Base Erosion and Profit Shifting (BEPS)
Update and possible implications for Switzerland

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Background and core principles of BEPS

Background of BEPS

« Beyond a number of high-profile cases, there is a more fundamental policy issue: the international common principles drawn from national experiences to share tax jurisdiction may not have kept pace with the changing business environment. Domestic rules for international taxation and internationally agreed standards are still grounded in an economic environment characterised by a lower degree of economic integration across borders, rather than today's environment of global taxpayers, which is characterised by the increasing importance of intellectual property as a value-driver and by constant developments of information and communication technologies»

(OCDE, BEPS report , Feb. 2013, p. 49)

Background of BEPS

- ➢**Traditional jurisdiction to tax rules** versus mobile capital and digital economy

- ➢**Separate entity approach** versus limits of dealing at arm's length principle

- ➢**Separate tax basis** versus absence of coordination

- ➢**Traditional harmful tax competition** primarily based on *ring-fencing* criterion versus new forms of preferential regimes (for example « *patent box* »)

Core principles of BEPS Action Plan

- **Coherence:** new international standards must be designed to ensure the coherence of corporate income taxation at the international level

- **Substance:** realignment of taxation and relevant substance is needed to restore the intended effects and benefits of international standards. **Split between income and value creation to be avoided** (minimized), in particular in the area of mobile capital

- **Transparency:** enhancement and development of transparency in key pressure areas (exchange of information on rulings dealing with preferential regimes)

- **Shift to mulilateralism**

Overview of BEPS Action Plan and comparable initiatives at EU level

Overview

Field	BEPS Action Plan	EU
Jurisdiction to tax	**Action 1** : **Digital economy (9.2014); Action 3** CFC rules (9.2015); **Action 6 : Treaty abuse (9.2014)**; **Action 7 :** Artificial avoidance of PE status(9.2015)	**Digital economy expert group** (on going since 10.2013) Recommandation **on aggressive tax planning** (12. 2012)
Taxable basis	**Action 2 : Hybrid mismatches (9.2014)**; **Action 4 :** Limitation on interest deductions and other financial payments (9-12.2015); **Actions 8, 9, 10 et 13 : transfer pricing** (9.2014 to 9.2015)	**Code of conduct** and proposed amendment to parent sub directive re hybrid arrangements (11.2013)
Harmful tax competition	**Action 5** (9.2014-9-12.2015): **substantial activity requirement** (review of patent box regimes in particular)	**Code of conduct** (review of patent box regimes by the end of 2014) and minimum standards of good governance in tax matters regarding third States **State aid** (in particular further impact of Gibraltar II ?)
Implementation	**Action 11** : Data on BEPS (9.2015): **Action 12** : Mandatory disclosure of aggressive tax planning arrangements (9.2015): **Action 14** : Dispute resolution (9.2015); **Action 15** : **multilateral instrument (9.2014-9.2015)**	

Harmful tax competition and patent boxes

Harmful tax competition and patent boxes

- BEPS action plan *"the "race to the bottom" nowadays often takes less the form of traditional ring- fencing and more the form of across the board corporate tax rate reductions on particular types of income (such as income from financial activities or from the provision of intangibles"*

- Action N 5: *Revamp the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes,* ***and on requiring substantial activity for any preferential regime"***

- Shift from traditional ring-fencing criterion to an"**activity nexus test"**

- What about the need to coordinate with Action 3 (CFC rules) ?

Harmful tax competition and patent boxes

➢**Controversial issues**

•**A definition of IP rights** which includes items not necessarily linked to an R&D activity (i.e. for example trademarks, domain names, trade secrets, etc.)

•**Preexisting (acquired) IP** which may benefit from the incentive without any "further development condition".

•**The link with R&D activity** with the entity benefiting from the patent box which is too weak (impact on outsourcing of R&D functions ?)

Harmful tax competition and patent boxes

- **Investigation on UK patent box (October 2013)**

- In the case of outsourcing to a group company, patent box is not necessarily associated with real economic activity and a substantial economic presence in the UK

- Profit calculation not in line with international agreed standards

- **Ongoing work on all European patent box regimes (review of all patent box regimes by the end of 2014)**

- Can a substantial activity test be reconciled with the **fundamental freedoms** and the case law of the CJEU in the area of R&D incentives (absence of explicit or implicit territorial restrictions) and, in the affirmative, under which conditions ?

