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International Tax

Switzerland Tax Alert

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SFTA updates guidelines for taxation of principal companies

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The Swiss Federal Tax Administration (SFTA) has provided the cantonal tax authorities with revised guidance on how to apply rules that affect the taxation of principal companies, which will impact both existing and new principal company rulings.

The taxation of Swiss principal companies is based on Circular Letter No. 8, published by the SFTA in 2001. Provided the requirements set out in the circular letter are met, the Swiss principal can allocate a fixed percentage of trading profits abroad (an international tax allocation), which renders those profits exempt from the Swiss tax base for direct federal tax purposes. Swiss principal structures often are established to benefit from Switzerland's favorable tax rates, advance tax ruling practice and business-friendly climate.

The SFTA has conducted tax audits of Swiss principal companies in recent years to assess whether the structures are in compliance with Circular Letter No. 8, and based on the experience gained from these audits, the SFTA has been reviewing the principal company allocation rules. Following numerous discussions with the cantonal tax authorities, the cantonal finance director conference and other interested parties over the last year, the SFTA has now provided revised interpretation guidelines to the cantonal tax authorities, including detailed calculation guidelines on how the circular letter should be applied.

The new guidelines for a principal company allocation are the following:

- **3% gross profit margin for commissionaires/LRDs:** The trading profit that benefits from the international tax allocation is newly linked to the margin/commission generated at the level of the commissionaire/limited risk distributor (LRD). As a result, a maximum allocation of 50% of the trading profit abroad is permitted only where the margin/commission at the level of the commissionaire/LRD does not exceed 3% of the gross revenue (or, if higher, the costs of the distribution company). The 3% gross revenue criterion applies to all industry sectors. Any excess margin paid to the distributors will result in an adjustment, i.e. the excess margin will not be subject to the international tax allocation.
- **Exclusivity of commissionaires/LRDs:** An international tax allocation may be claimed only if the distributing company makes sales exclusively for the principal, i.e. where the distributing company is entirely dependent

on the principal. A dependent relationship will be presumed to exist where at least 90% of the distributor's profit derives from trade with goods of the principal. If the 90% threshold is not met, an international tax allocation to the relevant commissionaire/LRD country will not be possible.

- **Outsourcing of principal operating functions:** If the principal's functions are partially outsourced to a foreign entity or entities, an international tax allocation still will be possible, but the profit mark-up on principal functions so outsourced will not benefit from the international tax allocation.
- **Effect of mutual agreement procedure (MAP)/advance pricing agreement (APA):** A MAP or an APA no longer will result in an automatic denial of the international allocation to the relevant country (which previously was the case); instead, there only will be an adjustment of the allocation quota.

The SFTA's new guidelines will impact both existing and new principal company rulings. All existing rulings likely will be reviewed by the competent cantonal tax authorities in cooperation with the SFTA, and where there is any deviation from the new guidelines, the rulings will have to be amended or they could be revoked. The SFTA has indicated that it will work with companies that may need to restructure their businesses as a result of the revised interpretation to find a practical and acceptable solution within the restructuring period, i.e. the period the company requires to adapt its supply chain to the new requirements.

Groups with existing Swiss principal structures should carefully review these structures and prepare for discussions with the tax authorities regarding the implementation of the new guidelines.
