SWITZERLAND

Swiss Court Decides Landmark Safe Harbor Transfer Pricing Case

by Alexander F. Peter

If administratively set safe harbor interest rates are surpassed, the total arm's-length interest rate can be set below the safe harbor, a Swiss court has ruled, rejecting the taxpayer's claim that only the safe harbor interest excess should be denied.

In a decision (No. 9C_690/2022) dated July 17 and published August 9, the Swiss Federal Supreme Court (Bundesgericht) quashed lower courts' judgments and held that intragroup loan interest rates outside an administratively defined safe harbor range are subject to a full revaluation from an arm's-length point of view. The noncompliance of the taxpayer renders the annually updated administrative circulars of the Swiss Federal Tax Administration nonbinding, the court said.

"The fact that the Federal Supreme Court decided the case with five instead of three judges shows that this is a fundamental and therefore important tax law issue," Thomas Hug of Deloitte's Zurich office told *Tax Notes* on August 15. "This is part of a development in which the tax authorities are increasingly examining transfer prices, and we are therefore also seeing corresponding transfer pricing judgments, which would not have been the case five years ago."

Hug pointed out that the court essentially took a "quid pro quo" approach. "Only if the taxpayer observes the rates, they are binding on the tax authorities. If the taxpayer does not comply, the tax authorities can ignore their circular and determine an arm's-length interest rate as part of the assessment. I would generally consider this to be in line with the OECD's transfer pricing guidelines on safe harbor rules, especially in the context of low-value-added services," he said.

On the other hand, a country's constitution with the therein embedded principle of equal treatment also plays a role, Hug added. "The taxpayer had complained that the tax authorities' assessment violated the Federal Constitution — a small transgression of the safe harbor rules can lead to a massive increase or decrease of the interest rate compared to a company that chooses an interest rate that is within the safe harbor range," he said. "The Federal Supreme Court, however, does not address this. There is no other Swiss court that again examines a violation of the constitution. In this respect, the Federal Supreme Court corresponds to the U.S. Supreme Court."

Scope of Circular's Binding Effect Contentious

In 2013 a foreign corporation, identified only as B AG, transferred its real estate portfolio to the Swiss permanent establishment of a subsidiary abroad (A AG). It then granted A AG an unsecured loan of CHF 500 million ($575 million at current conversion rates) at an interest rate of 2.5 percent and agreed to a current account credit balance in the same amount at an interest rate of 3 percent. The safe harbor interest rates for Swiss francs set by the Federal Tax Administration were between 1.5 and 2.75 percent in 2014 and between 1 and 2.25 percent in 2015, depending on the loan amount and real properties financed. During the assessment procedure, the cantonal tax authorities of Zurich did not consider the interest rates agreed to by the companies to be at arm's length. They determined that the arm's-length rate was only 1.08 percent and assessed a hidden profit distribution equivalent to the difference between the arm's-length and agreed rates.

The A AG appealed to the Zurich Tax Court and averred that the agreed interest rates were a market rates because of government-backed financing and B AG's implicit support, among other reasons. Alternatively, it argued, the safe harbor interest rates for the loans would be 2 percent in 2014 and 1.5 percent in 2015. Therefore, only 0.5 percentage point (2014) on the unsecured loan and 1 percentage point (2014) and 1.5 percentage points (2015) on the current account credit balance were nondeductible, it said.

The tax court in 2021 rejected the petition, saying the administrative circulars are not binding for the tax authorities and constitute only a rebuttable presumption that market rates are different. Thus, the Zurich tax office can deviate from the circulars' rates if the taxpayer, as in this case, does not substantiate the market rate sufficiently, the court said.

On further appeal by A AG, the Cantonal Administrative Court of Zurich in 2022 agreed

(SB.2021.00056) that the taxpayer did not prove its arm's-length claim, although it also — like the tax court — rejected witness testimony offered by A AG for its assertion. The court noted that the safe harbor rates serve to simplify tax administration and guarantee that all taxpayers are treated equally. Since the circulars do not aim to penalize taxpayers, only the excess interest rates can be disallowed, the court ruled, leading to an additional tax liability of CHF 1.15 million for both years combined.

Burden of Proof for Arm's-Length Interest Rate

On appeal by the Zurich tax office, the Federal Supreme Court annulled the 2022 ruling.

However, it did not agree with the office's claim that the circulars apply solely to federal income and withholding tax because cantonal and municipal income taxes are harmonized in Switzerland. The court also rejected the argument that the circulars are mere administrative guidelines without binding authority.

On the other hand, the court found the administrative court's reliance argument in A AG's favor unpersuasive. If a taxpayer like A AG does not observe the safe harbor rules, it cannot expect the tax authorities to adhere to them since it itself did not honor the protection against a detrimental assessment offered for compliant taxpayers, the court reasoned. Further, a noncompliant taxpayer thwarts the administrative simplification purpose because, as in this case, the tax authority must regardless analyze whether the agreed interest rate is in line with the arm's-length principle, the court concluded.

Nevertheless, the tax office, which has the general burden of proof for a profit-increasing assessment, did not sufficiently substantiate its own arm's-length rate interest either, the Federal Supreme Court said. It only assumed a 0.83 percent interest rate based on A AG's refinancing cost and took an additional margin of 0.25 percent from the applicable circulars. The administrative court will have to evaluate this issue on remand, the court said.

The Zurich Tax Court's public liaison officer told *Tax Notes* on August 16 that the administrative court might even refer the case to the tax court for further fact finding.

"It is positive to note that the Federal Supreme Court does not approve of the assumption by the tax court that the tax authority's interest rate is in conformity with the arm's-length principle, considering that it obviously had not carried out a benchmark analysis," Hug said.

The taxpayer in No. 9C_690/2022 was represented by Jonas Sigrist and Pascale Schwizer of Pestalozzi Rechtsanwälte AG. (Schwizer is now with Baker McKenzie.) ■