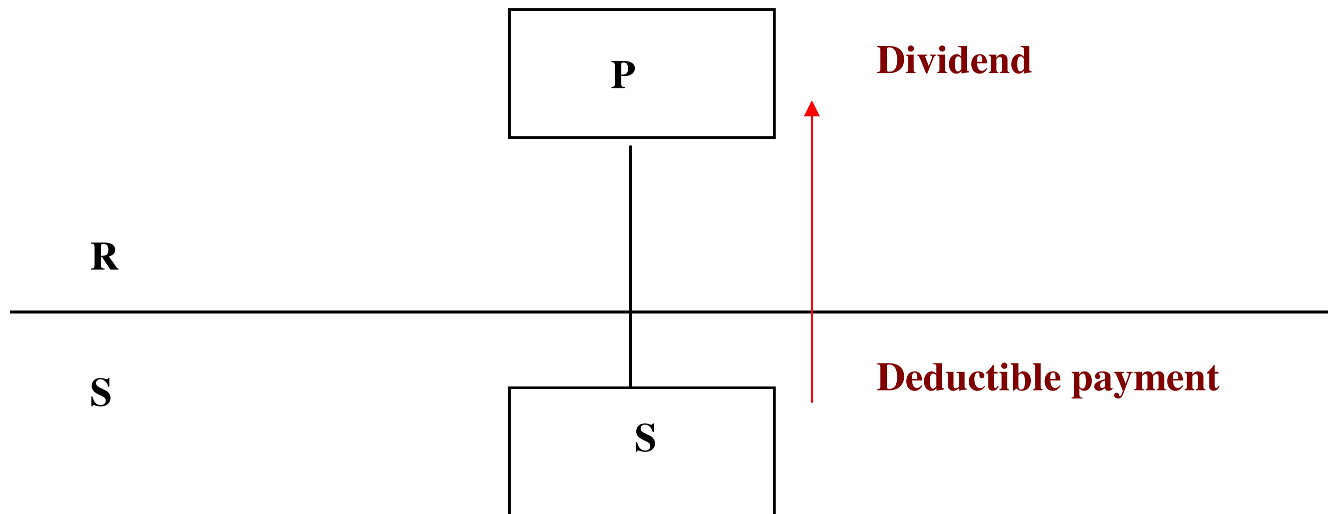
Harmful tax competition and patent boxes – State aid ?

State aid N 480/2007 - Spain	Gibraltar'formal investigation procedure of 16 October 2013
***"the scheme is open to any undertaking subject to corporate taxation in Spain** that develops intangible assets. Indeed, any corporate tax payer, independently from its size, legal structure and sector in which it operates can be the beneficiary (…) **The fact that not every undertaking decides to self-develop a qualifying intangible asset and then receives remuneration for the transfer of the right to use or exploit such asset merely reflects an economic reality**. In particular, the category of secret formulas or processes is so wide and horizontal in nature that it does not result in favoring undertakings which are in a legally or factually comparable position in the light of general policy objective pursued by the measure in question. There is nothing in these materials sent to the Commission by the Spanish authorities that may suggest that the objective of the measure was to make it restricted de facto to a particular group or sectors of undertakings"*	***« concerning the exemption of passive income derived from royalties, the Commission notes that it favors a specific group of undertakings, namely companies that obtain revenue from intellectual property rights… (…) no overall logic justifying the exemption for passive (…) royalty income has been found (….) and « re-establish the effect (…) that offshore companies exercising such activities, continue to benefit from zero taxation »***

