between July 1, 2006, and the entry into force of the new law, the Swiss Council of States has accepted to extend the Bonny Law until December 31, 2008. This is still to be approved by the National Council before it becomes applicable. The extension of the law will not be subject to debate before the National Council until this summer, i.e., conceivably after the legal expiration of the Bonny Law.

Thereafter, the extension of the law will be subject to a three-month period during which Swiss citizens have the right to request a referendum.

3. Changes to qualifying areas

Federal tax holidays are commune specific. In other words, they are only granted to businesses that are established in certain predetermined geographical communes (municipalities). Some of the qualifying communes are very close to well-developed cantons that do not have communes that qualify for the relief (such as Geneva and Zurich). Therefore, multinationals have often established their business outside the well-developed cantons in order to qualify for tax relief while taking advantage of nearby existing infrastructures, such as airports, large banking facilities, etc. This has led to considerable pressure from some of the well-developed cantons for a reconsideration of the qualifying communes in order to exclude communes that are considered as being too close in proximity.

This will certainly be discussed this summer when the National Council is required to accept the extension of the Bonny Law. It will also be discussed in the context of the New Regional Policy.

4. Filing and timing requirements

There will only be certainty concerning the extension of the law and the areas to which it will be applied after the expiration of the Bonny Law. For this reason, the Swiss Federal Department of Economy has again confirmed that in order to ensure that a tax holiday is granted based on current rules, requests must be filed with the federal authorities before the end of May 2006.

Typically included in the request for a tax holiday are the following:

- Request for relief with factual and legal substantiation
- Business plan
- Cost-benefit analysis
- Financial forecast
- Cantonal formal approval

Since the federal tax holiday ruling must be filed together with the formal approval concerning the cantonal and communal tax holiday, it is necessary to apply for the latter well beforehand. Depending on the canton of choice, such filing should take place before the end of April 2006 at the very latest. ■

New national salary statement for Switzerland

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The declared aims of the new salary statement are to produce a simplified and standardized form for the whole of Switzerland that can be processed electronically. A version of the salary statement is thus already available for voluntary use with the 2005 and 2006 salaries. The new salary statement will be introduced definitively as of January 1, 2007.

Nevertheless, certain cantonal trade associations are still against the new salary statement and are being supported in this by their cantonal parliaments. As is so often the case, the source of the criticism is less the salary statements themselves but the handling of the forms and the fear that small and mid-sized businesses (SMEs) in particular will have difficulty accepting the new salary statement for fiscal and especially administrative reasons. While no one denies that they will increase transparency, the new forms have become a thorny political issue as salary statements are now required to list the fringe benefits that are increasingly being paid. It is these fringe benefits, which have often gone undeclared in the past despite representing taxable income under current tax law, that have prompted much discussion and fuelled the fear that the new statement will result in an increase in taxes through the back door. The payment of fringe benefits in Switzerland has become more frequent due to the importation of salary systems from abroad, where certain fringe benefits have been introduced as a fixed salary component in the past few years, and also to the need to offer attractive employment conditions to qualified management staff, who are still highly sought after in certain sectors. Fringe benefits are paid out to staff in a wide variety of forms. In addition to company cars, they often take the form of private health insurance, additional accident insurance, preferential discounts on products and services, meal subsidies, etc. The new salary statement takes this state of affairs into consideration and the fact that these fringe benefits were often not declared correctly on the previous form.

At present, there is a pilot project under way to determine whether the new salary statement meets the needs of companies and especially SMEs. In particular, it will check whether the new salary statement can be implemented from a technical point of view, is a tolerable administrative burden and is a sensible solution from the economic and fiscal perspective.

Despite this test phase, which was initiated, and is being supported and supervised by the Swiss Association of Small Businesses, the latter writes that at the moment «everything is still open». However, it is clear that for direct federal taxes the Swiss Government will accept only the new document once (all or most of) the cantons change over to the new form. According to a resolution of the Swiss Tax Conference and the Financial Directors Conference, this will be the case by early 2007 (statement by the Swiss Tax Conference of June 10, 2005). At least all parties agree that using the old and new salary statements side by side is not a feasible solution and would be the worst-case scenario, especially for companies.

In February/March 2006, those participating in the pilot project have shared their experiences, which will be published in a final report in May 2006. According to the initial reports, the tests are going well and no problems have arisen. While the form would need to be simplified slightly to enhance its suitability for small businesses, major changes are not likely to be necessary (see also «NZZ» of Friday, February 3, 2006).

On the basis of this final report the Swiss Tax Conference will take the final decision in June 2006 as to which small adjustments to make, so that they can then be implemented by the end of the year.

