

Tax News

June 2007



Dear Reader

A new Customs Act went into effect in Switzerland on 1 May 2007. Although the individual amendments are not revolutionary in nature – for instance, there is no change in the unique Swiss practice of levying duty based on weight – the new act represents an important step forward. Whereas the old Customs Act, which dated back to 1925, was unsystematically structured, difficult to decipher, far from

compatible with EU customs legislation and behind the times in practical terms, the new act has an easy-to-follow structure and introduces EU-compatible terms and processes. Although most of the amendments were already common practice under the old act, the new act does boast some new features, most of which serve to simplify customs procedures. A case in point are errors made during registration. The new act makes it possible for mistakes made during the importers' registration process to be rectified in certain cases without having to resort to a formal appeal process. Another positive feature is the limitation that has been set on haulage contractors' liability with the aim of providing small and medium-sized companies with easier access to the market. On the other hand, some of the amendments are financially painful, such as Art. 15, which stipulates that importers of agricultural products subject to quotas imported during the «free period» must pay the difference in duty retrospectively if the products are still on the shelves when the open period comes to an end. It gets even more complex when it comes to the amendment to the regulations governing duty-free warehouses, which are now treated as domestic territory. The (positive or negative) implications for companies in this case will depend on how the amendments are applied in practice and above all on how the new act dovetails with the VAT Act. To summarize, the new Customs Act can be said to be a thoroughly successful piece of legislation that will attract attention from outside Switzerland's borders.

There have also been some amendments made to intercantonal tax competition. The Federal Court decided, as we all know, in its ruling of 1 June 2007, that degressive taxation, such as that embodied since 2006 in the new Obwalden tax provision for natural persons with a taxable income in excess of CHF 300,000 and taxable assets in excess of CHF 5 million, is unconstitutional, as it violates the principle that people should be taxed according to their financial means. Obwalden reacted to this decision by announcing plans to introduce the first-ever flat-tax rate for natural persons in Switzerland. The actual tax rate will depend on what the cantonal parliament decides, who have put the matter on the agenda of their 29 June and 5 July meetings. However, it is assumed that Canton Obwalden will do all in its power to retain a tax regime that is attractive to natural persons. The small canton is not giving up the fight in the face of these changing conditions but will continue to use innovative ideas to preserve and even enhance its competitiveness on the tax front. If Switzerland succeeds in evolving its tax system along these lines, it will remain a haven in the international tax arena.

Philip Robinson

Country Managing Partner Tax and Member of the Management Committee
philip.robinson@ch.ey.com

Table of Contents

- 1 **Editorial**
International Tax Law
- 2 **Offshore Tax Havens – Switzerland Included on List of Initial 34 «Offshore Secrecy Jurisdictions»**
- 3 **Recent Developments in International Transfer Pricing**
- 4 **French Commissionaire Deemed to Be Permanent Establishment of Its UK Principal**
- 6 **Germany: Corporate Tax Reform 2008**
National Tax Law
- 7 **Agreement on Taxation of Interest between the EU and Switzerland – Italy's Interpretation of Art. 15**
- 8 **Employees' Shares and Stock Options on the New Statement of Earnings**

www.ey.com/ch

Offshore Tax Havens – Switzerland Included on List of Initial 34 «Offshore Secrecy Jurisdictions»

Recently legislation has been introduced in both the US House and Senate to discourage the use of offshore tax havens by US individuals and corporations. At the heart of the legislation is an initial list of 34 «offshore secrecy jurisdictions», which includes Switzerland.

Michael Nadler, Principal, Ernst & Young US Tax Desk, Zurich; michael.nadler@ch.ey.com

The use of these offshore secrecy jurisdictions («OSJ») by US taxpayers would be discouraged under several provisions. Some examples of these provisions include (in general terms):

- creating a rebuttable presumption that receipts of amounts or things of value from an account in an OSJ is presumed to represent previously unreported income,
- requiring the filing of a report with the US treasury by US persons to disclose the existence of any financial accounts in an OSJ, regardless of amount (disclosure is normally required for financial accounts containing at least USD 10 000),
- extending to 6 years the statute of limitations (normally 3 years) for tax returns involving assets and money transfers to or from a financial account located, domiciled, or operating in an OSJ,
- requiring withholding agents that have knowledge that a US person has any financial account in an OSJ to file an information return,
- requiring any financial institution that opens, directly or indirectly, a bank, brokerage, or other financial account in an OSJ to report the transaction to the US IRS,
- limiting the protection a taxpayer takes from relying on the opinion of a tax advisor attributable to a transaction involving an entity or financial account in an OSJ,
- authorizing the US Treasury to prohibit foreign financial institutions found to be impeding US tax enforcement from issuing credit cards for use in the United States, etc.

