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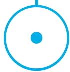

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THE INTERNATIONAL FORUM presents a comparative study of international tax law issues. Detailed responses to each topic are provided by expert practitioners based in major industrial countries.

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International Forum: Entity Classification – Branches, Disregarded Entities and Hybrid Structures

The OECD's recent focus on countering hybrid structures provides a renewed opportunity to explore the laws of different countries that apply to determine the classification of business entities as either transparent (or pass-through) or opaque (subject to entity-level income or profits taxes). Some countries are moving to change their classification regimes to narrow differences between the tax treatment of a foreign entity under their own systems and the treatment under the system of the country in which the foreign entity is resident or was created. Our questionnaire is designed to identify and highlight these rules and any recent changes to them.

I. Classification rules that apply in your home country

A. Does your country have objective rules for the classification of domestic and foreign business entities as being transparent or opaque for local income tax purposes?

B. If so, please describe your country's rules, highlighting any differences between the treatment of domestic and foreign entities.

C. Does the entity-classification system in your country include elective regimes for pass-through (or transparent) treatment?

D. If so, please describe these elective regimes and how broadly they may apply (e.g., are they limited to use by residents?)

E. Does your country permit regulated entities (such as banks or insurance companies) to be treated as flow-throughs for local tax purposes?

F. Where such a regulated entity is a foreign entity, is it permitted to conduct business locally other than through a locally organized entity (e.g., through a local branch of the foreign-organized entity)?

II. Treatment of branches and disregarded entities

A. Does your home country permit the conduct of business through a local branch (inbound investment)?

B. If so, are there any significant limitations?

C. Does your home country have rules for disregarded entities (DREs) (e.g., single-owner transparent entities)?

D. If so, are there any distinctions between the treatment of such DREs and the treatment of branches (inbound or outbound investment)?

III. Special rules relating to hybrid structures

A. Has your home country proposed or adopted any rules recently to address different entity status for foreign and local income tax systems?

B. If so, please describe the new rules, highlighting how they depart from or modify the prior law (or legal approach generally).

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Switzerland

Jonas Sigrist
Pestalozzi Attorneys at Law Ltd, Zurich

I. Swiss entity classification rules

A. Legal entities incorporated under Swiss law

As a general principle, all legal entities incorporated under the laws of Switzerland are subject to corporate income tax, i.e., taxed opaquely, separately from their shareholder(s)/member(s).[1] The organization of private ownership arrangements in Switzerland is governed by federal law, which provides for a *numerus clausus* for legal entities and other ownership structures. Legal entities under Swiss civil law include: an association,[2] a foundation,[3] a company limited by shares,[4] a partnership limited by shares,[5] a limited liability company,[6] a cooperative[7] and an investment company with variable capital (SICAV).[8] Commercial legal entities incorporated under Swiss law usually have the legal form of either companies limited by shares or limited liability companies.

By way of an exception to the general principle of the opaque taxation of legal entities, a collective investment scheme organized in the form of a SICAV is taxed transparently at the level of its investors, except on its income derived from directly-held real estate. A SICAV's income derived from directly-held real estate situated in Switzerland is subject to corporate income tax at the level of the SICAV at a reduced corporate income tax rate.[9] An investment company with fixed capital (SICAF) is taxed opaquely like other Swiss legal entities. Unlike a SICAV, a SICAF is not a separate legal form but is rather a company limited by shares that has the sole purpose of making collective capital investments.[10]

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[1] Swiss Federal Act on the Direct Federal Tax of December 14, 1990 (DBG), art. 49 (1); Swiss Federal Act on the Harmonization of Direct Taxes of the Cantons and Municipalities of December 14, 1990 (StHG), art. 20 (1).
[2] Swiss Civil Code of December 10, 1907 (CC), arts. 60 *et seq.*
[3] CC, arts. 80 *et seq.*
[4] Federal Act on the Amendment of the Swiss Civil Code (Part Five: The Code of Obligations) of March 30, 1911 (CO), arts. 620 *et seq.*
[5] CO, arts. 764 *et seq.*
[6] CO, arts. 772 *et seq.*
[7] CO, arts. 828 *et seq.*
[8] Swiss Federal Act on Collective Investment Schemes of June 23, 2006 (CISA), arts. 36 *et seq*.
[9] DBG, arts. 49 (2) and 72; StHG, art. 20 (1).
[10] CISA, art. 110 (1).

