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Swiss Supreme Court Restates Principles of International Profit Allocation under Swiss Domestic Law

Celine Martin (Homburger) · Friday, October 9th, 2020

Swiss Domestic Law provides for an unlimited personal tax liability for companies if their registered offices or their effective place of management is located in Switzerland. This tax liability however does not extend to permanent establishments abroad.[1] The delimitation methods of the tax liability for permanent establishments in foreign countries is based on the principles of Swiss federal law prohibiting the double taxation between two or more cantons within Switzerland itself.[2] As the methods developed for the intercantonal tax allocation can have inappropriate effects if they are applied to a cross-border relationship without modifications, the Swiss courts' practice considers certain adaptions of said method to be appropriate in international circumstances. In the case at hand, the Swiss Supreme Court has summarized the latest legal status in Switzerland regarding the application of domestic profit allocation methods for cross-border enterprises.

Facts of the case [3]

The two international companies in the case at hand have their headquarters in Switzerland. They belong to a group of companies under a Dutch parent. The companies supply military troops and civilian emergency forces in various crisis areas of the world with food, fuel and other products for daily needs. The corresponding goods are purchased in different countries and transported to the crisis areas. Due to the crisis situation and often limited infrastructure at the location of their activities, a geographically centrally located group company with its registered office in the United Arab Emirates supported the companies with services throughout the process (e.g. sourcing). For storage, treatment and transport of goods, the companies maintained various local infrastructure facilities such as warehouses, bottling plants and pipelines. During the tax periods in question, the focus of the business activities of the companies was in Afghanistan.

With these international activities in crisis areas, the companies had established foreign permanent establishments in the relevant tax periods, especially in Afghanistan as well as in other countries. As there were no double taxation treaties with any of these countries, the taxation and in particular the international tax allocation in relation to permanent establishment countries was exclusively governed by Swiss domestic law.

Based on a lengthy communication process, the companies received tax rulings from the cantonal tax authority with regard to the international allocation of their profits. In particular, the cantonal tax administration informed the companies in two letters that for the purpose of direct federal tax,

“domestic turnover” (corresponding to the costs incurred in Switzerland plus 50%) would be used as the basis for calculating the direct federal tax. For cantonal taxes, a different profit allocation method was applied under the then cantonal tax status.

After several years, the department for the supervision of the cantons of the Swiss Federal Tax Administration (hereinafter “SFTA”) started inquiries and came to the conclusion, that the letters (rulings) of the cantonal tax authority were contradicting the law (international profit allocation rules stated in the DFTA) and therefore qualified as inadmissible and ineffective “tax treaties”. Hence, they were to be revoked retroactively.

Issue at Stake and Decision of the Lower Court

At the heart of the case lies one of the fundamental principles of the Swiss legal system: the protection of confidence (Vertrauensschutz) in an assurance of a competent authority, the assurance here taking the form of a tax ruling. Such protection is given, if – inter alia – the tax ruling is in accordance with the law or, if not, an incorrectness of the tax ruling was not easily recognizable by the company in question acting in good faith.[4] Hence, the courts first had to decide whether or not the rulings were within the scope of the applicable law.

For the purpose of cantonal taxes, the rulings were found to have a basis in the applicable law and therefore upheld by the lower courts.

The treatment of the case for federal direct tax remained disputed. The lower court held that the international profit allocation method provided for in the rulings were against the applicable federal law (FDTA) and therefore inadmissible. However, it also ruled that the profit allocation solution proposed by the tax authority in the original tax assessments (taxing a huge bulk of the profit in Switzerland) was arbitrary and did not correspond to the facts of the case. It therefore ordered the cantonal tax authority to effect an adequate international profit allocation.

The companies appealed this decision to the Swiss Supreme Court with the main request to uphold the rulings based on the principle of confidence.

Principles on the International Profit Allocation stated by the Swiss Supreme Court

The Swiss Supreme Court focused on the question whether or not the rulings were covered by the federal law and principles on the international allocation of profit. For this purpose, it restated the principles on the international profit allocation in Swiss domestic law.[5]

The case at hand is only the second time the Swiss Supreme Court had the opportunity to decide on the allocation of profits of legal entities with unlimited Swiss tax liability to foreign permanent establishments based on domestic law.[6]

In such cases, according to the court’s practice, a two-step approach is necessary: First, the total world income of the company must be determined. Second, the profits attributable to the foreign permanent establishments must be separated from this total profit. It is only in this second step that the above-mentioned profit allocation methods come into effect.[7]

Whereas the law explicitly refers to the principles of Swiss federal law prohibiting the intercantonal double taxation between cantons, it does not describe what is to be understood by these principles. Accordingly, these principles are governed by case law only.

For intercantonal companies, the Swiss courts apply a quota-based approach to allocate the profit of a company between the canton of domicile and the canton(s) with a permanent establishment. The relevant quotas may be determined based on accounting (directly) or, if not possible, through auxiliary parameters (indirectly, e.g. based on turn-over, personnel expenses, location of assets etc.). The same allocation principles, preferably the method based on direct quotas, is applied for an international profit allocation.[8] This method requires a relative autonomy of the permanent establishment with a separate accounting.[9] The allocation of the income is then effected by quotas based on the accounting results.

