Swiss Base Company: Tax Avoidance Device for Multinationals

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NOTES

THE SWISS BASE COMPANY:
TAX AVOIDANCE DEVICE FOR MULTINATIONALS*

I. Introduction

Switzerland enjoys a unique position as one of the world's leading tax shelters for multinational corporations. Three major components combine to make Switzerland's tax climate attractive to multinationals. First, the average Swiss corporate tax rate is considerably lower than that in the United States and other European countries. Second, Switzerland has an extensive network of double taxation treaties with other nations. Third, and most important, Swiss tax law provides special privileges and even partial exemption from taxation to foreign-held Swiss "base companies," which may be defined as companies designed to concentrate profits from a multinational's worldwide operations in a low tax jurisdiction. Together, these factors provide tax advantages which have attracted many foreign corporations to Switzerland. However, such arrangements tend to deprive other nations of tax revenue because profit is centralized in Switzerland instead of being taxed outside Switzerland at a higher rate. As a result, many countries, including the United States, have enacted laws to curb the attractiveness of Switzerland as a tax haven; even the Swiss Government has taken steps to prevent abuse of its tax shelter privileges. Such measures have partially reduced Switzerland's tax shelter privileges. Yet its basic tax savings devices remain intact. Therefore, Switzerland continues to offer an attractive tax climate for multinationals wishing to defer taxes. This note examines the extraordinary tax savings which may still be gained by a multinational corporation through the establishment of a Swiss "base company."

II. Significance of the Swiss Base Company

In order to appreciate the significance of the Swiss base company as a tax shelter device, it is important to grasp the desirability of concentrating the profits of a multinational group in a nation with the lowest overall tax burden. The multinational corporation, with income sources from many nations, each with varying tax rates, can reduce its tax liability by pooling group profits in the area of lowest taxation. The wisdom of this activity from the standpoint of profit maximization is apparent. For instance, suppose a multinational parent corporation has its headquarters in the United States but has subsidiaries in several foreign countries. If the profits of those subsidiaries are remitted directly to the parent corporation, they are taxed at the United States rate of 48 percent. But if these same profits are remitted to a Swiss base company, they are then taxed

* Invaluable assistance in the preparation of this article has been made available by the Union Bank of Switzerland. The author, however, takes sole responsibility for any errors.

1 INT. REV. CODE OF 1954, § 11.
at no more than the maximum Swiss rate of 30-40 percent\(^2\) and usually at a much lower rate. The result is that a considerable tax saving is achieved. Earnings which would have otherwise been lost as taxes are then held by the Swiss base company. Of course, these profits kept in Switzerland are unavailable as dividends to the multinational’s parent corporation in the United States. However, this pool of capital concentrated in Switzerland is available for new profitable undertakings among the multinational group. W. A. P. Manser states the matter succinctly:

> It may well occur that a subsidiary, by reason of the success of its operations in one country, may be enjoying a high level of profits. At the same time, a subsidiary in another country may be embarking upon a new capital investment project, or may be encountering a period of transient financial deficit. The surplus resources of the one company can be used to replenish those of the other. In a typical group, simultaneous situations of this sort will be present in different parts of the total network at any given time, and will recur continuously . . . . What is required for the proper coordination and deployment of internally generated resources of this kind is a central clearing house, or treasury.\(^3\)

The Swiss base company acts as this central clearinghouse. If used to its fullest advantage, the fund of capital pooled in the Swiss base company will grow as a result of interest charges and fees paid to the base company by the multinational’s subsidiaries so that when the fund is ultimately returned to the parent corporation, the profit is greater than it would have been had the original profit been remanded directly to the parent without interposition of the base company.

Thus, the Swiss base company achieves two objectives: First, it defers United States taxes, permitting the multinational to pool its group profits; and second, this pool is available for further profitable undertakings before it flows back to the United States parent corporation and is taxed. The fact that many American and German multinationals have established base companies in Switzerland for these purposes attests to their usefulness and popularity. Attention now turns to the Swiss tax concessions which enable base companies to achieve these objectives.\(^4\)

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\(^2\) According to Dr. Kurt Locher, now Director of the Swiss Federal Tax Administration, the average tax incidence for Swiss corporations was about 25-30 percent in 1962. Locher, *Swiss Measures Against Abuse of Tax Conventions*, in *International Bureau of Fiscal Documentation, Swiss Measures Against Abuse of Tax Conventions* 9 (Supplement to the Bulletins for International Fiscal Documentation, Vol. XVI (1963)) [hereinafter cited as Locher]. Swiss tax rates have risen somewhat since then. Now the maximum tax on corporations, depending on the canton, is roughly 30-40 percent. Interviews held with members of the Swiss government, banking and business community, on file at the Notre Dame Lawyer Office.


