

Swiss Tax Agency: Arm's-Length Markup Only on Operative Costs

Posted on Oct. 22, 2024

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A recent judgment by Switzerland's Federal Supreme Court that all costs must be included in the market price of related-party transactions does not apply to international fact patterns, the Swiss Federal Tax Administration has said.

In its [October 8 statement](#), the tax administration clarified that a June 11 decision ([9C 37/2023](#)) by Switzerland's Federal Supreme Court (Bundesgericht) interpreting the cost-plus method under article 58(3) of the [Federal Direct Tax Act](#) covers only entities providing public services of general interest (like utilities companies) in a domestic setting.

Switzerland's arm's-length principle, as enshrined in article 58(1) of the Federal Direct Tax Act, disallows as a deduction "non-business-related benefits to third parties." Article 58(3) stipulates a more specific rule that "services provided by mixed-business companies operating in the public interest primarily to related parties are to be valued either at the respective market price, or at the respective production cost plus an appropriate mark-up, or at the respective final selling price less an appropriate profit margin; the result of each company is to be adjusted accordingly."

In its June 11 judgment, the Federal Supreme Court held that taxes are part of the production cost base under article 58(3) subject to the relative profit level indicator. The OECD transfer pricing guidelines are not indicative for article 58(3)'s construction and can — if at all — serve only an auxiliary role in interpreting article 58(3). The element in paragraph 2.37 et seq. of the [1995 OECD transfer pricing guidelines](#) (paragraph 2.49 et seq. of the [2022 guidelines](#)) requiring the elimination of taxes from the cost base because they are not related to a company's function is therefore irrelevant by virtue of a different Swiss practice, the court said.

"The historical background to that 'Swiss practice' is that, in the 1950s, Switzerland issued a circular stating that companies with a strong foreign business focus were effectively not taxable in Switzerland due to the allocation of that tax base to abroad," Thomas Hug of Deloitte AG's Zurich office told *Tax Notes* October 21. "Consequently, the tax administration declared in that circular that Swiss taxable income was to comprise at least 10 percent of total business costs, including taxes."

In 2004 Switzerland abandoned this practice in a new memorandum ([Circular No. 4](#)) and aligned with the OECD transfer pricing guidelines, Hug said.

"Article 58, paragraph 3, which applies to companies operating in the public interest, reflects this old practice," Hug said. "The Federal Supreme Court's ruling has caused significant international confusion, partly because the tax administration reaffirmed its OECD-compliant position in a Q&A in February."

In question 5 of the [February Q&A](#), the tax administration refers to the OECD's position that "a fundamental distinction must be made between operating costs, i.e. expenses that a company regularly incurs to keep business processes and systems running and to provide services that generate value added, and non-operating costs, such as taxes and financing costs." It said that "financing costs (at least for typical service companies and non-capital-intensive (routine) production companies) are also not usually incurred during actual operating activities and do not generate value added. As non-operating costs do not contribute to a company's value added, they are generally not included in the cost base."

In its October 8 statement, the tax administration reiterated that the hypothetical or calculatory approach to the cost-plus method, which includes taxes, is not compliant with the OECD transfer pricing guidelines and does not represent the tax administration's position for cross-border situations, which typically uses benchmark studies for comparables without taxes. Hence, in those cases, only operating expenses must be considered as part of the cost basis, and nonoperating ones like taxes are excluded, the statement says.

"The clarification by the Swiss tax administration is welcomed," Hug said.