On the basis of developments and the first results of the pilot project, it can be assumed that there will be no further delays with the introduction of the new salary statement. Companies that have put things on hold are therefore advised to push ahead with the implementation of the directives now so that there is enough time to set up the internal processes carefully. ■

Taxation of trusts in Switzerland, any news?

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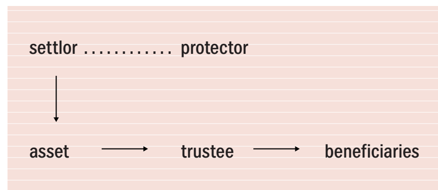
The concept of trust finds its origin in the Anglo-Saxon equity law. It is a tripartite legal institution whereby the settlor transfers to the trustee assets. The trustee is empowered and obliged to manage and dispose of the trust assets in favor of beneficiaries in accordance with the trust deed and the applicable law.



The title on the assets is established in the name of the trustee. However, the trust assets are independent from the trustee's personal assets.

The functions of the private express trust are multiple: estate planning/voting trusts/ unit trust, etc.

The concept of trust has not been received in the Swiss civil law.

Validly constituted abroad, a trust will be recognized as an «organized unit of assets and liabilities» under article 150 of the Federal Law on International Private Law.

The absence of reception of the trust under Swiss civil law and, a fortiori, under Swiss tax law, has led to a vacuum, progressively filled in by the practice.

However, the variety of tax practices leads to an insecurity and professionals (banks, fiduciaries, law offices) have claimed the establishment of a greater certainty in the domain of the taxation of trust relationships. Two initiatives have been launched:

- The recommendation by the federal government to the Swiss Parliament in view of a ratification by Switzerland of the Hague Convention on the law applicable to trusts and their recognition of July 1, 1985.
- The gathering of a Group of Experts within the Swiss Tax Conference on the theme of the taxation of trusts.

1. The Hague Convention

This Convention unifies the rules of conflict and offers a rule of conflict as well as a definition of the trust.

The Convention fixes the extend of the recognition. The Convention is not applicable to preliminary questions regarding the validity of a testament, the validity of a transfer of assets, etc. and makes a reservation in favor of the mandatory rules designated by the rules of conflict of the forum in the domain of succession and matrimonial issues.

Finally and, in particular, the Convention does not apply to fiscal matters.

It results that a ratification of the Convention by Switzerland will give Switzerland a platform of recognition of foreign trusts with a correspondent adaptation of Swiss legislation (international private law/ insolvency law), but will not give an answer in the field of taxation of trust relationships.

2. The convergence of tax practices through a circular

The Group of Experts has established common parameters of taxation, but at the same time has left open the door to negotiations with the competent tax authority in specific cases.

The consensus has been established around the following parameters:

1. The levy of a gift/inheritance tax at the creation inter vivos or mortis causae of a trust by a settlor resident in Switzerland
2. The taxation in the hands of the beneficiary or settlor of income generated or distributed from the trust, following the principles of fiscal realization and attribution
3. The recognition of the principle of fiduciary property (in the fiscal sense) in the person of the trustee
4. The principle of nontaxation of the trust (direct taxes) in the absence of a clear legal basis
5. The adaption of directives regarding the distributions out of an accumulation trust, in particular, the exclusion of a double taxation at the level of the beneficiary, resident in Switzerland
6. In the international context, the Group of Experts refers essentially to the principles and tax practices elaborated in the context of Swiss withholding tax, namely, around the concept of «beneficial ownership».

3. Conclusions

In conclusion there remain distances to be covered on the road towards more legal and tax certainty.

This objective is certainly worth, however, let us remain realistic: without reception of the trust in our legal system or without a legislative adaptation in view of the adoption of a similar institution, it is an illusion to pretend to create legal and tax certainty. The elaboration of a frame harmonized tax practice around certain parameters which are unanimously admitted has the advantage to respect the diversity of the institution of the trust and to leave open the possibility to put in place bespoke structures. ■

Announced changes to the VAT regime – a radical overhaul, cutting of red tape or simply tinkering with the existing system?

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A global phenomenon

Under the title «The Growing Burden», Ernst & Young recently published a widely acclaimed report – available online at http://www2.eycom.ch/publications/items/vat_growing_burden/en.pdf – on the impact of VAT around the world. The report provides a stark illustration of the enormous administrative and organizational problems associated with a system of VAT, which can represent an ongoing cost burden for the companies concerned. And this is clearly a global phenomenon. The report also highlights the importance of appropriate risk analysis and management systems for the companies in question.

