Switzerland has been a very attractive location for US multinational enterprises for several decades already. The last few years have shown an ever increasing interest for Switzerland as a location for (global or European/EMEA) headquarters or principal companies. What is less published and may be less known is the fact that Switzerland is also increasingly successful in attracting international licensing operations and holding companies. That trend has been further enhanced by the introduction in Switzerland and in the EC member states of measures equivalent to the (old) EC Parent-Subsidiary Directive and to the EC Interest and Royalty Directive as per July 1, 2005. Dividends, interest and royalties can now be paid free from withholding tax in qualifying relations between Switzerland and EC member states. This article describes the Swiss tax aspects of licensing and holding structures in general terms and deals with some of the practical tax questions that can arise when setting up such structures in relation to the US.

1. LICENSING

1.1 Intellectual property rediscovered
Multinational companies all over the world seem to be rediscovering the value of the intellectual property ("IP") they have developed and acquired over the years. Many of them have set-up research & development activities or licensing and trademark operations in Switzerland. Traditionally the fast moving consumer good industry has been driving this trend and more recently a considerable number of companies in the field of (bio)pharmaceuticals and life sciences have set up substantial operations in Switzerland.

1.2 Swiss companies owning IP
A Swiss company owning intellectual property which is licensed (mainly) to companies located abroad, can benefit from certain tax advantages at the local (i.e. cantonal and municipal) tax level by reason of its limited use of the local infrastructure. In such case, the effective overall corporate income tax burden generally ranges from 9 to 12% depending on the canton. This rate applies both to the company’s net licensing income and to possible future capital gains on the intellectual property.

The company is obviously allowed to deduct the expenses relating to the income, such as research and development expenses, salaries, legal fees, costs of financing and depreciation. In relation to (among others) intangibles the Swiss Federal Tax Administration has issued certain general safe harbor guidelines such as a debt-to-equity ratio of maximum 70%, a maximum USD interest rate of 5% and a maximum depreciation of 20% straight-line or 40% of declining book value. It is possible to obtain confirmation in advance from the Swiss tax authorities not only on the corporate income tax advantages, but also on the valuation of the IP upon entry and upon exit and regarding the cost structure and fees paid to related or unrelated foreign parties (advance transfer pricing agreements).

1.3 Use of the Swiss treaty network
A Swiss company (beneficially) owning intellectual property can make use of the extensive Swiss double tax treaty network. In qualifying group relations Swiss companies can also benefit from zero withholding tax between Switzerland and the 25 EC member states based on the provisions equivalent to the EC Interest & Royalty Directive (see above). A tax credit is available for any withholding tax paid after application of a treaty. Technically one third of such tax can be credited against Swiss income tax at each of the three tax levels, i.e. federal, cantonal and municipal. If the company benefits from tax base reductions, the credit will be reduced accordingly. However, if and to the extent double tax treaties concluded by Switzerland are used to reduce foreign withholding taxes, specific anti-abuse rules apply. In relation to the US, these rules are determined by the Limitation on Benefits ("LOB") provision in the US-Swiss treaty. In relation to Belgium, France and Italy, the respective treaties require among others that the income be fully taxed in the hands of the recipient (which implies an effective overall corporate income tax rate of 15 to 25% depending on the canton). With respect to Swiss tax treaties in general, the main requirement is that not more than 50% of the treaty protected licensing income is paid out as expenses to parties not entitled to the relevant treaty (i.e. companies or individuals abroad). Depreciation on intellectual property purchased from a foreign party is also considered a conduit payment falling within the 50% limitation.

1.4 Sublicensing structures
Swiss companies are sometimes used in sublicensing structures and the fact that Switzerland does not levy withholding tax on royalties paid is helpful in this respect. However, the stringent anti-treaty abuse rules described above make it difficult for Switzerland to compete with other jurisdictions such as Luxembourg or the Netherlands providing significantly better arrangements for sublicensing structures.

1.5 Licensing branch alternative
In cases where the 35% Swiss withholding tax on dividends proves an important obstacle, the use of a Swiss licensing branch should be considered as an alternative. Such structure typically combines a company in a jurisdiction with an excellent double tax treaty network for licensing, such as Luxembourg or Hungary, with the benefits of the generally lower corporate income tax rates in Switzerland. Branch profits distributed to the foreign head office are not subject to Swiss withholding tax.