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Apart from where the above exception applies, the income of a legal entity incorporated under Swiss law may be taxed directly at the level of its shareholder(s)/member(s) only in exceptional circumstances:

- Where a transaction between the legal entity and one of its shareholders, members, or other affiliates is not at arm's length and income of the legal entity is therefore attributed to the shareholder/member/affiliate; or
- Where there is an obvious abuse of law. In a situation in which a shareholder/member repeatedly fails to respect the separate personality of the legal entity and disposes of the legal entity's assets as if they were his or her own, the authorities may "pierce the corporate veil" and tax the entity's income and assets directly at the level of the shareholder/member. Such cases are, however, very rare.[11] The sole shareholder of a legal entity complying with capital protection and other key rules under Swiss corporate law generally faces no risk that the existence of the legal entity will be called into question for Swiss income tax purposes.

B. Legal entities incorporated under laws other than those of Switzerland

A legal entity incorporated under laws other than those of Switzerland (a "foreign entity") is generally treated like the Swiss legal entity form to which it is most similar.[12] To the extent a foreign entity's income is subject to taxation in Switzerland, the foreign entity is therefore generally taxed separately from its shareholder(s)/member(s). A foreign entity is considered tax resident in Switzerland and therefore subject to Swiss corporate income tax if its place of effective management is in Switzerland. A foreign entity that has its place of effective management outside Switzerland is subject to limited Swiss corporate income taxation to the extent it derives income from a permanent establishment (PE) in Switzerland (see II.A, below), from Swiss real estate, from rights *in rem* in Swiss real estate, from claims secured by Swiss real estate, or from trading in or intermediation with respect to Swiss real estate.[13]

As regards the similarity of foreign entities to Swiss legal entities, the following categorization is generally relevant:

- Similarity to a Swiss commercial company/corporate vehicle (company limited by shares, partnership limited by shares, limited liability company, cooperative): this results in opaque taxation at ordinary corporate income tax rates and in eligibility for the participation reduction for dividend income from, and capital gains on, qualifying shareholdings, which usually results in a virtual tax exemption for such dividend income and capital gains).
- Similarity to a Swiss collective investment scheme: this results in opaque taxation if the foreign entity concerned is similar to a SICAF and/or if it is directly invested in real estate. Otherwise, the foreign entity is treated as a flow-through vehicle for Swiss income tax purposes.
- Similarity to any other Swiss legal entity (mainly associations and foundations): this results in opaque taxation at lower corporate income tax rates but not in eligibility for the participation reduction (i.e., dividend income from, and capital gains on, all shareholdings of the foreign entity are taxable).

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[11] Decisions of the Swiss Federal Supreme Court BGE 136 I 65, consideration 5.4; 132 III 489, consideration 3.2; 131 II 627, consideration 5.2; 126 I 122, consideration 5b; 109 Ib 110, consideration 3; 103 Ia 20, consideration 4; 102 Ia 468, consideration 4.

[12] DBG, art. 49 (3); StHG, art. 20 (2).

[13] DBG, arts. 50 *et seq.*; StHG, arts. 20 *et seq.*

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For a foreign entity to be classified as a legal entity for Swiss income tax purposes, it must in any case have its own legal personality separate from its member(s)/shareholder(s) according to the laws under which it was established. According to more recent practice, however, the possession of separate legal personality alone is not sufficient for a foreign entity to be classified as a legal entity for Swiss income tax purposes. Rather, an overall analysis of all the circumstances needs to be performed that also takes into account the income tax treatment of the legal entity in its country of incorporation, as well as the features of the entity under the applicable laws of incorporation. In a situation in which: (i) a foreign entity has no organizational independence from its shareholder(s)/member(s) like a Swiss legal entity; and/or (ii) the entity is not subject to corporate income tax under the applicable foreign laws, the Swiss authorities or courts may conclude that the foreign entity is more similar to a Swiss flow-through vehicle than to a Swiss legal entity. In such circumstances, the foreign entity is treated like a partnership or sole proprietorship for Swiss tax purposes, despite being a separate legal entity.