The initial OSJ list includes several «mainstream» countries such as Switzerland, Hong Kong, Latvia, Luxembourg and Singapore. The Treasury would be authorized to amend the list. A key focus would be on those jurisdictions that did not have effective information exchange practices with the United States.

As appears obvious from the above, the proposed legislation will impact both US taxpayers and financial institutions with significant administrative responsibilities imposed on financial institutions. Given the current difficult fiscal climate whereby budget writers have been focusing on ways of increasing tax revenues, the legislation may present a politically palatable way to raise revenues. The policy would be to clamp down on perceived abuses such as tax deferral from doing business overseas in questionable jurisdictions. At this point in time, it is too early to predict the likelihood of passage of this legislation. ■

Recent Developments in International Transfer Pricing

Transfer pricing continues to be a key issue for a large number of national tax administrations. The Russian finance ministry is a case in point, having recently presented a draft amendment to a number of areas of tax legislation that centres mainly on transfer pricing. At central focus of the bill is the problem of how to determine market prices.

Salim Damji, Partner, Head Transfer Pricing, Zurich; salim.damji@ch.ey.com

Ulrike Wolff, German Attorney at law, LL.M., M.R.F., Manager, Tax; ulrike.wolff@ch.ey.com

Gregor Freimoser, Master's degree in economics, Senior, Tax; gregor.freimoser@ch.ey.com

To strengthen the position of the Russian tax authorities in transfer pricing disputes the bill aims to allow a certain increase in the number of permissible information sources¹ and methods used to determine market prices for transfer pricing purposes. One particularly burning issue is the fact that the list of sources permitted by the bill includes those provided to the Russian authorities by other taxpayers. The use of such confidential data from official taxpayers' files is tantamount to the use of so-called «secret comparables» by the Russian authorities².

Since 1 January 2007 formal transfer pricing documentation requirements have been applied to cross-border transactions within multinational enterprises (MNEs) in Sweden. That transfer prices are a key issue for the Swedish tax administration was highlighted by two disputes between Swedish car maker Volvo and the Swedish tax authorities that attracted public attention in January of this year. The tax authorities held the Volvo Group liable for the equivalent of approximately CHF 260 million in additional taxes, claiming that Volvo had distributed cars at below arm's-length prices to dealerships in countries with high import duties and employed improper tax planning structures involving loans granted by its parent company Ford in the USA.

Norway, too, is introducing documentation obligations for intra-group transfer pricing within MNEs on 1 January 2008. The Norwegian provisions will oblige

taxpayers to submit to the tax authorities within 45 days upon request an appendix to their annual tax returns along with transfer pricing documentation. For taxpayers who fail to comply with this requirement, the tax authorities can set transfer prices at their discretion and charge a penalty tax rate (plus interest) of normally 30%.

Following a number of delays, transfer pricing documentation requirements are expected to enter into force in China for the 2008 calendar year. According to preliminary information, the documentation regulations will follow OECD transfer pricing guidelines with particular emphasis on functions and risk analyses as well as comparative analyses of third parties. The proposed transfer pricing documentation regulations will in all probability include an analysis and description of transactions between related parties along with information on internal group financing, the purchase and sale of goods, provision of services, transfer and licensing of intangible assets and cost allocation. ■

¹ Under current transfer pricing regulations the tax authorities are permitted to use «official information sources» only.

² Barring few exceptions (notably China), the use of «secret comparables» has been condemned by the OECD and most tax administrations.

French Commissionaire Deemed to Be Permanent Establishment of Its UK Principal

On 2 February 2007, the Administrative Court of Appeals of Paris took the position that a commissionaire of a UK principal company constituted a permanent establishment of such company in France, confirming the position taken earlier by a lower court on the same case. This decision does not break new interpretive ground and, based on the facts identified by the Court, seems to be in line with existing French case law on similar topics.