1.6 Swiss fiduciary registrants
Occasionally Swiss companies are used on a fiduciary basis, e.g. as a trademark registrant on behalf of a company located in a jurisdiction with insufficient trademark protection. In such case, the parties involved need to conclude a proper fiduciary agreement under Swiss law and need to obtain advance confirmation from the Swiss tax authorities on the tax treatment, i.e. how much taxable income the company should report as a remuneration for its fiduciary services. As the fiduciary company is not the beneficial owner of the intellectual property, it cannot make use of the double tax treaties concluded by Switzerland.
2. HOLDING

2.1 Increased demand for Swiss holding companies

As more and more US multinationals are setting up operations in Switzerland, holding functions are often added to the platform. There is, however, also an authentic additional demand for Swiss holding companies and much of this probably relates to the fact that the Swiss holding regime is one of the very few on-shore systems providing for participation exemption without subject-to-tax requirements or controlled foreign corporation (“CFC”) restrictions. The absence of such anti-abuse provisions makes Switzerland the preferred European holding location for so-called “difficult participations”, i.e. subsidiaries on-shore and off-shore that do not pay (sufficient) corporate income tax in their home country (e.g. a company benefiting from a special tax holiday or other kind of general exemption or a company in a country without normal corporate income such as is often the case in the Middle East or in a tax haven jurisdiction). The position of Switzerland as a holding location is further enhanced by the entry-into-force of measures equivalent to the EC Parent Subsidiary Directive (as described above) which also affects US companies active in Europe. Finally, Swiss holding companies are not only used by US multinational companies, but increasingly also by US resident individual entrepreneurs or private equity investors who are engaged in active business operations in jurisdictions where they would otherwise be facing subject-to-tax questions or CFC issues.

2.2 Swiss holding regime

For qualifying dividends and capital gains derived from participations a Swiss company can generally benefit from a tax deduction, the so-called participation deduction, which is applied at all three tax levels (i.e. federal, cantonal and municipal). Furthermore, at the cantonal and municipal levels a special holding privilege may be available, providing for a full exemption from cantonal and municipal income tax.

2.3 Participation deduction

For qualifying dividends and capital gains, the participation deduction is granted as follows: all income, including all dividends and capital gains derived from participations, is normally included in the taxable income. On this taxable income, the income tax (federal rate 8.5%) is calculated. Subsequently, a deduction of income tax is granted for qualifying dividends and capital gains derived from participations. The deduction is equal to that part of the income tax that is attributable to the net profit of such dividends and capital gains. The question whether the income qualifies for the participation deduction is different for dividends and for capital gains:

(i) In the case of dividends, it means dividends from a participation of which at least 20% of the nominal share capital is held, or alternatively, which has a fair market value of at least CHF 2 million (approx. 1.6 million USD). There is no minimum holding period.

(ii) In the case of capital gains, it means gains on the disposal of at least 20% of the subsidiary’s total nominal share capital. The shares disposed of must have been held for at least twelve months. For the 20% threshold, different disposals in one and the same financial year may generally be added up.

For completeness sake, it should be noted that for a pure Swiss holding company (100% of assets and 100% of income relating to qualifying participations) the participation deduction effectively results in a full exemption. The only tax due in such case is annual net wealth tax at cantonal and municipal level at rates ranging generally from 0.1 to 0.5%.

2.4 Cantonal (and municipal) holding privilege

At the cantonal and municipal level the same participation deduction system as described above for federal tax purposes is available. However, an even more favorable tax treatment can be obtained under the so-called holding privilege providing for a full exemption from cantonal (and municipal) income tax for all income, including dividends and capital gains from any kind of participation. On the basis of harmonized cantonal tax law, a Swiss company qualifies for this special holding privilege if its assets consist for at least 2/3 of participation assets or, alternatively, if its income consists for at least 2/3 of participation income. Advance confirmation can be obtained from the cantonal tax authorities to secure that the holding privilege is indeed applicable.