Swiss income tax classification of a foreign entity as a legal entity may typically be rejected in situations in which the entity is involved only in making passive investments (rather than any operational business activity) and the shareholder(s), member(s), or settlor(s) have extensive rights or abilities to control the entity. In practice, this is most relevant for:

- U.S. limited liability companies (LLCs) and S-corporations that are not subject to U.S. federal income taxes;[14] and
- Foundations controlled by their settlors and establishments with undivided capital established under the laws of Liechtenstein that are not subject to ordinary corporate income taxation in Liechtenstein.[15]

As a result of the practice described above, the Swiss tax treatment of Swiss tax residents' equity interests in foreign entities that are not subject to tax under the applicable foreign laws may be uncertain. It is generally possible to remedy this uncertainty by obtaining a tax ruling from the competent cantonal tax administration. Ruling practice, however, is not always consistent. For example, the author is aware of tax rulings concerning similar Delaware LLCs that are disregarded for U.S. federal income tax purposes, some of them confirming taxation of the LLC concerned as a legal entity and others treating the LLC concerned as a flow-through vehicle for Swiss income tax purposes.

C. Partnerships and trusts

"Swiss" partnerships and other vehicles without legal personality separate from their owners are always taxed transparently at the level of their partners/owners.[16] "Foreign" commercial partnerships and other "foreign" companies without separate legal personality, however, are taxed opaquely like legal entities for

[14] Decisions of the Swiss Federal Supreme Court 2C_895/2013 of September 18, 2015; 2P.318/2005 of December 13, 2005.
[15] Decisions of the Swiss Federal Supreme Court BGE 107 Ib 309; 2C_564/2017 of April 4, 2019; decision of the Zurich Administrative Court SR.2015.00036 of November 16, 2016.
[16] DBG, art. 10.

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Swiss income tax purposes.[17] Swiss income tax legislation does not define what "foreign" means in this context. Views differ as to the relevance of: (i) the laws governing a partnership's organization; (ii) the place of the partnership's business; and (iii) the place of the partners' tax residence.[18]

According to prevailing practice, a partnership is considered foreign for Swiss income tax purposes to the extent its income is attributed to a partner/owner that is tax resident outside Switzerland. That is, opaque taxation at the level of the partnership applies to the extent the partnership's income is subject to tax in Switzerland, while the partner to whom such income is attributed is not tax resident in Switzerland (this is typically the case if the partnership has a fixed place of business in Switzerland). To the extent a partnership's income is attributed to a partner/owner that is tax resident in Switzerland, however, the income is taxed transparently at the level of that partner. This is the case regardless of whether the partnership is organized under Swiss or foreign law and/or whether it is managed in or outside Switzerland (it should be noted in this context that income attributed to a PE outside Switzerland is unilaterally exempt from Swiss taxation, see II.B., below).

If a Swiss tax resident partner is an individual, income attributed to the partner is generally classified as income from independent personal services, regardless of whether the partnership income is derived from personal activities and/or from a passive investment. That is, the partnership income is generally subject to ordinary individual income taxation (in most cantons at progressive rates), as well as subject to Swiss social security contributions (without cap). If a Swiss tax resident partner is a legal entity, the attributed partnership income is generally subject to ordinary corporate income tax (it should be noted that Swiss corporate law does not allow a legal entity to be a partner of a Swiss unlimited partnership or a general partner of a Swiss limited partnership other than for regulated collective investment purposes[19]).