III. Swiss Tax Concessions

Switzerland is a confederation of over two dozen separate and autonomous cantons. Each canton is composed of municipalities which also retain a measure of autonomy. All of these governmental units levy and collect taxes. The federal taxes have relatively minor impact on corporate income. The major tax burden on corporate income is incurred at the lowest governmental levels, the canton and the municipality. In 1970, for instance, over 80 percent of direct taxes collected by all levels of government were collected by the cantons and municipalities. Therefore, while the federal government grants some tax incentives attractive to base companies, the incentives having the greatest impact on corporate taxes are granted by the cantons and municipalities. The nature of these incentives differs greatly. Most incentives apply categorically to specific types of corporate activity, but the amount of the incentive is dependent on which canton or municipality is chosen as the corporate domicile.5

A. The Federal Level

In order to appreciate the significance of the federal tax concessions, an examination of the Swiss federal tax structure is required. The basic federal tax is known as the Federal Defense Tax, originally a temporary war measure enacted to cover defense expenditures arising from the Second World War but now a permanent source of federal revenue. The Federal Defense Tax has two components: a tax on income and a tax on net worth. Because the cantons and municipalities retain so much tax authority, the federal taxes of Switzerland are low. The federal tax on income at its highest progressive rate is only 8.8 percent and the flat-rate tax on net worth is only 0.0825 percent.6

5 Arthur Andersen & Co., Switzerland, supra note 4, at 1-7, 71-72, 118; 13 European Taxation 200 (1973); Interviews supra note 2.
6 The Federal Defense Tax (Eidgenössische Wehrsteuer; impôt fédéral pour la défense nationale), has two components, one on income and one on net worth.

Income: The income tax element of the Defense Tax is a tax on income according to its relation to the corporation's net worth. It is designed to impose a low tax burden on corporations with a small return on investment and a higher tax burden on corporations with a great return on investment. Computation of the tax on income of a corporation with a net worth of over SFr. 50,000 ($20,000) may be expressed as:

A. A minimum income tax of 3.3 percent;
B. On that part of total profit which exceeds 4.0 percent of net worth (defined as paid-in capital plus reserves) an additional 3.3 tax is levied;
C. And on that part of total profit exceeding 8.0 percent of net worth, an additional 4.4 percent tax is levied;
D. But in any event the total tax may not exceed 8.8 percent of profit, which is reached when profit equals or is greater than 22 percent of net worth.

Net worth: A flat-rate tax on net worth of 0.0825 percent is levied. Net worth is defined as paid-in capital plus reserves. Bianchi, supra note 4 at 3-4; European Taxation, Section A, Switzerland—1, 2 (1974); 2 European Taxation 19-32 (1962); Arthur Andersen & Co., Switzerland, supra note 4, at 71. The Federal Defense Tax is periodically reenacted for a limited term. Under the present act, it will continue until 1982. Bianchi, supra note 4, at 4.
These already low rates of tax are capable of further reduction through the use of federal tax concessions which apply to base companies as well as ordinary corporations that have holdings outside of Switzerland. First, the net worth tax, levied on paid-in capital plus reserves, is not levied on foreign permanent establishments and foreign-situs real estate. This is not an extraordinary exemption. It is granted on the theory that such property will normally be taxed in the foreign country where it is located anyway.

A second, and more significant, federal tax exemption known as the "substantial interest" exemption, reduces a Swiss company's tax base in proportion to the income which it receives from a substantial interest in the capital of another corporation. Since the normal tax base of a Swiss corporation for the Federal Defense Tax is its worldwide income, the relief granted by the substantial interest exemption can be of major importance for a company whose income sources are chiefly, if not entirely, foreign. The exemption will apply if either of two substantial interest requirements is met:

1. The Swiss company holds at least a 20 percent participation in another Swiss or foreign corporation; or

2. the Swiss company holds a participation exceeding two million Swiss francs in another Swiss or foreign corporation.

To illustrate the effect of the substantial interest exemption, suppose that Multinational A has a Swiss base company holding an interest of over 20 percent in a German subsidiary which contributes one-fourth of the Swiss base company's income. In this instance, there will be a reduction of one-fourth in the Swiss base company's Federal Defense Tax. Hence, the effective income tax rate, if levied at its maximum rate of 8.8 percent, would be reduced to 6.6 percent by this exemption. The result should also be considered where the base company derives all of its income from foreign permanent establishments or real estate. If so, all of its income would be exempted from the federal income tax.

The substantial interest exemption is therefore of great significance. It has broad application and may have the effect of substantially reducing, if not entirely eliminating, a base company's liability for federal income tax.

B. The Cantonal and Municipal Levels

Even more generous tax concessions are available to base companies at the cantonal and municipal levels. In the past, cantons and municipalities competed

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7 A permanent establishment in Swiss law consists of (1) a fixed place of business from which the enterprise conducts (2) substantial activities (3) permanently. Merely operating through an agent or using a warehouse outside of Switzerland will not qualify. TAXATION IN SWITZERLAND, supra note 4, at 75; ARTHUR ANDERSEN & Co., SWITZERLAND, supra note 4, at 93.

8 ARTHUR ANDERSEN & Co., SWITZERLAND, supra note 4, at 73.


10 See note 9 supra.
with each other to offer attractive tax concessions in order to bring investment to their locality. Multinational corporations could "canton shop" to find the best possible domicile for tax purposes. Such concessions, more difficult to find today, have been provided in two ways. First, many cantons and municipalities have made statutory provision for base companies which are typically given tax incentives so long as their business operations remain outside Switzerland. Second, multinational corporations have negotiated directly with cantonal and municipal authorities for tax concessions. The type of concessions granted also varies. While the decentralization of Swiss taxing authority among 25 cantons and hundreds of municipalities makes it difficult to make broad generalizations, very often the following types of concessions have been granted: (1) exemption from cantonal and municipal income taxes and a reduced rate of cantonal and municipal net worth taxes or (2) a lump-sum tax payable yearly.

