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Interest yield from cash pool balances

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In a landmark transfer pricing decision in a tax litigation case that Pestalozzi handled for a multinational group, Zurich Administrative Court has qualified the previous practice of the Swiss Federal Tax Authorities.

General background - "dealing at arm's length" & safe harbour interest rates

According to the "dealing at arm's length principle", service relationships between companies that are part of the same group have to take place under the same conditions as they would between independent third parties.

For cash pool balances, this means that interest must be paid at standard market rates. If the interest earned on cash pool balances is clearly lower than the standard market interest, this has the following tax implications in Switzerland:

- The corporate income tax base is increased by the amount by which the interest falls short i.e. the company that has the cash pool balance is taxed as if it had received interest at the standard market rate.
- At the same time, the assumption is made that there was a dividend distribution in the amount by which the interest actually received falls short of the standard market interest, a distribution which is liable for Swiss dividend withholding tax.

The Swiss Federal Tax Authorities ("Swiss FTA") publish safe harbour interest rates every year, with these recognised as being at arm's length interest rates without any further evidence being provided. The safe harbour interest rates are determined based on returns on long-term investments. As such, the safe harbour interest rates categorically do not apply to receivables with a term of less than 12 months.

If, in individual cases, the interest rates specifically agreed differ from the safe harbour interest rates, it must be proven, in such individual cases, that the interest rate agreed is a standard market rate.

What was the court case about?

A Swiss company forming part of a multinational group of companies took part in a cash pool. The Swiss company therefore had a cash pool balance stretching over a period of several years. These were short-term balances which could be withdrawn within a few days. The cash pool balance bore interest at rates that were below the Swiss FTA’s safe harbour interest rates. By the end of the financial years in question, the cash pool balance amounted to 70% or more than 80% of the Swiss company’s balance sheet total. The tax authorities were of the opinion that there was a long-term loan for the amount by which the cash pool balance never fell short in a particular financial year.

From this, the tax authorities concluded that the company must have received correspondingly higher interest income, in particular an interest rate for long-term loans (as opposed to short-term balances) that is in line with the market. The tax authorities therefore took a view that has been established in Swiss practice for some time now. The tax authorities also believed that there were a relatively narrow range of interest rates that were in line with the market. From this, the tax administration drew the conclusion that, where interest rates differed from the Swiss FTA’s safe harbour interest rates by more than 25%, it would not be possible for the company to provide proof to the contrary (proof that the specifically agreed interest rate is in line with the market). In so doing, the tax authorities adopted a view that has also been in practice for some time now. The company fought both the tax administration’s positions in court. On the one hand, the company was of the view that even if there is a positive cash pool balance spanning several years, one cannot conclude, per se, that there is a long-term loan. The company also submitted evidence to demonstrate that even if there were long-term loans in that specific case, the standard market interest rate would have been significantly lower than the Swiss FTA’s safe harbour interest rates.

What was the court’s decision?

Zurich Administrative Court admitted that the company was correct in that, even if a cash pool balance spanning several years does not fall short of a positive minimum balance, it cannot per se be concluded that there is a long-term loan.

Instead, it would need to be considered what constitutes a suitable liquidity reserve when it comes to forward-looking financial planning. To start, the average cash pool balance must be calculated (arithmetic mean of the cash pool balance at the start and at the end of the financial year). The resulting amount must then be reduced by a further suitable liquidity reserve. This ensures that any intrinsic uncertainty in terms of planning with regard to the actual future liquidity requirement is taken into account. The amount of this liquidity reserve shall be determined in the isolated case in question.

Zurich Administrative Court also admitted that the company was correct in that the Swiss FTA’s safe harbour interest rates have no probative value if the Tax Administration wishes to refute evidence supplied by the company demonstrating that the specific interest rate agreed is in line with the market, since the Swiss FTA’s safe harbour interest rates, naturally, are set without taking into consideration the circumstances at play in the individual case. As a result, the Administrative Court ruled that the interest rate for long-term loans demonstrated by the company was to be recognised as being in line with the market for tax purposes, even if it did differ substantially from the Swiss FTA's safe harbour interest rates.

The court's decision is final.

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