Mere joint-ownerships/simple partnerships and trusts are always taxed transparently, regardless of whether the owners are tax resident in or outside Switzerland. In the absence of domestic trust legislation, a trust cannot be established under Swiss law. The Swiss tax authorities classify trusts for Swiss tax purposes on a case-by-case analysis as either revocable, irrevocable fixed interest or irrevocable discretionary trusts. Depending on this classification, taxation applies at the level of the settlor or at the level of the beneficiaries, but never at the level of the trustee.[20]

D. No elective regimes

There are no elective regimes in Switzerland. Thus, a legal entity incorporated under Swiss law cannot opt to be disregarded for tax purposes or otherwise to be treated transparently. Even if the tax authorities pierce the corporate veil in the case of an obvious abuse (see I.A., above), neither the legal entity nor its shareholder/member is entitled to claim transparent taxation.[21]

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[17] DBG, arts. 11, 49 (3); StHG, art. 20 (2).

[18] Silvia Hunziker/Jsabelle Mayer-Knobel, in: Martin Zweifel/Michael Beusch (ed.), Kommentar zum Bundesgesetz über die direkte Bundessteuer, 3rd edition, Basel 2017, art. 11 no. 3.

[19] CO, arts. 552 (1) and 594 (2); CISA, art. 98 (2).

[20] Circular no. 30 of the Swiss Tax Conference regarding the taxation of trusts of August 22, 2007.

[21] Decision of the Swiss Federal Supreme Court BGE 136 I 65, E. 5.4.

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In principle, the only way to achieve transparent taxation is to operate a business/investment through a partnership or sole proprietorship instead of through a legal entity. There are, however, a number of reasons why it is usually more tax-efficient to operate a business/investment through an opaquely taxed legal entity:

- All active and passive income derived from a partnership or sole proprietorship is generally subject to social security contributions. In the case of a legal entity, social security contributions only apply to (formal and constructive) salary payments made by the entity to its employees.
- Dividend income derived from shareholdings of at least 10% usually benefits from a substantially lower income tax rate when it is derived by an individual.
- Corporate income tax rates are usually significantly lower than the income tax rates applying to individuals.
- Capital gains derived from the sale of privately held shares are generally tax-free, while capital gains from the sale of the assets of a partnership or sole proprietorship are subject to income tax.

The Swiss tax classification of a foreign entity that lacks features similar to those of a Swiss legal entity and/or is not subject to foreign corporate income tax can be unclear (see I.B., above). When applying for a tax ruling or discussing the classification of such an entity with the Swiss tax authorities, the member(s)/shareholder(s) of the entity may therefore have a certain amount of leeway in moving the classification of the entity in such a direction as to achieve either opaque or transparent taxation.

E. Regulated entities and branches

1. Collective investment schemes

Swiss tax law provides specific rules for collective investment schemes. Opaque taxation applies to SICAFs as well as to income derived from directly held real estate by all collective investment schemes irrespective of their legal form (see I.A., above). Transparent taxation at the level of the Swiss tax resident investors applies to all other income of all collective investment schemes other than SICAFs. The Swiss tax authorities classify as collective investment schemes all vehicles with such purpose that have authorization for distribution from the Swiss Financial Market Supervisory Authority (FINMA) in Switzerland. The taxation of a foreign collective investment scheme depends on whether it is more similar to a SICAF (i.e., a closed-ended fund organized as a legal entity) or to any other legal form of Swiss collective investment scheme (such as a contractual fund (FCP), a limited partnership for collective capital investment or a SICAV).[22] A foreign vehicle that has no license from FINMA for distribution as a collective investment scheme in Switzerland will still be treated by the Swiss tax authorities as a collective investment scheme if it is similar to a Swiss collective investment scheme (depending on its purpose, activities, regulatory status abroad, and typical bodies such as asset manager and custodian bank).[23]

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[22] CISA, arts. 7 *et seq.*

[23] Circular no. 25 of the Swiss Federal Tax Administration regarding the taxation of collective investment schemes and their investors of February 23, 2018, ciph. 3.1 and annex IV.

2. Other regulated entities

Swiss tax law does not contain any rules that would preclude regulated vehicles from being taxed transparently. That is, only regulatory requirements restricting the legal form for a regulated business may limit transparent taxation.