Taxpayers looking at or already taking advantage of the beneficial treatment offered by commissionaire structures should in any case ensure that the wording of relevant agreements and their practical implementation respect the legal definition of a commissionaire, i.e. that of an independent agent that always acts in its own name (but on behalf, at the risk and for the account of its principal).

Jean-Marc Girard, International Partner, Tax; jean-marc.girard@ch.ey.com

Lionel Noguera, Manager, Tax; lionel.noguera@ch.ey.com

A commissionaire turned into a dependent agent

The commissionaire, ZIMMER SAS, used to be a full-fledged distributor in France for products of the principal, ZIMMER LTD., until 1995, when it was converted into a commissionaire. The French tax authorities claimed that the principal had a French permanent establishment for FY 95 and 96 as the commissionaire had the power to bind the principal in commercial transactions pertaining to the principal's own activities. The commissionaire contract indicated that the commissionaire «could accept orders, display quotes and documents in tender offers and conclude sales contracts on behalf of the principal without obtaining its approval» and that it could «engage in price negotiations, grant rebates and discounts or payment modalities with current or new customers without specific prior approval by the principal».

Based on these facts, the Court of Appeals applied article 4.4 of the Tax Treaty signed between France and the UK on 22 May 1968, whereby a dependent agent can constitute a permanent establishment of its principal if it is acting on its behalf and has and habitually exercises in France the authority to conclude contracts in the name of the principal.

Concurrently and under the same logic,

the Court considered that the exception of article 4.5 (whereby independent agents normally do not constitute permanent establishments) was not applicable in this case, holding that: «the circumstance that ZIMMER SAS, pursuant to its commissionaire status, acted in its own name and could not actually conclude contracts in the name of its principal has no impact on the capacity of such company to bind its principal in a commercial transaction pertaining to its own activities.»

Analysis

This decision does not break new interpretive ground as far as tax law and treaties are concerned, as the Court exclusively based its application of article 4.4 of the tax treaty over article 4.5 on a specific set of facts. Although the decision of the Court may not be final (as the principal may have appealed it before the Conseil d'Etat, France's highest tax court), it is nevertheless possible to draw useful inferences from these facts in the review of existing or planned commissionaire structures.

The Court in fact recharacterized the existing commissionaire agreement into a dependent agent relationship based on:

- 1) the power granted to the commissionaire to enter into contracts, negotiate prices and grant discounts on behalf of the

- principal without its prior approval;
- 2) certain control rights granted to the principal in respect of sales and advertising;
- 3) the assumption by the principal of risks arising from the performance of sales contracts;
- 4) the fact that the commissionaire acted exclusively for the UK principal.

While this last argument is an economic circumstance assessed by the judge in the course of its review of the facts, the first three reflect known criteria for the assessment of a dependency relationship under the OECD Model Commentary or relevant French case law.

Power to contract on behalf of the principal

Indeed, the Commentaries to the OECD Model Tax Convention assert that a person that is authorized to negotiate key elements of a sales contract in a way binding on the foreign enterprise may be viewed as exercising authority to negotiate or conclude contracts in the name of the latter. French tax courts have concluded to the existence of a PE in several comparable situations, even where such person is a legal entity distinct and separate from the foreign enterprise.

By contrast, however, under applicable French commercial law a commissionaire does not contract in the name of the principal but always in its own name, and may therefore not bind the principal when contracting with a client. There may still be ways to set general parameters at principal level, such as general terms and conditions, price lists or ranges of prices.

Control rights and risk attribution

Furthermore, a French entity is generally deemed to be dependent vis-à-vis a foreign enterprise where the activities it carries out for or on behalf of the foreign enterprise are subject to detailed instructions or to comprehensive control by such foreign enterprise. A French company may also be viewed as dependent if it does not bear entrepreneurial risks in connection with the activities it carries out (e.g., if its own costs are fully covered by the foreign enterprise) or if the foreign enterprise represents a substantial portion of the revenues of the French company.