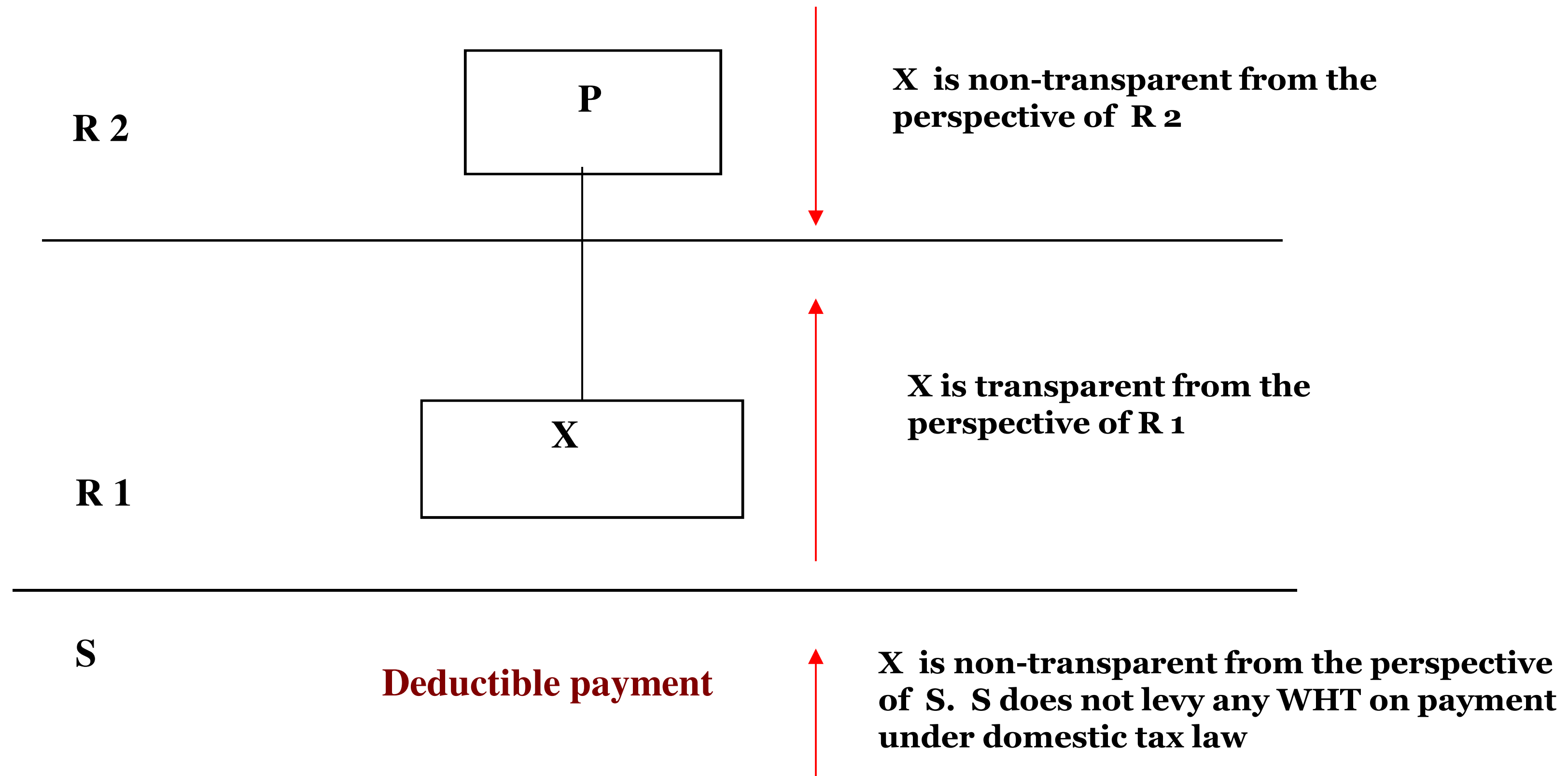
BEPS: implications for Switzerland (selected issues)

Hybrid arrangements – Action 2

Action 2 – Example 1: Hybrid instrument



Action 2 – Example 2: Reverse hybrid



Action 2 – Forthcoming discussion draft

- Forthcoming discussion draft is expected to provide primary and secondary « linking rules »

- Conceivable options are (i) forcing the inclusion in the residence State in the case of deductibility of payment in the source State and (ii) deny the deduction in the source State in the case of dividend characterization in the residence State or absence of fiscal attribution therein (reverse hybrid)

Action 2 – Swiss participation reduction

- **Swiss participation reduction system** (Art. 69-70 DBG) contains already a so-called "linking rule" in the case of deductible payment in the source State. Art. 70(2)(b) DBG indeed provides that: " *Keine Beteiligungserträge sind: Erträge, die bei der leistenden Kapitalgesellschaft oder Genossenschaft geschäftsmässig begründeten Aufwand darstellen »*

- On the other hand**, the law** does not provide any solution with respect to reverse hybrid cases where, for example, Switzerland treats the entity as non-transparent and the source State transparent. Further, under Swiss law, a foreign entity with a legal personality is assimilated to a domestic Swiss corporate entity for tax purposes (Art. 49(3) DBG)

Action 4 – Limitation on interest deductions

- In this area, issues at stake concern in particular

- Identifcation of suitable model: stand-alone versus group-wide approach ?
- Design issues (based on the type of business ?)

- Impact on Swiss thin capitalization rules (Art. 29a StHG and 65 DBG) taking into consideration that such rules are currently based on (i) separate entity approach, (ii) borrowing capacity based on FMV of individual assets and (iii) apply only between related parties ?

Action 5 – Harmful tax competition

- Impact of Action 5 on III Corporate tax reform and licence box regime which Switzerland is now considering

BEPS and exemption method ?

- Under the Swiss corporate tax system, worldwide taxation is strongly limited by the principle of territoriality

- In line with CIN, Profits allocated to a foreign permanent establishment **are unconditionally exempted** (Art. 52(1) DBG). The law does not contain any "switch over clause" as regards low taxed passive income. Recently, however, the Swiss Supreme Court has limited the scope of the exemption method in such a way on the basis however, in our view, of a very controversial **contra legem interpretation** of the statute (BGE 139 II 78)
- With respect to the participation reduction (Art. 69-70 DBG), the lawmaker has not provided any subject-to-tax requirement
- Swiss DTCs generally strictly follow art. 23A OECD MC

- Impact of BEPS ? In particular in triangular cases ? Future of art. 23 A OECD MC ? Impact of Action 6 ?