At this point, a closer examination of cantonal and municipal taxation is required. The basic forms of taxation remain approximately the same as at the federal level. Both an income tax and a net worth tax are levied. But there the similarity ends, for the overall tax burden, formula for tax assessment, and types of concessions granted are very dissimilar.

Most Swiss cantons and municipalities have a two-part formula for determining the income or net worth tax. The first step of the formula is to apply the basic tax rate fixed by cantonal law. The canton of Zurich, for instance, has a progressive income tax rate which may vary from as little as 2.3 percent to as great as 11.5 percent. This basic rate is used by both the canton and the municipality, so that the combined basic income tax rate could reach as high as 23 percent. The second step in the formula is for the canton and each municipality within the canton to periodically establish a coefficient, or "multiple," by which the basic rate above is multiplied to determine the actual tax. The multiple currently used in the canton of Zurich is 1.20; the multiple used by the municipality in which the city of Zurich is located is 1.49. Thus, the effective maximum tax in the canton of Zurich was the basic tax of 11.5 percent multiplied by 1.20 or 13.8 percent. Likewise, the effective maximum tax in the municipality is 11.5 percent multiplied by 1.49 or 17.135 percent. Therefore, the maximum combined cantonal-municipal tax on income is 30.935 percent. The same formula is applied to determine the net worth tax. The basic net worth tax is 0.15 percent, multiplied by 1.20 for the canton and 1.49 for the municipality.

What is most significant here is that the effective cantonal-municipal tax, although not nearly so burdensome as United States taxes, is nevertheless a substantial tax. It also has a substantial tax impact, for about four-fifths of all direct taxes are collected at the cantonal-municipal levels. Because the cantonal and municipal taxes impose the greatest tax burden on corporate activities,
special concessions which grant relief from these taxes are therefore of great significance.

1. Substantial Interest Exemption

At the cantonal and municipal levels a substantial interest exemption identical to that granted by the confederation is generally allowed. Hence, income from another corporation in which a Swiss company owns at least a 20 percent participation or which is valued over two million Swiss francs is not taxed.\(^1\)

2. Pure Holding Company

The pure holding company is one of several types of statutory base companies which have been recognized in many of the cantons of Switzerland. The statutory base company receives tax concessions in exchange for limiting the kinds of activities in which it may engage.

The pure holding company may be described as a type of statutory base company whose primary or exclusive purpose is to hold stock in other corporations. So long as that remains its primary activity, it is exempt in all but two cantons from cantonal and municipal income taxes, and, generally, a reduced rate of net worth tax is applied.\(^2\) In 1973 in the canton of Zurich, for instance, a pure holding company enjoyed no tax on income and a reduced net worth tax of 0.06 percent, to which the cantonal multiple of 1.20 and the municipal multiple of 1.49 were applied.\(^3\)

An advantage of the pure holding company device is that no minimum holding is required as with the substantial interest exemption. The only requirement is that the principal source of the pure holding company's income be generated from holdings in other corporations. Even though the extent of the pure holding company's interest in any single company is so small that it is disqualified from the substantial interest exemption, the income is still exempt from cantonal and municipal income taxes.\(^4\)

3. Domiciliary Company

The domiciliary company may be described as a type of statutory base company having no business activities in Switzerland but which has its seat or domicile there. The domiciliary company has been termed a "mailbox company," for it generally must not have office space or personnel in Switzerland.\(^5\) Some cantons, however, grant domiciliary status even though the domiciliary company

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\(^1\) 9 \textit{European Taxation} 8 (1969); 2 \textit{European Taxation} 29 (1962).

\(^2\) 13 \textit{European Taxation} 196 (1973); 2 \textit{European Taxation} 30-31 (1962); \textit{Taxation in Switzerland, supra} note 4, at 52-53.

\(^3\) \textit{European Taxation}, Section A, Switzerland — 29, Masterpage — 2 (1974).

\(^4\) \textit{See} note 15 \textit{supra}.

\(^5\) 13 \textit{European Taxation} 196 (1973); 2 \textit{European Taxation} 31 (1962).
has a small office and a few employees. There are two common uses for the domiciliary company: (1) invoicing sales, and (2) licensing patents.

The invoicing of sales purpose is commonly effected as follows. Suppose Multinational A produces components in its American plant for a product which is assembled and sold by a foreign subsidiary in Germany. A normal procedure in the absence of a Swiss domiciliary company would be for Multinational A to sell directly to the German subsidiary at a profit. Corporation A would then be taxed at United States tax rates on that profit. When the subsidiary assembled the product and finally sold it, that profit would be taxed in Germany, another high tax jurisdiction. The domiciliary company enables the multinational group to concentrate its profits in the lower tax jurisdiction, namely Switzerland, by transfer-pricing techniques. This can be accomplished by the American parent corporation selling the goods, not directly to its German subsidiary, but by selling them through the intermediary Swiss domiciliary company. The American parent corporation would sell the components to the Swiss domiciliary company at near cost so that it takes little profit in the United States. The Swiss domiciliary company would then resell the goods to the German subsidiary at a substantially higher price than it paid for the goods, thereby making a sizeable profit in Switzerland. The result is that the profit has been centered in Switzerland, the country with the lowest tax burden.