In the first international profit allocation of the Swiss Supreme Court for a company with its headquarters in Switzerland[10], the judges of Mon Repos considered that the application of the quota-based methods are deemed to no longer be admissible under the current version of the OECD Model Convention.[11] Furthermore, due to multiple deficits of the quota-based methods, there is a general tendency in Swiss literature as well as from the Swiss Federal Tax Administration to apply the direct object-based method which prevails in international law.[12] The Swiss Supreme Court held it to be imperative that a profit allocation for an international airline company had to follow the object-based method with a direct calculation of the profit of the foreign permanent establishments.[13]

In the case at hand, the Swiss Supreme Court did not go quite that far, but reconfirmed its general position that certain amendments to these methods are appropriate and necessary in order to effect an international profit allocation taking into account the economic, legal and social circumstances in international cases.[14]

It drew a line however – due to the explicit reference in the law – stating that the fundamental principles of the intercantonal methods still have to be applied. The court held that one fundamental principle deriving from the systematic understanding of the law[15] is the two-step mentioned above, whereby any profit allocation has to start from the total world income of the company in question.[16]

Decision of the Swiss Supreme Court

In light of the principle of an unlimited personal tax liability in Switzerland for the world income with an exemption for profits of foreign permanent establishments stated in the law, the Swiss Supreme Court concluded that, with regard to direct federal tax, the tax rulings were against the law. They were deemed to operate the wrong way around: instead of basing the calculation on the world income of the companies and then exempt a foreign profit, they rather started with a purely Swiss figure (local cost approach) and calculated the taxable profit in Switzerland without taking into account any foreign figures, be it profit or losses. To that extent, it confirmed the decision of the lower court.[17]

However, for such an “incorrect” ruling to actually be inadmissible, such incorrectness would also have had to be easily recognizable by the companies in question when the rulings were received.[18] As the lower court had stopped its description of the facts and its considerations with the incorrectness of the rulings, the appeal was admitted by the Swiss Supreme Court and the case was referred back to the lower (cantonal) court to determine whether the companies could in fact have easily recognized the incorrectness of the rulings.

Remarks

Whereas Swiss cross-border cases without applicable tax treaties such as the one at hand are becoming ever rarer, the case illustrates the applicable rules for the international allocation of profit under Swiss domestic law. The considerations of the Swiss Supreme Court provide an overview of the relevant principles, as well as the conflict between the explicit reference to the intercantonal profit allocation principles in the wording of the law on the one hand, and a contemporary profit allocation in light of international principles on the other hand. Where the Swiss tax treaties contain profit allocation rules under the current OECD Model Convention, these rules take precedence over the unilateral rules in Swiss law.[19] Due to the nature of the Swiss profit allocation rules with a strict unilateral exemption of profits from foreign permanent establishments, which might even be defined broader than under the international tax treaty rules, even with a tax treaty in place there might still be room for interpretation from an unilateral point of view. It remains to be seen how the Swiss Supreme Court will handle future cases of a similar nature and whether the internationally prevailing allocation method directly based on the permanent establishments' separate accounting will get more credit in the application of general Swiss profit allocation rules as well.

[1] Art. 52 al. 1 Federal Direct Tax Act (FDTA); SR 642.11; the same principle applies for business operations and real estate abroad.
[2] Art. 127 al. 3 Swiss Constitution; SR 101.
[3] Decision of the Swiss Supreme Court 2C_1116/2018 dated 5 August 2020 (decision in German language); see A.-C. for the details of the facts of the case and a summary of the proceedings.
[4] Decision of the Swiss Supreme Court 2C_1116/2018 dated 5 August 2020, cons. 5 f.
[5] Decision of the Swiss Supreme Court 2C_1116/2018 dated 5 August 2020, cons. 7.2 f.
[6] Art. 52 al. 1 DFTA; Decision(s) of the Swiss Supreme Court 2C_151/2017, 2C_152/2017, 2C_178/2017, 2C_179/2017, dated 16 December 2019 (the cases, all united in one decision, concerned the international profit allocation of an international airline company and inter alia the allocation of the profit deriving from the operation of international aircrafts).
[7] Decision of the Swiss Supreme Court 2C_1116/2018 dated 5 August 2020, cons. 7.4.
[8] Decision of the Swiss Supreme Court 2C_1116/2018 dated 5 August 2020, cons. 7.3.2.
[9] Decision(s) of the Swiss Supreme Court 2C_151/2017 et al., dated 16 December 2019, cons. 3.4.
[10] See fn. 6 above.
[11] Decision(s) of the Swiss Supreme Court 2C_151/2017 et al., dated 16 December 2019, cons. 3.5.3.
[12] Decision(s) of the Swiss Supreme Court 2C_151/2017 et al., dated 16 December 2019, cons. 3.5.3 with references.
[13] Decision(s) of the Swiss Supreme Court 2C_151/2017 et al., dated 16 December 2019, cons. 3.9.
[14] Decision of the Swiss Supreme Court 2C_1116/2018 dated 5 August 2020, cons. 7.2.
[15] Art. 52 al. 1 and 3 FDTA.
[16] Decision of the Swiss Supreme Court 2C_1116/2018 dated 5 August 2020, cons. 7.4.
[17] Decision of the Swiss Supreme Court 2C_1116/2018 dated 5 August 2020, cons. 7.6, 7.7 and 8.
[18] Decision of the Swiss Supreme Court 2C_1116/2018 dated 5 August 2020, cons. 8.3.
[19] General precedence of international public law over unilateral law based on Art. 5 al. 4 of the Swiss Constitution.

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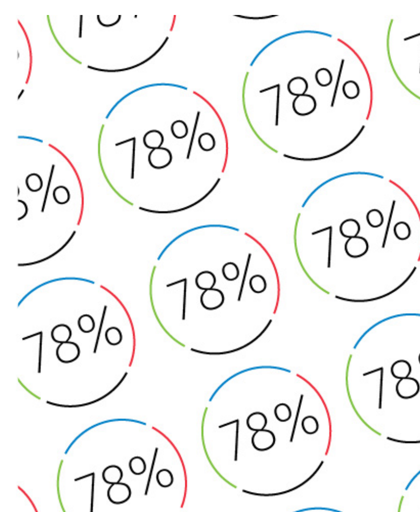

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