The facts assessed by the Court indicate that at least some the above criteria appeared to be met, although the factual summary contained in the decision does not enable us to accurately verify the degree of control exercised by the principal or the exact definition of the risks it agreed to bear (as in a commissionaire structure the principal bears most of the risks tied to the performance of the sales contracts in any case).

Other European countries

The characterization of commissionaires in European countries depends on the approach taken by their local tax authorities when analyzing the relationship between the principal and its commissionaire.

Broadly speaking, the study of local regulations and practice reveals that European countries follow two slightly different courses. A first group of countries seems to adopt a more formalistic ap-

proach, similar to that of France described above. Those countries focus on the formal aspects of the legal relationship (*Hungary, Sweden*). By contrast, a second group of countries focuses directly on the economic substance of the relationship (*Norway, Slovakia and the Czech Republic*).

The formal approach (*France, Hungary, and Sweden*) can be defined as follows:

The tax authorities define whether or not the commissionaire constitutes a permanent establishment by relying on formal elements of his relationship with the principal.

In that respect, particular attention is given to whether the commissionaire has the authority to act in its own name only. It usually entails that the commissionaire does not constitute a permanent establishment.

However, it must be noted that, in addition to formal aspects of the relationship, the tax authorities may nevertheless look further into the agreement and its implementation with the view of determining whether it confirms the apparent independent status of the commissionaire. The tax authorities will then apply the economic substance approach, as described below.

The economic substance approach (*Norway, Slovakia, and the Czech Republic*) can be characterized as follows:

Under the substance approach, the tax authorities do not rely on formal elements of the relationship between the principal and the commissionaire. The relationship is thus directly analyzed on its material content in order to determine whether or not the commissionaire constitutes a permanent establishment.

Among the facts that reveal if a commissionaire constitutes a permanent establishment, the most prevailing are whether or not the commissionaire can bind the principal when entering into contracts with third parties and whether or not, based on relevant economic circum-

stances, it must be regarded as dependent or independent from the principal. Additionally, a commissionaire will be regarded as a permanent establishment where its activities are subject to detailed instructions or comprehensive control by the principal and where the entrepreneurial risk lies with the principal.

Next steps

This court decision is a reminder that, in supply chain management structures, most tax risks lie in the detail, be it in the precise wording of legal agreements or in their effective factual implementation.

Taxpayers looking at or already taking advantage of the beneficial treatment offered by commissionaire structures should ensure that:

- the wording of the commissionaire agreement respects the legal nature of a commissionaire and could not be analyzed or recast by the tax authorities as a contractual arrangement of a different nature under a substance-over-form approach;
- the commissionaire agreement grants sufficient latitude to the commissionaire for carrying out its daily activities and limits the principal's oversight to a strict minimum;
- the principal has no (physical) presence whatsoever in France;
- the principal is not involved, directly or indirectly, in any sales activities in France.

Existing commissionaire arrangements should be subject to detailed review in this respect, and amended where necessary. ■

Germany: Corporate Tax Reform 2008

As previously announced in the December 2006 and March 2007 editions of Ernst & Young Tax News, on 25 May 2007 the German Bundestag concluded its deliberations on the «Corporate Tax Reform 2008». Before the reform comes into force it has to be approved inter alia by the German Bundesrat and at the time this issue of Tax News went to press approval had still not been granted (approval is anticipated for 6 July 2007). No fundamental amendments or delays are to be expected in view of the intensive political coordination, meaning that taxpayers can start preparing for the major changes set out in this article.

*Heiko Kubaile, Tax Advisor, Senior Manager, Head German Tax Desk, Zurich;
heiko.kubaile@ch.ey.com*

The core feature of the planned corporate tax reform involves a reduction in the nominal rate of corporation tax from 25 % to 15 %. As a result the total tax burden on corporate profits will fall from the current 38.65 % to 29.83 % (14 % trade tax + 15 % corporation tax + 0.83 % solidarity surcharge). The 15 % nominal corporation tax rate will apply for the first time during the 2008 fiscal year to those corporations whose fiscal year coincides with the calendar year; for companies whose fiscal year is otherwise arranged, it will apply for the first time in the fiscal year ending in 2008. However, in future trade tax will no longer be tax deductible.