Swiss financial market regulation legislation does not provide for any specific restrictions regarding the legal form of banks. A bank established under Swiss law can therefore either be organized as a commercial legal entity (a company limited by shares, a limited liability company, a partnership limited by shares or a cooperative), as a commercial partnership (an unlimited partnership or a limited partnership) or as a sole proprietorship.[24] Traditionally, many privately-owned Swiss banks were organized in the legal form of unlimited partnerships and treated as flow-through vehicles for Swiss income tax purposes. The owners' unlimited personal liability for their bank served as a promotional tool. While around 80 Swiss private banks have been organized in the legal form of unlimited partnerships in the past, only around five still remain in that form today. Most privately-owned banks converted into companies limited by shares, because most owners nowadays consider the organization of a bank as an unlimited partnership too risky and outmoded. Significant reductions in the ordinary corporate income tax rates and tax discounts for dividend income have also eroded the fiscal benefits of being organized as a flow-through vehicle.

Since insurance companies must be organized either as companies limited by shares or as cooperatives,[25] all insurance companies established under Swiss law are taxed opaquely.

3. Swiss branches of foreign legal entities

Switzerland generally places no limitations on the business activities of Swiss branches of foreign legal entities. Subject to restrictions on foreigners and foreign controlled vehicles investing in Swiss real estate,[26] a Swiss branch of a foreign entity (or of a foreign partnership or foreign sole proprietorship) is generally allowed to carry on any (regulated or unregulated) activity subject to the same requirements as apply to a legal entity established under Swiss law. Foreign banks and insurance companies often operate through branches rather than through subsidiaries in Switzerland to facilitate compliance with solvency and equity requirements. While a foreign insurance company operating in Switzerland must be organized in a legal form similar to a Swiss company limited by shares or to a Swiss cooperative, there is no such requirement for foreign entities operating in other sectors.

Swiss branch structures often raise more complicated questions under Swiss tax, corporate and regulatory legislation than do Swiss subsidiaries of foreign parent companies. It is therefore usually more efficient and

[24] Swiss Federal Act on Banks of November 8, 1934, art. 1 (1).

[25] Swiss Federal Act regarding the Supervision of Insurance Companies of December 17, 2004, art. 7.

[26] Swiss Federal Act on the acquisition of real estate by persons from abroad of December 16, 1983.

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more common for a foreign entity to establish a Swiss subsidiary rather than a Swiss branch. The main reasons for establishing a branch rather than a legal entity in specific circumstances include the desire to:

- Avoid having to comply with the solubility and equity requirements for a separate subsidiary applying to regulated companies;
- Avoid Swiss dividend withholding tax on profit repatriations;
- Consolidate tax losses;
- Achieve more flexibility under foreign corporate law; and
- Achieve simpler and swifter exit/liquidation.

II. Treatment of branches/permanent establishments

"Branch" is a term used for Swiss corporate law rather than for Swiss income tax purposes. A branch is a place of business separate from the head-office of a vehicle, with the branch having a certain degree of economic independence.[27] Branch offices situated in Switzerland (of both Swiss and foreign entities, partnerships and sole proprietorships) must be registered with the Swiss commercial register.[28] A place of business that is geographically separate from the head-office of the entity of which it is a part but that has no economic independence is generally not classified as a branch and requires no registration with the Swiss commercial register. The commercial register authorities generally register any branch without scrutinizing its activities and functions.

For both Swiss domestic and international tax law purposes, it is the term "permanent establishment" rather than the term "branch" that is relevant. Under Swiss domestic tax law, "a permanent establishment is a fixed place of business, in which the business operations of an enterprise or of an independent profession are wholly or partially carried out. Permanent establishments particularly include branches, manufacturing plants, workshops, points of sale, permanent representations, mines, as well as construction sites lasting for at least twelve months."[29] The Swiss domestic law PE concept is broadly the same as the PE concept under Article 5 of the OECD Model Convention, subject to the following principal differences:

- A Swiss domestic law PE always requires a fixed place of business. Thus, a dependent agent does not give rise to a PE in Switzerland, unless it is acting through a fixed place of business in Switzerland;
- Merely auxiliary activities may still give rise to a PE under Swiss domestic tax law; and
- For a Swiss tax resident legal entity to have a PE in a canton different from the canton in which its place of effective management is located requires that the PE have a certain level of significance – in both qualitative and quantitative terms. There is generally no such threshold for the existence of a Swiss PE of a vehicle that is not tax resident in Switzerland.