The second major use for the domiciliary corporation is in the patent licensing field. A multinational corporation which has patented a technological process and desires to make it available to its subsidiaries or third parties may find the domiciliary company device useful. Again the objective is to concentrate a multinational's group profits in Switzerland, the low tax jurisdiction, by using the patent licensing device as another means of skimming profit from related companies in higher tax jurisdictions by imposing a fee or royalty on the use of the patent. The size of the fee or royalty will vary depending on the value of the patent and the desirability of shifting profit to Switzerland.

4. Tax Holiday For New Enterprises

Some cantons encourage foreign corporations to establish new enterprises by granting a tax holiday for a period of five to ten years after the enterprise has been founded. The length of this tax holiday is negotiated with cantonal and municipal authorities. A concordat to which all cantons have adhered limits such concessions to the year of incorporation plus nine subsequent years, and the concession is to be made only to nonresident aliens with no profit making activity in

19 See note 18 supra; UNION BANK OF SWITZERLAND, FOUNDING A COMPANY IN SWITZERLAND 27-31 (1972).
20 BNA, U.S. BUSINESS OPERATIONS IN SWITZERLAND, supra note 4, at A-24; UNION BANK OF SWITZERLAND, FOUNDING A COMPANY IN SWITZERLAND 27 (1972); ARTHUR ANDERSEN & CO., SWITZERLAND, supra note 4, at 93-94.
22 See note 21 supra.
Switzerland for ten years prior to incorporation in Switzerland. Nevertheless, such a concession is a powerful incentive for multinationals to establish a base company in Switzerland.  

5. Operating Sales Company

Large multinational corporations with their principal place of business outside Switzerland may enjoy tax benefits without meeting the strict limitations of a statutory base company such as a pure holding company or domiciliary company. Since a primary objective of cantonal and municipal tax incentives has been to strengthen and solidify Switzerland's position as a world commercial and financial center and to bring prosperity to the Swiss economy, a corporation with characteristics that the Swiss authorities find desirable may be able to find certain municipalities within some cantons which will tax only a fraction of corporate profits at the normal rate or tax the entire corporate profits on a lump-sum basis. This tax concession is designed primarily for a multinational which consents to establish or rejuvenate an actual operating company in remote or underdeveloped areas of Switzerland and which produces and sells goods and services.

6. Mixed Company

A novel approach which allows one to combine more than one type of tax concession has been the creation of the combined, or multipurpose, company. The combined company may enjoy the tax advantages of all three of the above companies. A Swiss base company which carries on the business of an operating sales company, domiciliary company, and holding company at the same time is allowed in some cantons to keep separate books for each activity. Therefore, it can have the "three-in-one" advantage of allocating the measure of income derived from each type of activity to the appropriate special tax category in order to take advantage of the concession granted in favor of each kind of income.

7. Service Company

The service company is a special type of domiciliary company whose major activity is to manage subsidiaries in Europe or throughout the world. Like other base companies, the service company is normally not taxed on income and a reduced rate of net worth tax is applied depending on the canton or municipality where it is domiciled; but, unlike other base companies, the service company employs a sizable staff and may own an office in Switzerland without losing special tax status. The service company is designed to concentrate multinational group profits in Switzerland by charging fees to related subsidiaries for...
marketing, advertising, and technical assistance. Such fees are normally deductible from the foreign subsidiary's local income taxes and are paid to the Swiss service company to avoid taxation.26

The usefulness of the service company is limited by the practical use for such services. According to W. A. P. Manser, "A high degree of managerial and technical expertise must be habitual to the industry concerned, and a high reservoir of such expertise must exist in the parent company concerned for this to enter into consideration as a significant factor." Manser feels that only companies producing a consistent flow of innovations will be in a position to obtain consistent payments for services. Besides, he notes, a variety of natural and official circumstances, to be more fully explained later, militate against abnormally large charges for such services. Nevertheless, certain industries which have a high rate of innovation, such as chemicals, oil, and electronics, may find the service company device advantageous.27

8. Caveat

A general caveat must be recognized to the use of these special base companies to defer taxes. While it is still possible today to establish base companies in Switzerland, it is becoming increasingly difficult to do so. In recent years Switzerland's cantons have been saturated with foreign-held corporations. Inflation, too, spurred by Switzerland's international business relationships, has caused the federal government to take measures to protect the Swiss currency. And most recently there has been increased concern about the great number of foreigners taking up residence in Switzerland. Thus, the number of cantons and municipalities in which extremely favorable tax climates are to be found has declined. Nevertheless, a substantial number of such areas still exist and can be successfully utilized for base companies.28

IV. Measures Against Tax Abuse

The central purpose of the establishment of a Swiss base company is to defer taxes of foreign-source income by pooling a multinational's profits in a low tax jurisdiction. Because this objective deprives other nations of tax revenue, many countries, including the United States, have enacted legislation designed to curb the attractiveness of Switzerland as a tax haven. Diplomatic pressure has also caused the Swiss themselves to prevent flagrant abuses of their tax shelter privileges. These actions have limited, but have not substantially impaired, the

27 W. Manser, supra note 3, at 93-95.
28 By its executive decision of Nov. 20, 1974 (R.O. 1974, p. 1822) amended Jan. 22, 1975, (R.O. 1975, p. 105) the federal government has temporarily ordered that Swiss banks must levy 10% negative interest on all funds deposited in Swiss currency belonging to foreigners residing abroad and also to corporations domiciled in Switzerland but in foreign hands and having no economic activity in Switzerland. Because of the existence of Swiss banks outside of Switzerland, this order does not necessarily pose a difficulty for Swiss base companies. Interviews, supra note 2.
basic attractiveness of Switzerland as a tax haven for multinationals. These barriers to full exploitation of Swiss tax shelter privileges will now be examined.