The current regulation of external financing by shareholders (§ 8a KStG) that mainly concerns interest payments to major equity holders will be replaced by a general «interest barrier», which will apply to all forms of external financing (including bank loans). After the reform, companies will only be able to make deductions from taxable income for interest equivalent to interest income from the same fiscal year; further interest costs may be deducted only up to a maximum of 30 % of taxable earnings before interest, taxes, depreciation and amortisation (taxable EBITDA). Originally, the intention was to use the taxable EBIT (taxable earnings before interest and taxes).

Beginning in 2009, income gained by private investors from capital assets and

specific «speculation gains» will be subject to a settlement tax of 25 % to which solidarity surcharge and church tax will be added (altogether 27.82 % or 28 % depending on federal state). Persons on low rates of taxation can opt for a tax assessment. The deduction for advertising costs will in principle be discontinued entirely (gross tax). The half-income tax rule will be abolished and be replaced by a partial income tax rule (exemption of only 40 % of dividends) for shares in a company's assets of individuals in sole proprietorships or partnerships. At the last minute a restriction was introduced determining that losses incurred on disposal of privately held shares can only be offset against profits from the same source.

The date on which the Bundesrat approves the bill is significant for the semi-annual and annual accounts under HGB (Commercial Code) and IFRS rules. For the calculation of deferred taxes in consolidated financial statements drawn up in conformity with the German HGB the new regulations – and therefore the tax effects resulting – are to be taken into consideration when the Bundestag and Bundesrat finally adopt the law. If the Bundesrat gives its approval on 6 July 2007, companies with statements drawn up according to IFRS (IAS 12.47) may not include the tax effects resulting from the corporate tax reform in the interim statements compiled to 30 June 2007; this also

applies if statements are only drawn up after 6 July 2007. The US GAAP standards stipulate that amendments to legislation should only be taken into account on «enactment», in our opinion therefore not before the law is signed by Germany's President. ■

Agreement on Taxation of Interest between the EU and Switzerland – Italy's Interpretation of Art. 15

In the ruling 93/E, dated 10 May 2007, the Italian tax authorities have stated their position on Art. 15 of the Swiss-EU Savings Agreement («Agreement») and how it will apply to corporations which benefit from special tax regimes in Switzerland.

Alberto Lissi, Attorney at law, Certified Tax Expert, Senior Manager, Tax; alberto.lissi@ch.ey.com
Claudio Bertini, Assistant, Tax; claudio.bertini@ch.ey.com

Art. 15 of the Agreement extends an integral part of the European Union Directive on parent companies and subsidiaries and that on interest and licence fees to Switzerland, in particular the stipulations applying to exemption from withholding tax on cross-border dividend, interest and licence payments between group companies.

The Agreement, which according to the Italian tax authorities applies within Italian law without any need of implementation into local law, lays down specific requirements to be met for exemption from taxation at source. Among other requirements Art. 15 of the Agreement stipulates that both companies must be «subject to tax» and both must adopt the legal form of a limited company.

With respect to how the term «subject to tax» would be interpreted, the Italian tax authorities now represent the viewpoint that Italy would have to regard a Swiss company that benefits from tax privileges on a cantonal, municipal or federal level as not «subject to tax». Therefore payments from an Italian company to a Swiss company, classified for tax purposes as a domiciliary or holding company, would as a rule not be exempt from taxation at source under the provisions of Art. 15 of the Agreement. The Italian tax authorities base their decision in particular on the decision of the EU Commission taken on 13 February 2007 in connection with the tax dispute with Switzerland. In the opinion of the EU Commission, all state aid – including tax privileges for corporations – constitutes a breach of the Agreement between Switzerland and the European Economic Community of 22 July 1972.

What should be taken into account, however, is that the Italian interpretation of the term «subject to tax» as in Art. 15 of the Agreement differs from that of the Swiss tax authorities. From Switzerland's standpoint granting of tax privileges is not considered detrimental to the application of Art. 15 of the Agreement. As a consequence of these two differing interpretations, dividends paid from a Swiss company benefiting from tax privileges to an Italian parent company are exempt from Swiss withholding tax. Conversely, dividends paid over by an Italian company to a Swiss parent company benefiting from tax privileges are, however, subject to Italian tax at source (a partial reduction of the Italian tax may be generally obtained based on the Swiss-Italian double tax treaty). ■

Employees' Shares and Stock Options on the New Statement of Earnings

More and more companies are choosing to remunerate their employees with shares or stock options. But the complexity surrounding the taxation of such securities and how to report them on the new statement of earnings pose a number of problems. This is therefore a good opportunity to briefly review the tax treatment of shares and stock options in order to enable a better understanding of the type of information which has to be included on the new statement of earnings, hereinafter referred to as «NSE».