A PE does not necessarily have to be registered as a branch. If a branch registers with the Swiss commercial register, however, the Swiss tax authorities usually take the view that the branch gives rise to a Swiss PE. However, where a foreign vehicle does not carry on any business activities through its Swiss-registered

[27] Decisions of the Swiss Federal Supreme Court BGE 117 II 85, consideration 3; 108 II 124 consideration 1.
[28] CO, art. 931 (2).
[29] DBG, arts. 4 (2) and 51 (2); StHG.

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branch office, it could be argued that the branch does not give rise to a PE.

A. Inbound: Swiss permanent establishment of a company that is tax resident outside Switzerland

If a foreign legal entity has a fixed place of business in Switzerland that qualifies as a PE, the income and net equity attributed to the PE is subject to Swiss corporate income and capital taxes,[30] unless the entity is tax resident in a jurisdiction with a tax treaty with Switzerland that restricts Switzerland's taxing rights in these circumstances. Such a restriction generally applies if the PE's activities are of a merely auxiliary nature in terms of Article 5(4) of the OECD Model Convention.

It has consistently been Swiss practice to attribute income of a foreign legal entity that has its place of effective management outside Switzerland to a Swiss PE based on a direct method.[31] Thus, Swiss practice widely follows the authorized OECD approach (AOA) concerning Article 7 (2) of the OECD Model Convention[32] and basically treats a Swiss PE of a foreign vehicle as if it were a separate entity for income and capital tax purposes. If a Swiss PE has branch accounts in which its transactions are recorded in a manner that respects the arm's length principle – including fictional transactions with divisions of the same entity that are not part of the Swiss PE based on a function analysis – Swiss income taxation is imposed based on the branch accounts. If there are no branch accounts, taxation is usually imposed in accordance with the OECD transfer pricing guidelines, with the cost plus method often being used for smaller PEs.

Unlike in the case of outbound situations (see II.B., below), a Swiss PE of a foreign entity that is tax resident outside Switzerland cannot claim losses suffered outside Switzerland. That is, the income attributed to the Swiss PE is subject to corporate income tax regardless of the foreign entity's overall profit or loss position. The Swiss Federal Supreme Court has ruled that this distinction between inbound and outbound situations does not constitute discrimination in violation of Switzerland's tax treaties.[33]

B. Outbound: permanent establishment outside Switzerland of a Swiss tax resident company

Swiss domestic tax law unilaterally exempts income of a Swiss tax resident legal entity that is attributed to a PE outside Switzerland.[34] For purposes of allocating income to a PE outside Switzerland, Swiss domestic tax law refers to the practice developed for purposes of allocating profit for tax purposes between head-offices and PEs in different cantons within Switzerland.[35] These rules deviate from direct allocation in accordance with the AOA. Instead, the method used for the intercantonal tax allocation is a prorated allocation of the entire profit of a legal entity to all its sites. If an entity draws up separate branch accounts for its PE(s), the tax allocation of the entire profit generally conforms to these branch accounts. However, there is no requirement under Swiss law to draw up separate branch accounts. If there are no branch accounts, the income allocation is made based on auxiliary factors, generally turnover in the case of income from services, and the location of

[30] DBG, art. 51 (1)(b) and (2); StHG 21 (1)(b).

[31] DBG, art. 52 (4), decision of the Swiss Federal Supreme Court 2C_1116/2018 of August 5, 2020, consideration 7.3.2.

[32] OECD, Model Tax Convention on Income and on Capital, Condensed Version 2017, p. 177 *et seq*.

[33] Decision of the Swiss Federal Supreme Court 2P.140/2005/leb of November 28, 2005, consideration 4.

[34] DBG, art. 52 (2).

[35] DBG, art. 52 (3).