A. Swiss Tax Decree Against Abuse of Tax Treaties

The operation of double taxation treaties becomes paramount in the operation of a Swiss base company. Stated broadly, the objective of double taxation treaties is to assure the overall tax burden on a transfer of income across national boundaries is no greater than that of the higher tax jurisdiction. But in many specific instances, that objective is thwarted. For example, an examination of corporate tax rates in Germany and Switzerland reveals that the maximum German rate of 51 percent is the higher. It might therefore be logical to expect that the combined German-Swiss tax on such a distribution of dividends from Germany to Switzerland would be about equal to the German tax. Yet, the reality is quite different. Operation of the German-Swiss tax treaty reduces the German tax from 51 percent to as little as 30 percent. And by operation of the substantial interest and pure holding company tax concessions, no Swiss income tax will be imposed and only a minimal net worth tax will be applied. Thus, the combination of a double taxation treaty and base company status effectively reduces the tax on this profit distribution to about one-half the tax liability which would have been imposed, had the same transaction taken place wholly within Germany.

Because this type of tax advantage could be gained in many countries with which Switzerland had tax treaties, international attention focused on Switzerland in the 1960's as a so-called "tax haven." Individual views varied widely. "The fact that the tax incidence is generally lower in Switzerland than abroad," wrote Dr. Kurt Locher, Director of the Swiss Federal Tax Administration, "does, of itself, entitle a foreign State to reproach Switzerland of this situation." Even more outspoken was Dr. Walter Ryser:

It can hardly be disputed, however, that among those who have chosen Switzerland, there have been some smart operators. From this fact it was only a short step to the generalization alleging that our country was encouraging tax evasion. . . . There is certainly a great deal of exaggeration. In any case it is difficult to see why Switzerland should be ashamed of enjoying a tax climate which is still reasonable. On the contrary, the insidious idea which seems to inspire some of our critics, according to which the only acceptable attitude from the point of view of international co-operation is to fall into line with the law of the least favored, in other words, the law of the country paying the highest taxes, should be resolutely fought against.

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29 W. MANSER, supra note 3, at 84-89.
30 ARTHUR ANDERSEN & Co., Tax and Trade Guide: Germany 29 (1968); 2 EUROPEAN TAXATION 55-46 (1962); EUROPEAN TAXATION, Section D, REPORT ON GERMAN TAX EVASION I-12 (1964).
31 Locher, supra note 2, at 10-11.
32 Id. at 11.
33 Ryser, Measures Taken By Switzerland Against the Improper Use of Double Taxation Treaties, in INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION, SWISS MEASURES AGAINST ABUSE OF TAX CONVENTIONS 22 (Supplement to the BULLETIN FOR INTERNATIONAL FISCAL DOCUMENTATION, Vol. XVI (1963)).
Nevertheless, in 1962 the Federal Tax Administration issued a Tax Decree concerning measures against the improper use of tax conventions concluded by Switzerland with other nations.\textsuperscript{34}

The 1962 Tax Decree and its accompanying Circular Letter addressed to the cantonal authorities were a result of increasing international pressure on Switzerland to limit its preferred treatment of foreign base companies. Of no less importance was the general state of the Swiss economy, saturated in 1961 with some 2,500 foreign-owned base companies, of which roughly 1,000 were American-controlled and 700 were German-controlled.\textsuperscript{35} The 1962 Tax Decree provides that a base company will not be permitted to claim the benefit of a double-taxation treaty in two major business contexts. First, where over 50 percent of the foreign income to which treaty relief is claimed is paid to the parent corporation as debt interest, royalties, expenses for development, advertising, sales promotion, or traveling, no treaty benefit may be obtained. If less than 50 percent of the treaty-relief income is used to satisfy such claims, then there is no treaty abuse and the treaty relief will be granted. This is aimed particularly at domiciliary companies holding patents and generally at any conduit company through which income is passed to the parent corporation. Thus, a patent holding company which pays a 60 percent royalty to its United States parent on fees received for licensing the parent’s patent to subsidiaries violates the Decree and would be required to reduce its royalties to the parent to less than 50 percent. The second abuse arises when the base company acts not as a conduit for income, but where it accumulates income by failing to make profit distributions to the parent corporation. This is considered an abuse if the base company’s interest-bearing creditors’ accounts total more than six times net worth, its debts to the parent bear interest at a rate exceeding 7.5 percent, or less than 25 percent of the accumulated income to which a tax convention applies is distributed each year. For instance, a base company which accumulates all of its income and makes no profit distributions could be in violation of the Decree and therefore might be required to distribute at least one-quarter of its income in order to benefit from Switzerland’s double taxation treaties.\textsuperscript{36}

So, the 1962 Tax Decree clearly limits, but does not severely diminish, the usefulness of the Swiss base company. Within the above limitations there are still considerable tax savings to be gained. This is evidenced by the fact that in the nine months after the issuance of the 1962 Tax Decree, the number of holding companies in Switzerland rose from over 4,400 to about 5,240.\textsuperscript{37}

\textsuperscript{34} Decree of the Federal Council Concerning Measures Against the Improper Use of Tax Conventions Concluded By the Swiss Confederation (of December 14, 1962), in International Bureau of Fiscal Documentation, Swiss Measures Against Abuse of Tax Conventions 33-36 (Supplement to the Bulletin for International Fiscal Documentation, Vol. XVI (1963)).