Plans for reform in Switzerland – a radical overhaul and the need for action

The recognition of the growing burden posed by VAT has prompted a raft of political measures in Switzerland of late. On February 15, 2006, the Swiss Federal Council decided to broaden the reform agenda, moving away from isolated measures in favor of a complete overhaul of Swiss VAT legislation. As a result, the project looks set to be delayed. The special working group set up for this purpose is expected to have its final report ready by the summer of 2006.

Although the planned full draft has yet to be fleshed out and published, some of the basic outlines are already known. The big question for the companies affected is whether there are any preemptive measures they can take. It looks likely that the legislators will dramatically reduce the exemption list (items on which input tax is not currently deductible). Thus, a whole range of previously exempt revenues will be taxable. However, it will now be possible to deduct input tax for the revenues generated. From a systemic point of view, the legislature will have to provide for the possibility of retroactive input tax relief. Thus, companies with revenues which have previously been exempt should already be taking steps to ensure that accounts payable vouchers where input tax has been levied are present and correct and kept on file so that they do not miss out on this opportunity. In the case of long-term debts or contracts relating to revenues which are currently exempt, it would also be advisable to incorporate a tax clause under civil law which would allow any taxes that may become payable in the future to be passed on to the client.

An end to red tape as far as VAT is concerned? Businesses need to act now!

Also on February 15, 2006, the Federal Council decided to increase the legal safeguards in relation to VAT and make the process fairer. It also announced that it intended to dramatically reduce the payment-related costs for taxpayers. Accordingly, four motions were passed, aimed at putting an end to the red tape that has beset VAT in the past. The Swiss Federal Tax Administration (FTA) will no longer be able to impose charges for checks and controls – despite the fact that the relevant forms have not been correctly completed – if it emerges that the federal government has nevertheless received the due taxes in full. This will go a long way towards slashing the current red tape. It will be achieved by means of amendments to the Ordinance on the Federal Law with regard to Value Added Tax, based on which the FTA will be required to change its administrative procedures.

What will this mean for companies currently facing charges resulting from failure to complete the relevant forms correctly?

In line with FTA administrative policy, the new arrangements will apply immediately to all pending cases. Thus, any taxpayers facing surcharges (purely for failure to complete the relevant formalities correctly) should already be giving careful consideration to if and how they might ensure that they do not lose the right of legal redress. This involves contesting a decision and requesting a ruling, followed by a formal appeal process. If the taxpayer proposes to make a payment towards the surcharge for the purposes of stopping the default interest payment period, this must be done in the proper legal manner and the FTA must be duly notified prior to payment.

It is difficult to assess the precise impact of the planned changes at this juncture. Careful consideration should be given to the best approach on a case-by-case basis.

New arrangements for sponsorship and donations

On March 3, 2006, the Federal Tax Administration announced a change in the applicable procedures with regard to sponsorship and donations in the case of charitable organizations (and these alone!).

Under the new arrangements, recipients of sponsorship are now essentially liable for tax on these payments on the basis that they constitute a taxable advertising service.

Under certain (restrictive) conditions, however, the underlying donations are deemed not to be subject to VAT, thus reducing the recipient's input tax liability accordingly. In any event, contributions to charitable organizations are no longer taxable if the name or company name of the sponsor is used in a «neutral» form in publications of their choice or if just the logo or the corresponding company is featured. The same applies if the sponsor is mentioned by name and his logo is also mentioned. However, donations will result in a reduction in retroactive input tax relief for the recipient charitable organization. The same applies mutatis mutandis to recipients of contributions from charitable organizations who use the donor's name or logo.

Policy on the third-party funding of foundations

The FTA first announced its policy on the funding of foundations in its statement of March 3, 2006. The new arrangements govern the reduction of input tax in the case of taxpaying foundations funded by contributions from third parties. The applicable arrangements depend on the nature of the funding.

If funding comes from the founder and if the assets donated to the foundation are carried in the accounts as capital – in a way which has no effect on the balance sheet – and if this capital will be preserved in the future, then the assets in question are not included for the purposes of calculating the reduction in input tax. If, however, the assets are booked to the income statement or will not be preserved, then the founder's contributions will form the basis of the calculation of the reduction in input tax. If funding is provided by someone other than the founder, all such contributions must always be included in the calculation of the reduction in input tax. If the foundation is funded by income from the foundation's own assets, then the retroactive input tax relief must be reduced accordingly.

Conclusion

VAT legislation and the corresponding administrative practices and procedures are constantly changing, and this trend looks set to become even more pronounced in the medium term. Details of what form the planned changes might take have yet to be released. However, we can safely assume that a great many firms will be affected. Specifically, companies should be drawing up plans now and carefully starting to put them into action. ■

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