3. SOME TYPICAL SWISS TAX ISSUES IN RELATION TO THE US

3.1 Swiss dividend withholding tax

A Swiss company paying a dividend generally needs to withhold and pay 35% tax to the Swiss Federal Tax Administration and the foreign recipient can subsequently apply for a partial or full refund based on the provisions of a tax treaty, if and to the extent applicable. In relation to US shareholders, the US-Swiss tax treaty determines that Switzerland is allowed to levy 15% withholding tax on dividends, unless the US shareholder is a company (beneficially) owning at least 10% of the voting stock of the company paying the dividends, in which case Switzerland can only levy 5% withholding tax. The US shareholders need to apply for the partial refund they are entitled to (20 or 30%, respectively), unless relief at source is available (see below).

3.2 New reporting rules and relief at source for Swiss dividends

Since January 1, 2005, Swiss subsidiaries can fulfill their withholding tax obligations on dividends paid to foreign parent companies, resident in a country that has a tax treaty with Switzerland by way of a reporting procedure. The foreign recipient of the dividend must have a substantial participation in the Swiss company paying the dividend. This condition is met if the foreign company has at least such a participation that entitles it under the applicable double tax treaty to an additional reduction of, or complete relief from Swiss withholding tax. In the case of a US parent company this implies at least 10% of the voting rights (see above).

3.3 Swiss withholding tax claim on capital surplus

Swiss tax law determines that any payment by a company to its shareholders that does not represent a repayment of nominal share capital is subject to a 35% dividend withholding tax claim. This (too) narrow definition has a rather peculiar effect in the sense that repayment of capital surplus (or “share premium”) is considered a taxable distribution rather than a repayment of paid-in capital. This problem arises, among others, if an application is made for a merger or reorganization exemption (e.g. to avoid the 1% Swiss capital contribution tax) because under the current practice of the Swiss Federal Tax Administration the amount of nominal share capital created in an exempt merger or reorganization is generally restricted (e.g. at maximum 15 or 30% of all value contributed). The remainder will have to be booked either as capital surplus, with the withholding tax claim, or as a debt which would typically create taxable interest income in the hands of the shareholder. Only if a shareholder can claim full relief from Swiss withholding tax this problem does not
really materialize, but US tax payers are typically subject to a 15 or a 5% Swiss withholding tax. As the Swiss withholding tax on repayment of capital will normally not be creditable against US income tax, this represents an additional tax burden for them. The use of a hybrid instrument (i.e. debt for Swiss tax purposes, but equity from a US tax perspective) could be considered to mitigate this problem.

3.4 Swiss company as a Qualified Foreign Corporation

The Jobs and Growth Tax Relief Reconciliation Act of 2003, enacted in the US on May 28, 2003 and effective as of January 1, 2003, generally provides that a dividend paid to an individual shareholder from either a domestic corporation or a “qualified foreign corporation” is subject to tax at the reduced rates applicable to certain capital gains, i.e. at a maximum tax rate of 15%. A qualified foreign corporation includes certain foreign corporations that are eligible for benefits of a comprehensive income tax treaty with the United States which the Secretary determines is satisfactory for purposes of this provision and which includes an exchange of information program. On October 20, 2003, the IRS confirmed that the treaty with Switzerland meets these requirements, which means that dividends from a company that is resident of Switzerland under the treaty and that meets all requirements of the treaty, including the applicable limitation on benefits provision, are taxed in the hands of a US resident individual shareholder at a maximum rate of only 15%. The 15% Swiss dividend withholding tax (see above) should in principle be fully creditable against US income tax. This particular new feature under US tax law is responsible for a renewed interest in Swiss companies for US individual investors.

3.5 Entity classification (“check-the-box”) and the preferred use of a GmbH/Sàrl/SAGL

When setting up a Swiss company, US investors, both corporate and private, generally prefer to use the Swiss GmbH/Sàrl/SAGL, a limited liability company, which entity is eligible for partnership treatment under US entity classification rules, instead of e.g. the AG/SA, a corporation, which is a so-called per se corporation under those rules. This preference relates to the fact that from a US tax perspective, the partnership treatment can provide greater flexibility and may avoid certain concerns (e.g. in connection with the US CFC rules known as “Subpart F”). A particular Swiss tax problem with the GmbH/Sàrl/SAGL, however, is the legal maximum nominal share capital of 2 million CHF (approx. 1.6 million USD). Shareholder equity contributions in excess of the legal maximum (or in excess of the allowed nominal capital under a facilitated merger or reorganization, see above) will have to be booked as capital surplus (“share premium”). Such capital surplus is subject to the Swiss dividend withholding tax claim described above and US shareholders should therefore consider making “hybrid” contributions, i.e. debt from a Swiss tax perspective but equity for US tax purposes.