\textsuperscript{35} Locher, supra note 2, at 10-11.

\textsuperscript{36} See note 34 supra; Interviews, supra note 2; Circular Letter, Federal Tax Administration, December 31, 1962, in International Bureau of Fiscal Documentation, Swiss Measures Against Abuse of Tax Conventions 37-50 (Supplement to the Bulletin for International Fiscal Documentation, Vol. XVI (1963)).

\textsuperscript{37} European Taxation, Section D, Report on German Tax Evasion 8-9 (1964).
B. The Swiss-German Double Taxation Treaty

A most recent development in the gradual tightening of restrictions designed to curb the abusive use of Swiss base companies is the 1972 Swiss-German Double Taxation Treaty. This new treaty, which amends the Swiss-German Double Taxation Treaty of 1931, reflects many of the forms of restrictions of the 1962 Swiss Tax Decree Against Treaty Abuse. Its series of new provisions tackles the problem of German firms establishing Swiss base companies to diminish their German tax liability. Its provisions are significant because they show the trend toward limiting, though not substantially impairing, the effectiveness of Switzerland as a tax haven. The treaty is also significant because next to the United States, there are more German-controlled Swiss base companies than any others. Finally, the treaty's provisions have a direct impact on an American multinational doing business in Germany and establishing a Swiss base company to save on German taxes.  

Germany has a split-rate income tax on dividends. There is a basic 15 percent income tax upon the corporation when it makes a dividend distribution. Subsequently, the dividend is subject to a second tax in the hands of the recipient. If the recipient is another corporation which does not distribute the dividend to its shareholders, then the recipient corporation pays a supplementary tax of 36 percent. Hence, the total effective German tax rate is 51 percent. However, by operation of the old double taxation treaty with Switzerland, dividends paid by a German subsidiary to a Swiss holding company were subject only to the initial tax of 15 percent plus a withholding tax of 15 percent. A higher 25 percent withholding tax was applied if the holding company owned at least one-quarter of the German subsidiary's stock. Thereafter, the dividend was beyond German tax jurisdiction in a Swiss base company which qualified for exemption from Swiss income tax and was liable for only the minor net worth tax. Thus, the Swiss base company device saved 11-21 percent on German taxes. It was estimated that some 8,000 Swiss base companies were connected with German businesses to take advantage of this arrangement at the time of the 1972 treaty amendment.

The amended treaty incorporates aspects of the 1962 Tax Decree almost verbatim and adds some new weapons, but does not dramatically change the relative advantage to be gained from ownership of a German subsidiary through a Swiss base company. Requirements similar to the 1962 Tax Decree are recited in order for the benefits of the Swiss-German tax treaty to apply. These make it necessary that a base company limit interest-bearing creditors' accounts to six times net worth, that its interest obligations not exceed the average rate of debt interest, that not more than 50 percent of the corresponding base company's income be used to satisfy claims of a parent corporation, and that at least 25 percent of income to which the Swiss-German tax convention applies be distributed each year. Some of the treaty's new limitations provide that: A German

38 See text of treaty in EUROPEAN TAXATION, Section C, Germany-Switzerland at 1-22 (1973); Locher, supra note 2, at 10; Interviews, supra note 2.
39 See note 38 supra; 11 EUROPEAN TAXATION at 1/213-1/221 (1971); CCH 1974 COMMON MARKET REP., supra note 4, at ¶¶ 23,338-23,347.
citizen taking up residence in Switzerland who has been subject to German taxes for five years may be subjected to German taxes for five years after he vacates Germany and moves to Switzerland; a Swiss base company that deals with one of its related companies in Germany must treat its transactions with that company at arm's length; profits of a related company managed from Switzerland may be included in the profits of the controlled German corporation; and dividends will be subject to a 25 percent withholding tax if paid by a German subsidiary to a Swiss holding company controlling at least 20 percent of the voting power of the German company (thereby qualifying for the Swiss substantial interest exemption).40

The new amendments to the German-Swiss tax treaty may be viewed as evidence of the increasing trend toward the delimitation of the benefits granted to base companies. The current trend is clearly in the direction of enforcing a rule of arm's length transactions in the sphere of international taxation. Yet, it is significant that the German tax can still be limited to 30-40 percent with proper planning. While the new Swiss-German tax treaty limits the benefits of a Swiss base company, the tax savings to be gained remain substantial.

C. The Swiss-United States Double Taxation Treaty

While a major purpose of the Swiss base company is to accumulate income, it has been demonstrated that Swiss tax abuse legislation requires that some of that accumulated income be distributed. Whenever a profit distribution is made from a Swiss base company to its American parent, the terms of the Swiss-United States Tax Treaty enter into force.