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the production factors, assets, employment costs and rental costs in the case of income from manufacturing activities.[36] In its decision of August 5, 2020, the Swiss Federal Supreme Court confirmed that the rules regarding the allocation of income between cantons for PE taxation purposes generally apply to the allocation of the income of Swiss tax-resident companies with PEs outside Switzerland.[37]

A Swiss head-office can set off losses incurred by a foreign PE against its taxable income, provided such losses have not yet been set off against income in the jurisdiction in which the PE is situated. If and when the PE derives net income (i.e., rather than incurring a loss) during any of the seven years following the deduction of PE losses by the Swiss head-office, Swiss income taxation applies with respect to the PE's losses that were deducted by the Swiss head-office.[38]

The rules contained in Switzerland's tax treaties prevail over the Swiss domestic tax allocation rules. Thus, the allocation of income should generally be made using a direct method in accordance with the AOA whenever a PE is situated in a jurisdiction that has a tax treaty with Switzerland that includes a provision in line with Article 7 (2) of the OECD Model Convention.[39] Where a company draws up separate branch accounts, the tax allocation based on the AOA usually produces the same result as a tax allocation based on Swiss domestic tax rules.

C. Permanent establishments of transparently taxed structures

The rules outlined in this section regarding the attribution of income to Swiss PEs of foreign legal entities (outbound situations, as outlined in II.A., above) as well as those regarding the attribution of income to foreign PEs of Swiss tax-resident legal entities (inbound situations, as outlined in II.B., above) also apply to PEs of transparently taxed structures:

- Income attributed to a Swiss PE owned by a foreign partnership, a foreign sole proprietorship or a legal entity reclassified as a transparent vehicle is subject to Swiss corporate income tax at the level of the Swiss PE to the extent the owners of the vehicle are tax resident outside Switzerland. To the extent the owners of such a PE are tax resident in Switzerland, transparent taxation of the PE's income applies at the level of those Swiss tax resident owners.
- Income attributed to a foreign PE owned by a partnership, a sole proprietorship or a legal entity reclassified as a transparent vehicle is unilaterally exempt from Swiss income taxation.

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[36] For more details see Hannes Teuscher/Frank Lobsinger, Martin Zweifel/Michael Beusch (ed.), Interkantonales Steuerrecht, 2nd edition., Basel 2021, § 30 no. 16 *et seq*.
[37] Decision of the Swiss Federal Supreme Court 2C_1116/2018 of August 5, 2020, consideration 7.3.2.
[38] DBG, art. 52 (3).
[39] Stefan Oesterhelt/Susanne Schreiber, in: Martin Zweifel/Michael Beusch (ed.), Kommentar zum Bundesgesetz über die direkte Bundessteuer, 3rd edition, Basel 2017, art. 52 no. 17.

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III. Special rules relating to hybrid structures

Switzerland supports the OECD Base Erosion and Profit Shifting (BEPS) project and implements the minimum standards of the Multilateral Instrument (MLI), but has made a reservation to Articles 2 *et seq.* of the MLI, which address hybrid mismatch arrangements.[40] Switzerland has neither introduced any specific rules addressing situations in which different classifications are given to an entity under Swiss domestic income tax law and foreign income tax law nor does it plan to introduce specific new rules targeting hybrid mismatches in the near future.

Switzerland has neither controlled foreign corporation (CFC) legislation nor any other explicit rules subjecting income to taxation in Switzerland based on its (non-)taxation abroad. The only explicit provision in Swiss tax law that addresses hybrid mismatches was in place long before the development of the BEPS project and relates to the participation reduction for dividend income. Under the Swiss participation reduction rules, dividend income paid by a subsidiary to its Swiss parent company generally benefits from an indirect virtual tax exemption at the level of the Swiss parent. A company subject to Swiss income tax may, however, only claim the participation reduction with respect to income that is not tax-deductible at the level of the payer.[41] Moreover, the participation reduction is denied for distributions made by a foreign entity that is not similar to a Swiss commercial company/corporate vehicle.[42] While taxation of the distributed profits at the level of the distributing foreign subsidiary is not a requirement for claiming the participation reduction, the Swiss tax authorities and courts may also take into account whether the foreign subsidiary is subject to ordinary corporate income tax in making their similarity analysis (i.e., in comparing the subsidiary to a Swiss commercial company/corporate vehicle).