Michael W. Hildebrandt, Partner, Tax; michael.hildebrandt@ch.ey.com

Employees' shares

In Switzerland, shares issued to employees are taxed at grant, or more precisely at the time when the employee accepts the grant made to him. Thus the remuneration triggered is equivalent to the difference between the market value of the share, reduced by a discount of 6% per year of the restriction period, and its acquisition price. Unlisted shares are given an estimated value a priori using a valuation method which is recognized by the Federal Tax Administration. More and more frequently, we are also seeing restricted share units which, in simple terms, are a promise to issue shares. In this case, tax is only due when the employee actually receives the shares.

Employees' stock options

In principle, the taxation of stock options is regulated by Federal circular no. 5 of 1997 which states that stock options are taxed at grant unless the option cannot be evaluated or qualifies as an expectative right rather than as stock option. Here the remuneration is equivalent to the difference between the value of the option and the subscription price (exercise price of the option). The taxable value of the option should thus be determined on the basis of a mathematical model, such as the Black-Scholes formula. This rule is generally speaking thoroughly followed by the French-speaking cantons. Nonetheless, and subject to a ruling approved by the Cantonal Tax Authorities, the time at which stock options are taxed may be deferred until the options are exercised. In this situation, the remuneration is calculated as the

difference between the subscription price and the value of the underlying share.

The Swiss German cantons, by contrast, follow the Federal directive of 2003. Although the method of determining remuneration is similar to that practised in the French-speaking cantons, the point at which taxation occurs may vary depending on the characteristics of the employee stock option plan. In effect, the stock options are taxed at grant when their value can be determined and if they are not subject to a restriction period. Options with a risk of forfeiture are taxed at the end of the restriction period if their value can be determined at that time. Stock options which do not match any of the conditions listed above are taxed when the options are exercised.

Statement of earnings

First of all, it should be noted that all benefits in kind have to be indicated on the new statement of earnings, and shares and options are deemed to be such benefits. Generally speaking, the benefit should be converted into an amount in figures and inserted under point 5 of the NSE, which has been specially foreseen for this purpose. In addition, an addendum should be attached to the statement of earnings to allow the tax authorities to check if the value of the benefit in kind has been determined correctly. This addendum should include all information relating to the participations awarded to the employee, i.e. according to the directives in this area, the precise name of the employee stock option plan, the preferential price at which the employee received the securities, the

date of issue of the rights, the type of rights issued, the market value, the discount for the restriction period and the number of rights granted. If a valuation was established, it should also be stated whether it was approved by the tax authorities.

As we have seen above, taxation of shares or stock options may take place at three different moments – at grant, on irrevocable acquisition of the option, or on exercising the option. The procedure in each case is described below:

- 1) At grant: The benefit in kind should be converted into an amount in figures and inserted under point 5 of the NSE, after deduction of social security contributions. In addition, an addendum must be attached to the statement of earnings.
- 2) On irrevocable acquisition of the right: At grant, only a comment should be made under point 15 of the statement of earnings: «Issue of shares (respectively options), taxable at irrevocable acquisition of right.» In the year of taxation, the benefit must be converted into an amount and mentioned under point 5, after deduction of social security contributions. In addition, the addendum must be established.
- 3) At exercise: As under point 2).

Conclusion

If the new rules for issuing NSEs are simple, the way in which shares and options are handled is still complicated due to the associated tax regulations. For this reason, we recommend that you obtain competent advice before completing the statement of earnings. ■

Imprint

Tax News

Electronic publication in German, French
and English

Designed and produced by

Ernst & Young Ltd
Tax and Corporate Communications &
Marketing
P.O. Box, 8022 Zurich

Subscriptions/address changes

www.ey.com/ch/newsletter