In general, the Treaty provides that dividends paid by a Swiss base company to its American parent are subject to a maximum Swiss tax of 15 percent, which may be reduced to just 5 percent if the shareholder is a corporation controlling 95 percent of the voting power of the Swiss base company. Likewise, the maximum Swiss tax on interest paid by the Swiss base company to its American creditor is 5 percent. Finally, royalties and other consideration for the right to use patents, copyrights, trademarks, and other similar property are exempt from Swiss taxation.41

40 See note 38 supra.

41 Convention With the Swiss Federation For the Avoidance of Double Taxation With Respect to Taxes On Income, May 24, 1951, [1952] 2 U.S.T. 1751; EUROPEAN TAXATION, Section C, Switzerland-U.S.A. 1-6. In order to receive the treaty benefits, a taxpayer must file for a partial refund of the Anticipatory Tax (Verrechnungssteuer; impôt anticipé), a withholding tax of 30 percent on any distribution of profit by a Swiss corporation to shareholders, whether described as a dividend or not. The tax is collected within thirty days of the distribution but may be fully reclaimed by a Swiss individual or corporation receiving the dividend by showing that the payment is includable in taxable income so that it will be subject to the Defense Tax. If the dividends are paid to the recipient outside the country, then the recipient's profits are not subject to domestic Swiss taxes. Hence, as a rule no refund is made in the absence of a double taxation treaty with the recipient's country. In this way, taxation of dividends of a Swiss company distributed to a foreign parent corporation captures profits which would otherwise have escaped taxation in Switzerland. ARTHUR ANDERSEN & Co., SWITZERLAND, supra note 4, at 111-12; TAXATION IN SWITZERLAND, supra note 4, at 66-69. Switzerland has double taxation treaties with Antigua, Austria, Barbados, British Honduras, Denmark, Dominica, Falkland Islands, Finland, France, Gambia, Germany, Grenada, Ireland, Japan, Malawi, Montserrat, Netherlands, Norway, Pakistan, Rhodesia, St. Christopher, St. Lucia, Seychelles, South Africa, Spain, Sweden Trinidad, United Kingdom, United States, and Zambia. EUROPEAN TAXATION, Section C, Switzerland 1-3 (1974).
These generally favorable tax concessions must be considered in light of Article IV of the Treaty, which requires that transfers of profit between related Swiss and American companies be at arm's length:

Where an enterprise of one of the contracting States, by reason of its participation in the management or the financial structure of an enterprise of the other contracting State, makes with or imposes on the latter, in their commercial or financial relations, conditions different from those which would be made with an independent enterprise, any profits which would normally have accrued to one of the enterprises, but by reason of those conditions have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

Hence, if the American parent transacts its affairs with a Swiss base company so as to manipulate extraordinarily high profits to Switzerland which otherwise would have flowed to the American parent, the Treaty gives United States authorities the power to tax those profits, even though the profits have not reached the American parent. This type of provision is indicative of the modern trend in sophisticated tax laws of developed countries such as the United States, France, and Germany.

The thrust of these laws is that taxation of a foreign transaction should depend not upon whether there has been an artificial transfer designed to avoid taxation, but rather upon what the companies would have done in an arm's length transaction.

D. The United States Internal Revenue Code

While this note is directed primarily at Swiss taxation and therefore cannot detail the United States tax consequences of the use of a base company, it is important to briefly mention provisions of the Internal Revenue Code which have an immediate impact on the use of a Swiss base company.

United States income taxes have traditionally been applied to the worldwide income of American corporations, but no tax was applied to American-controlled foreign subsidiaries and base companies which are creatures of foreign and not American law. Therefore, the profits of a Swiss subsidiary were generally deferred from U.S. income tax until paid to the American parent corporation. Now two

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42 Convention With the Swiss Federation For the Avoidance of Double Taxation With Respect to Taxes On Income, May 24, 1951, [1952] 2 U.S.T. 1751; EUROPEAN TAXATION, Section C, Switzerland-U.S.A. at 2. To a similar effect, see art. III, § 3 which states:

Where an enterprise of one of the contracting States is engaged in trade or business in the territory of the other contracting State through a permanent establishment situated therein, there shall be attributed to such permanent establishment the industrial or commercial profits which it might be expected to derive if it were an independent enterprise engaged in the same or similar activities under the same or similar conditions and dealing at arm's length with the enterprise of which it is a permanent establishment. Id.

43 Its statutory counterparts are found in the laws of eight West European nations: Belgium, Denmark, France, Great Britain, Greece, Italy, Sweden and West Germany. Haeberli, supra note 22, at 216, n. 11. He also notes that despite these laws it is extremely difficult for tax authorities to evaluate the shifting of profits among a multinational group. Haeberli, supra note 22, at 217. For a discussion of French and American law on this point, see Note, Assault on Multinationals: French and American Reallocation Provisions, 50 NOTRE DAME LAWYER 662 (1975).
major exceptions exist to that general rule in the Internal Revenue Code, § 482 and Subpart F, which threaten such deferral techniques.\textsuperscript{44}

The terms of § 482, similar to Article IV of the Swiss-United States Treaty, are designed to cause American corporations to deal with a base company on an arm’s length basis. The section provides that the Commissioner of Internal Revenue may reallocate income between affiliated companies in order to more clearly reflect the income of each entity. Hence, § 482 can be used to prevent an American parent company from abusing the transfer-pricing mechanism by shifting profits from the U.S. parent to a Swiss base company.\textsuperscript{45}