A foreign legal entity engaged in business activities through a fixed place of business in Switzerland that meets the requirements for classification as a PE will be subject to corporate income taxation at the level of the Swiss PE, regardless of whether the foreign entity owning and operating the fixed place of business in Switzerland is classified as an opaquely taxed legal entity or as a flow-through vehicle. If a Swiss tax resident legal entity has a foreign subsidiary that carries on its activities through a fixed place of business outside Switzerland, the classification of the foreign subsidiary is usually not relevant because:

- If the foreign subsidiary is classified as an opaquely taxed foreign legal entity for Swiss income tax purposes, it will not be subject to Swiss income tax. The subsidiary's Swiss parent company will be subject to Swiss income tax on dividend income distributed to it by, and capital gains derived from the disposal of shares in, the subsidiary, but will generally benefit from a virtual tax exemption with respect to such dividend income and capital gains because of the participation reduction.
- If the subsidiary is disregarded and classified as a flow-through vehicle for Swiss income tax purposes, the income attributed to the fixed place of business outside Switzerland will be classified as income attributable to a foreign PE and therefore unilaterally exempt from Swiss income taxation.

[40] Swiss Federal Gazette 2018, pp. 5389 et *seq.*; https://www.sif.admin.ch/sif/en/home/multilateral/unternehmensbesteuerung.html (visited on July 20, 2021).
[41] DBG, art. 70(2)(b); for the application of this rule for cantonal income tax purposes, see Felix Richner/Walter Frei/Stefan Kaufmann/Hans Ulrich Meuter/Tobias Rohner, *Kommentar zum Zürcher Steuergesetz*, 4th ed., Zurich 2021, § 72 nos. 9 *et seq*.
[42] Circular no. 27 of the Swiss Federal Tax Administration regarding tax relief on income from shareholdings of corporates and cooperatives of December 17, 2009, ciph. 2.3.2.

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The foreign entity classification becomes relevant, however, when a Swiss tax resident person owns a foreign vehicle that has no fixed place of business outside Switzerland that is classified as a PE (for example, a mere passive investment vehicle). In such situations, the Swiss tax authorities and courts may consider that taxation may be imposed in Switzerland based on the following approaches:

- Where the vehicle is a legal entity, by reclassifying the entity as a partnership or sole proprietorship and therefore as a flow-through vehicle for Swiss tax purposes (even though the entity has its own legal personality) in situations in which the entity's corporate bodies do not have sufficient organizational independence from the entity's owner(s) and/or where the entity is disregarded for corporate income tax purposes in the jurisdiction of its incorporation or place of effective management (see I.B., above).
- By concluding that the place of effective management of the foreign vehicle is in Switzerland, with the result that the income of the vehicle is subject to corporate income tax in Switzerland.

In either of the above situations, the income of the foreign vehicle only becomes subject to corporate income tax to the extent it cannot be attributed to a PE of the vehicle outside Switzerland. In general, the PE concept is the same in both inbound and outbound situations. Scholars are of the opinion that the same criteria should always apply in determining whether there is a PE in Switzerland as those that apply in determining whether there is a PE outside Switzerland.[43] The Swiss Federal Supreme Court has ruled, however, that the thresholds under Swiss domestic tax law for a PE outside Switzerland may be higher than for a PE in Switzerland. In particular this may be the case if the income of the PE is not subject to tax in the other jurisdiction, because the unilateral exemption under Swiss domestic tax law for foreign PE income is designed to prevent double taxation, not to create double non-taxation.[44]

Jonas Sigrist is a Partner with Pestalozzi Attorneys at Law Ltd, a major Swiss full-service law firm.

[43] Stefan Oesterhelt/Susanne Schreiber, in: Martin Zweifel/Michael Beusch (ed.), Kommentar zum Bundesgesetz über die direkte Bundessteuer, 3rd edition, Basel 2017, art. 52 nos. 6 f.
[44] Decisions of the Swiss Federal Supreme Court BGE 139 II 78 of October 5, 2012, consideration 3.1; decisions 2C_738/2014 and 2C_739/2014 of August 21, 2015, consideration 2.4.

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