Executive Summary

The Swiss Federal Tax Administration (SFTA) has issued in January 2014 “clarifications” of the existing rules (applied until January 2014). According to the SFTA’s communication, a comprehensive survey and several tax audits of Swiss principal companies in 2012 revealed that the existing guidelines had not always been applied correctly and consistently. As a consequence, the SFTA had drafted the clarifications in order to ensure a consistent application of the existing circular no. 8 / 2001, which sets the guidelines for the taxation of Swiss principal companies for federal income tax purposes. These clarifications referred to:

- exclusivity of distributors;
- remuneration of distributors;
- outsourcing of principal functions;
- mutual agreement procedures (MAP) and advance pricing agreements (APA).

Further to subsequent discussions initiated in spring 2014 with an interest group composed by some of the largest Swiss Principal companies and the Big 4, the SFTA has revisited some of the requirements of the “clarifications” with respect to:

- exclusivity of distributors;
- remuneration of distributors.

The SFTA has communicated the respective clarifications to the cantonal tax authorities in March 2015. The “clarifications” - in their amended versions - shall be applied with immediate effect to all pending and new ruling requests and existing principal rulings shall be aligned starting from 2016 onwards. Existing Swiss principal companies should review their individual set-up in collaboration with their tax advisor in order to be prepared for the upcoming discussions with the Swiss tax authorities.

Detailed Discussion

According to the 2014 and 2015 communications of the SFTA, circular no. 8 / 2001 remains in force and should not be amended. The communication serves in the view of the SFTA as “a clarification” of the existing rules “in order to prevent the abusive application of the international profit allocation” mechanism for Swiss principal companies. It is fair to assume that the clarifications may have an impact on the level of taxation for federal income tax purposes and in most cases will result in a dilution of the benefits available under existing principal rulings. As federal tax is concerned, the impact on the effective tax rate (ETR) may be an increase in a range of 0% to 2.6% for principals with a toll or contract manufacturing arrangement or a 0% to 3.8% increase for pure trading principals.

The cantonal tax authorities have initiated the process to communicate the clarifications to the taxpayers concerned.

Exclusivity of Distributors

The foreign distributors must be “exclusively” engaged in the distribution of goods for, or on behalf of, the Swiss principal or other principal companies within the group. According to the clarification regarding exclusivity, other activities are allowed as long as at least 90% of the distributor’s total income is derived in the long term from the sale of goods for affiliated principal companies.

Remuneration of Distributors

Only trading income of the Swiss principal company that is derived from qualifying distributors will be eligible for the favorable principal allocation. If a distributor does not meet the 90% requirement, the principal allocation should, according to the communication of the SFTA, be disallowed for trading income resulting from this particular distributor. Non-compliance with the 90% requirement in the short term should not be harmful. The evidence to prove the fulfillment of the 90% requirement must be provided by the Swiss principal company for each qualifying distributor in a respective excel sheet based on local financial statements as an enclosure to the tax return.

In its communication, the SFTA indicated certain flexibility to allow for making the necessary operational changes within a reasonable time frame, should certain distributors no longer be able to meet the entry test as a result of the new 90% requirement. In cases where a restructuring of distribution companies (in order to meet the exclusivity test) is overly complex and time consuming and would only be accomplished by the time when Swiss Corporate Tax Reform III is supposed to become effective (i.e. between 2018 and 2020), the SFTA signaled some flexibility for this 90% test not to be enforced (at least for a transitional period). However, individual proofs of the above-mentioned complexity and an agreement with tax authorities will be required in such case.

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just a threshold to measure a maximum acceptable profit margin for the commissionaires/LRDs. The payments made by the Swiss principal company to its related distributors should generally remain tax deductible to the extent they are commercially justified. It appears that the application of a fixed profit margin is, however, problematic as it may lead to discrimination of principal companies operating in high margin sectors, such as the pharmaceutical or high technology industry. One may question as to whether concerns regarding the distributors’ adequate remuneration could be better addressed for economically justified higher returns by applying a certain limit as a safe haven threshold, which would allow for a more flexible and differentiated handling taking into account the actual facts and circumstances of each individual case including the specifics of the industry, the products and the customers.

The information regarding the remuneration of the qualifying distributors must be provided by the Swiss principal company based on a detailed calculation template as an enclosure to the tax return. The template must include all the relevant (consolidated) financial data derived from the local financial statements of the qualifying distributors to enable the review of any remuneration made in excess of the applicable threshold.