3.6 Base erosion test and anti-conduit regulations

The US-Swiss LOB provision contains a base erosion test determining basically that not more than 50% of the gross income of an entity can be deducted for tax purposes and paid out to non-residents of either state. In addition, the anti-conduit regulations under US domestic tax law will need to be taken into account and the combined application of both sets of rules means that Swiss entities licensing or financing into the US can generally not make use of sublicensing agreements or (re)funding in relation to US source royalties or interest income. This further implies that for US source income, the best option would normally be either a) a Swiss company owning the intellectual property or loan receivables and benefiting from reduced taxation or b) a Swiss branch (with similar tax benefits) of a foreign company in a jurisdiction that has a more favorable treaty with the US (i.e. without extensive LOB provisions and without a triangular case provision which would make the use of a foreign branch less attractive).

3.7 Some practical LOB questions

Under the additional derivative benefits provision in the US-Swiss Memorandum of Understanding a Swiss company owned for 95% or more by seven or fewer residents of a Member State of the EU or the EEA or a party to NAFTA that has a comprehensive tax treaty with the US providing for at least equivalent benefits, can be granted discretionary treaty relief. This does, however, not help Swiss companies that are not listed and are beneficially owned by a wider group of shareholders, i.e. eight or more persons owning 95% or more. The limitation at seven seems rather arbitrary and the US Treasury Department Technical Explanations do not provide any “justification” other than “the limitation on the number of shareholders is set at seven in recognition of the fact that most of the companies that would want to use this provision will be subsidiaries of EU owners (i.e. in most cases there will be a single owner)”. It seems to be overlooked that a widely owned but not listed company can not qualify under this provision.

The US-Swiss treaty contains a number of provisions dealing with Trusts. In certain cases, however, the question comes up whether the treaty can be applied, for example in the case of a so-called “Grantor Trust” set up by a US resident. For US income tax purposes (but not for estate tax purposes) a Grantor Trust is ignored and the assets remain owned by the Settlor and the income that the Trust generates is taxed in the hands of the Settlor. The problem is that the treaty defines as a resident “a [...] trust, but only to the extent that the income derived by such [...] trust is subject to tax [...] either in its hands or in the hands of its [...] beneficiaries”, which implies that a Grantor Trust of which the income is taxed in the hands of its Settlor (instead of the Trust itself or its beneficiaries) is not a resident for purposes of the treaty. There seems to be no rational explanation for such exclusion.

The recognized stock exchange definition under the US-Swiss treaty contains a limitative enumeration of stock exchanges. Also in connection with the derivative benefits provision, one would rather expect all regulated stock exchanges in the EU, EEA and NAFTA countries to be recognized. There seems to be no reason for excluding e.g. the Brussels, the Toronto and all of the Nordic stock exchanges. In this respect it is encouraging to see that the US Treasury Department seems to recognize these concerns, as for example the 2005 US-Swedish protocol contains the following new definition: “a recognized stock exchange located within the European Union or in any other European Economic Area state or in Switzerland”.

Finally, a particularity with the derivative benefits provision in LOB provisions of US tax treaties with many EU member states is that typically under the ownership tests companies owned by shareholders in EU, EEA and NAFTA countries can qualify, but companies owned by Swiss shareholders can not. Furthermore, the Swiss stock exchange is often not mentioned as a recognized stock exchange. In practice this could imply, for example, that a Swiss multinational would be confronted with US withholding tax issues in case of licensing or financing US subsidiaries through a company in the EU. Under the 2005 US-Swedish protocol this is dealt with by determining that “the term “equivalent beneficiary” means a resident of a member state of the European Union of any other European Economic Area state or of a party to the North American Free Trade Agreement, or of Switzerland”. This new protocol further explicitly recognizes the Swiss stock exchange.