Subpart F, an extremely complex set of provisions which grapple with the deferral of U.S. income taxes through the use of a “controlled foreign corporation,” generally provide that the undistributed profits of a base company created to avoid United States taxes can be indirectly taxed in certain circumstances by assessing the American shareholders of the parent corporation controlling the base company with a “constructive dividend.” A constructive dividend can be imposed only where the base company is a controlled foreign corporation, a company directly or indirectly owned by United States persons holding over 50 percent of its stock. Even then a constructive dividend can be imposed only on shareholders with 10 percent or more of the voting power of the controlled foreign corporation. Thus, it is possible that a foreign base company can be completely owned by U.S. shareholders and not be subject to the imposition of a constructive dividend if the voting stock is equally divided between eleven or more unrelated shareholders.\textsuperscript{46}

These and other U.S. income tax consequences must be carefully scrutinized in determining whether an American multinational corporation should establish a base company. Inclusion of a Subpart F “constructive dividend” in the income

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The so-called “simple” formula of cost plus a margin of profit isn’t so simple in many cases, the European investigator adds. “The main problem,” he adds, “is determining the costs, especially if the product is highly complex and manufactured in a distant country. And the allocation of research, administrative costs and other overhead to any given product may be largely arbitrary. You almost have to take the company’s word for it.” Carley, supra note 22.


of its American shareholders, for instance, could destroy the usefulness of the base company. With proper planning, however, the impact of these provisions of the Internal Revenue Code can be minimized.

E. Swiss Tax Harmonization Proposals

In addition to the tightening of income tax laws and double-taxation treaty provisions by foreign countries, there are current proposals within Switzerland to harmonize the tax laws among the cantons and municipalities which might lead to reduction in the variety or quality of tax concessions.

In 1968 the cantons instructed the Ritschard Committee to draft a proposed law on direct taxes to be used by the cantons in a movement toward tax harmonization.\textsuperscript{47} The Committee made a multitude of proposals for increasing the efficiency and fairness of the tax laws but did not particularly focus on the question of modification of tax concessions granted to base companies. However, it was suggested that a necessary consequence of any tax harmonization movement would be the destruction of the provincial nature of the present Swiss tax system upon which the tax concessions granted to base companies depends. Yet, the Committee did not indicate an attitude adverse to tax concessions. On the contrary, it suggested that pure holding companies remain exempt from income tax but be more precisely defined.\textsuperscript{48} More recently, however, it has been suggested that domiciliary companies should lose their tax privileges. But on this as well as other proposals to limit such privileges, the last word has not yet been spoken.\textsuperscript{49}

It must be remembered that the cantons still retain potent political influence so that it is unlikely that drastic changes in the overall tax structure will suddenly transpire. It would not be expected that the Committee called by the cantons, the primary benefactors of the present system of tax concessions, would propose that such concessions be scrapped. If such a change is to take place, then, it will be at the behest of other nations objecting to Switzerland as a tax haven. There is no indication today that Switzerland will change its stance to meet those demands, for there is a natural hesitancy to change a tax system which, when connected with Switzerland's commercial and financial advantages, has been a recognized component of its prosperity.\textsuperscript{50}

\textsuperscript{47} 13 European Taxation 202-08 (1973); Interviews, supra note 2.
\textsuperscript{48} See note 47, supra.
\textsuperscript{49} Tax harmonization proposals anticipate preservation of the holding company, but a current proposal advocates an end to the domiciliary company. See Höhn, Die Harmonisierung der direkten Steuern des Bundes und der Kantone, 42 Archiv für Schweizerisches Abgabenrecht 125 (1973). Dr. Kurt Locher, Director of the Swiss Federal Tax Administration, has stated, however, that the domiciliary company should not be harshly criticized, since it is a sensible device for avoiding double taxation where tax relief is not otherwise provided in a double taxation treaty. But, he adds, "It loses its justification, though, if under an existing double taxation treaty the foreign treaty partner reduces its taxes, and on account of the domiciliary privilege in Switzerland the profit nevertheless bears no cantonal or municipal, but only federal, income tax." Locher, Steuerprobleme der multinationalen Unternehmen, 41 Archiv für Schweizerisches Abgabenrecht 417, 422 (1973). See also note 47 supra.
\textsuperscript{50} See note 49 supra.
V. Conclusion

The Swiss base company is an attractive mechanism for deferral of an American multinational corporation’s taxes by acting as a central clearing house interposed between the American parent and its foreign subsidiaries. The potential for tax savings has been extraordinary because of Switzerland’s low average rate of corporate taxation, extensive network of double-taxation treaties, and, especially, the cantonal and municipal tax concessions providing special privileges and even exemption from taxation to foreign held base companies. In recent years, the United States and other nations have applied diplomatic pressure and enacted new laws to limit the usefulness of the Swiss base company. Switzerland has issued the 1962 Tax Decree against treaty abuse and is studying proposals to harmonize cantonal and municipal taxes, making it probable that the sphere of tax saving activities which a Swiss base company may perform will remain limited. Despite such limitations, the Swiss base company remains an attractive device for American multinational corporations wishing to defer taxes and have a pool of assets which can be shifted among foreign subsidiaries.

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