It appears that even in its slightly amended form (i.e. the 5% mark-up on higher costs), the 3% test on the gross remuneration of distributions is too restrictive and may lead to a significant loss of the federal income tax benefit for a wide population of the Swiss principal companies.

Outsourcing of Principal Functions
The SFTA puts an increased focus on the level of economic substance required to respect the contractual centralization of functions, responsibilities, and risks in the Swiss principal. According to the communication of the SFTA, the key principal functions should be performed in Switzerland and adequate economic substance should be available to ensure alignment of returns with value creation.

Circular no. 8 / 2001 lists some functions that a principal company may perform. In the case of outsourcing of some key operational principal functions, the SFTA takes the position that the profit generated by the foreign companies for carrying out those functions should be considered in the principal allocation mechanism (resulting in a reduction of the principal allocation by 35 to 50% of the outsourced profit). The view of the SFTA seems to be that all functions listed in circular no. 8 / 2001 are key operational principal functions.

However, outsourcing of functions is at the end a business decision (e.g. costs efficiency for some support activities). Thus, according to the general understanding, only outsourcing of trading related core principal functions should be detrimental and only where such functions were previously defined by a ruling to be core principal functions for the individual principal company’s business to be carried out in Switzerland (as this may differ from company to company). This is in contrast to non-trading related functions such as e.g. manufacturing, administrative functions or financing – that should not adversely affect the principal allocation mechanism. While the SFTA did not yet take a final position in that respect, the consensus of other stakeholders is in any case quite clear that outsourcing of mere auxiliary/administrative functions should not be harmful.

MAP and APA
Diverting from its former position and, as already stated in 2014 communication, SFTA now acknowledge that a corresponding adjustment on the basis of a MAP or an APA should, from a Swiss perspective, not result in the disallowance respectively in a dilution of the principal allocation for the respective income. If intra-group transactions with a foreign distributor are subject to a profit adjustment abroad, a corresponding adjustment in Switzerland should be possible on the basis of a MAP or an APA without jeopardizing the principal allocation.

Next Steps
According to the communication of the SFTA made in 2014, most of the cantonal tax authorities have informed the Swiss principal companies about the “clarifications”. The taxpayers concerned were also invited to fill in a template based on the 2013 financials in order to measure the impact of the “clarifications” on the Principal allocation.

According to the 2015 amended clarifications, a new communication – accompanied by a revised template – is currently being distributed by the cantonal tax authorities to the taxpayers concerned.

In the communication of the SFTA made in 2014 and still valid, it was mentioned that the review of existing principal companies should be done on a case-by-case basis and any particular actions, such as amending existing tax rulings or determining a timeline for necessary changes to align with the clarified rules, should be agreed upon based on the actual facts and circumstances and in consultation with the competent federal tax inspector at the SFTA. The tax authorities also indicated flexibility in terms of timing, should a group be required to restructure its distribution affiliates in order to comply with the new requirements.

According to the communications of the SFTA, the clarifications are immediately applicable to pending and new ruling requests with the Swiss tax authorities. Principal companies, which already benefit from an existing principal ruling, should align to these clarifications from 2016 onwards.

Implications
Given the most recent developments as outlined above, it appears wise that each Swiss principal company should, in close collaboration with their tax advisors, review as soon as possible its centralized supply chain model in light of the mentioned clarifications of the practice guidelines and the upcoming discussions with the Swiss tax authorities. The scope of review should, in particular, include the following elements:

• ensure that the relevant facts as described in the tax ruling are consistent with the actual facts and circumstances;
• review the activities performed by the foreign distributors and ensure compliance with the entry test;
• review the gross margins of the qualifying distributors and examine to what extent a potential excess portion may dilute the principal allocation amount in future fiscal years;
• review nature, extent and impact of key principal functions outsourced to foreign companies, if any;
• adjust the effective tax rates for future tax provision calculations, if necessary;
• establish an appropriate internal documentation and reporting system for Swiss tax compliance purposes in order to be ready with the increased disclosure obligations in connection with the “clarifications”;
• consider mitigation strategies in case of non-compliance with the new requirements;
• identify opportunities to claim a corresponding adjustment in Switzerland through a MAP or consider obtaining a bilateral APA for transactions with related distributors.

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