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SWISS TAX AUTHORITIES TURN FOCUS TO TRANSFER PRICING ISSUES

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Swiss Tax Authorities Turn Focus to Transfer Pricing Issues

- Deloitte's Thomas Hug explains Swiss transfer pricing trends
- Tax authorities increasingly aligning with global standards

Switzerland has long been known for its attractive tax rates, so there has been little risk of multinational enterprises shifting tax revenue out of Switzerland through aggressive transfer pricing. It's therefore not surprising that Swiss tax law contains no explicit transfer pricing provisions and no requirement to maintain formal transfer pricing documentation.

However, because of recent international developments—the OECD's Base Erosion and Profit Shifting Project and Pillar Two initiative, as well as pressure from the EU—Switzerland has had to align its national tax system with new international standards.

In light of these developments, and in particular to align with OECD guidelines, Swiss tax administrations have identified transfer pricing as a new area of focus.

Strengthening Expertise

Because of Switzerland's federal structure, corporate income tax is assessed by 26 different cantonal tax administrations. Some of these, due to their size, didn't have the resources and expertise to deal with complex transfer pricing cases.

However, this has changed in recent years. Alongside continuous training of tax inspectors on transfer pricing matters, some cantons, such as the Zurich cantonal tax administration, have established their own specialist teams for transfer pricing and valuations.

The Swiss Federal Tax Administration, which exercises overall supervision over the cantons and is responsible for Swiss withholding tax, has had its own transfer pricing unit for several years.

New Clarifications Published

In late February, the federal tax administration launched a new website to publish its practice on transfer pricing topics in a Q&A format. The content contains little that is surprising from an outsider's perspective but provides much-needed clarification for disputed matters in Switzerland.

This launch went hand in hand with a new transfer pricing dossier published in January by the Swiss Tax Conference, an umbrella organization of cantonal tax administrations.

The federal tax administration pointed out that although the Organization for Economic Cooperation and Development Transfer Pricing Guidelines aren't legally binding on Switzerland, they are often used by tax administrations and courts as a source of interpretation of the arm's length principle. Its statement emphasized that the Swiss tax administrations will continue to align their practice more closely with the OECD guidelines.

The federal tax administration also provides clarification on cost-based transfer pricing methods—cost-plus and transactional net margin method.

First, the previous practice in some cantons of including taxes in the cost base has been abolished and harmonized with international practice.

The administration also clarifies that no profit markup may be applied to pass-through costs and that Switzerland also applies the simplified approach for low value-adding services per the OECD guidelines.

Switzerland has also adopted the principles of the 2019 US court ruling *Altera Corp. v. Commissioner* and allows share-based payments as tax-deductible costs in cost-sharing arrangements.

Intercompany financing. The most detailed statements relate to intercompany financing. The safe-harbor rates will continue to be published annually. However, if a multinational enterprise doesn't comply with these, it must provide evidence that the rates are arm's length.

The federal tax administration expects a benchmark study to consider various elements of the financial transaction, such as maturity, start date, currency, rating, any guarantees/collateral. However, the rating should focus less on the borrower's rating and more on the rating of the financial transaction. This includes any collateral, for example.

In the absence of a rating from an independent rating agency, the taxpayer must determine the rating, for example by using the same methodology as rating agencies or by using rating software. If a loan is granted in a foreign currency, the federal tax administration expects a justification.

In addition, it must always be examined whether realistic financing alternatives would have been available to the borrower.

The federal tax administration will in future focus not only on whether the controlled loan bears an arm's-length interest rate, but also on whether the financial transaction itself is at arm's length.

Documentation. The transfer pricing dossier outlines that Switzerland has no formal documentation requirements other than complying with country-by-country reporting requirements.

However, taxpayers are obliged to provide evidence to support arm's-length behavior upon request. This emphasizes that professional documentation, which could be based on the OECD approach, should nevertheless be prepared in Switzerland.

Trends in Court Cases

With tax administrations increasingly scrutinizing the transfer pricing models of groups with a presence in Switzerland, it isn't surprising that the courts are also having to deal with more such cases. The cases are different in kind, but the following main trends can be identified:

- **Cash pooling.** Judgments relate to whether deposits in foreign cash pooling arrangements are to be classified as short term or long term, which has an impact on the interest rate.
- **Offer as third-party comparable.** Bank offers are no longer accepted as comparable transactions for benchmarking purposes.
- **Post merger and acquisition transactions.** Judgments relate to reorganizations and modified transfer pricing models immediately following foreign groups' acquisition of Swiss companies. There is often a dispute about the extent to which the transfer prices must comply with the purchase price allocation under International Financial Reporting Standards or US Generally Accepted Accounting Principles.

Consequences for Multinational Enterprises

From the outside, these recent Swiss developments may not seem significant. But in reality, they represent a major step toward more clarification in disputed matters.

Multinational enterprises with a presence in Switzerland need to be aware that transfer pricing is becoming increasingly important there, as it is internationally, and that tax administrations are aligning their practice with the OECD guidelines.

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