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SWISS FEDERAL SUPREME COURT "CLARIFICATION" ON THE APPLICATION OF THE SFTA SAFE HARBOUR INTEREST RATES AND ITS POTENTIAL IMPACT ON PRACTICE

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In its ruling 9C_690/2022 of July 17, 2024, a five-judge panel of the Swiss Federal Supreme Court ruled on the binding effect of the "safe harbour" interest rates published annually by the Swiss Federal Tax Administration ("SFTA"). According to the Supreme Court, the tax authorities are not bound by the published interest rates if interest rates agreed between associated companies are below or above the published minimum or maximum rates. In this case, according to the Federal Supreme Court, the tax authorities must instead determine the "actual" arm's length interest rate.

FACTS AND PROCEDURAL HISTORY

The appellant company (A. AG), a subsidiary of a corporation incorporated based on federal law (B. AG), is subject to limited tax liability in the Canton of Zurich on the basis of permanent establishments.[1] In 2013, A. AG entered into a credit facility agreement with its parent company with a maximum credit limit of CHF 1 billion. On the basis of this agreement, the two companies agreed on a fixed term loan (61 months) of CHF 500 million at an interest rate of 2.5% per annum. For the difference between the credit limit and the fixed loan, a current account was agreed at an interest rate of 3% per annum.

The Cantonal Tax Administration of Zurich ("TA ZH") took the view that the agreed interest rates were not at arm's length, in particular because the existing government guarantee of the parent company had not been taken into account when determining the disputed interest rates. The TA ZH subsequently claimed deemed dividends for the 2014 and 2015 tax periods. The deemed dividends were initially calculated on the basis of an interest rate of 1% per annum, which was determined at the discretion of TA ZH. A. AG's objection to this was partially upheld by the tax administration and the at arm's length interest rate was set at 1.08%. The TA ZH calculated the rate of 1.08% on the basis of the average interest rate for the refinancing of B. AG with bonds of 0.83% and added a margin of 0.25%. This approach was confirmed by the Tax Appeal Court of the Canton of Zurich in its decision of March 10, 2002.

[1] For a more detailed description of the facts, see the ruling of the Administrative Court of the Canton of Zurich SB.2021.00056 of May 25, 2022.

The Administrative Court of the Canton of Zurich partially upheld the appeal against the ruling of the Tax Appeals Court and referred the case back to the lower court for recalculation and a new ruling in line with the considerations. In essence, the Administrative Court was of the opinion that the interest rates published annually by the SFTA should be adhered to and that these rates define the arm's length range of applicable interest rates. A correction of a not at arm's length interest rate was therefore only possible to the amount of the published minimum or maximum interest rates. The TA ZH appealed against this ruling to the Federal Supreme Court, which rejected the position of the Administrative Court and upheld the opinion of the TA ZH.

REASONING AND KEY STATEMENTS OF THE FEDERAL SUPREME COURT

On the merits of the case, the Federal Supreme Court addressed the objection raised by TA ZH that the interest rate circulars published by the SFTA are not applicable to state and cantonal income taxes and are only binding for the purposes of federal income tax and withholding tax. In this respect, the Federal Court recalled that the income tax rules are harmonised between the federal and cantonal levels, which means that the SFTA interest rates are also applicable to federal and cantonal income taxes.[2]

With regard to the nature of the SFTA circulars on permissible interest rates, the Federal Supreme Court first stated that they serve to simplify the application of the arm's length principle. The simplification lies in the fact that the published interest rates, as "safe harbour rules", justify the assumption that there is no deemed dividend if the taxpayer complies with these rules. [3] Conversely, or if the taxpayer deviates from the published rates, there is a rebuttable presumption of a deemed dividend. In this case, it is up to the taxpayer to prove that the interest payments are in fact at arms' length. In addition, the Federal Supreme Court stated that the interest rate circulars of the SFTA should only be deviated from if the applicable legal provisions are not convincingly specified.[4]

With regard to the case at hand, the Federal Supreme Court stated that the binding effect of the interest rate circulars only exists as long as the taxpayer itself adheres to the interest rates defined therein. If the taxpayer deviates from these rates, there is no reason why the tax authority should continue to be bound by the safe harbour rules and not be allowed to determine the actual arm's length interest rate.[5] In these cases, there is neither a violation of the protection of legitimate expectations nor of the principle of equal treatment, especially since the taxpayer itself has deviated from the SFTA interest rates. Finally, the deviation from these interest rates would also undermine the purpose of the safe harbour rules, i.e. administrative simplification, as the tax authorities would have to check in these cases whether the interest rate claimed was in line with the arm's length principle.[6] Against this background, the Federal Court did not see any violation of the law in the TA ZH's determination of what it considered to be the arm's length interest rate, which deviated from the FTA interest rates.

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2 Judgment FSC 9C_690/2022 of July 17, 2024, E. 6.1.
3 Judgment FSC 9C_690/2022 of July 17, 2024, E. 4.1.
4 Judgment FSC 9C_690/2022 of July 17, 2024, E. 4.2.
5 Judgment FSC 9C_690/2022 of July 17, 2024, E. 6.2.
6 Judgment FSC 9C_690/2022 of July 17, 2024, E. 6.2 in fine.

However, with regard to the actual determination of the arm's length interest rate by the TA ZH, the Federal Supreme Court found that the Administrative Court of the Canton of Zurich had not addressed the issue of the legitimacy of taking into account a "margin" of 0.25% based on the interest rate circulars of the SFTA. In this respect, the Federal Supreme Court referred the matter back to the lower court for reconsideration.

THOUGHTS ON THE REASONING OF THE FEDERAL COURT AND ITS IMPLICATIONS

The above-mentioned decision of the Federal Court raises several questions, both in terms of its reasoning and its possible consequences for practice, which will be addressed in the following.

To the extent that the Federal Court has denied a violation of the principle of equal treatment, one can agree with the court as long as it will be ensured that the tax authorities consistently apply the arm's length interest rate in all cases where a taxpayer deviates from the SFTA interest rates. In other words, the tax authorities should not be able to rely on the SFTA rates on a case-by-case basis as this would lead to unequal treatment of taxpayers who deviate from the SFTA rates. Similarly, the individual application of the effectively higher administrative costs by the tax authorities when assessing the participation exemption would also violate the principle of equal treatment[7] – to the extent that this was actually intended by the legislator[8].

The Federal Court's argument that the purpose of the interest rate circulars in terms of administrative simplification can no longer be achieved if the taxpayer deviates from the maximum permissible interest rates is not entirely convincing, if at all. According to the case law of the Federal Supreme Court, the tax authorities can no longer limit themselves (while maintaining the principle of equal treatment) to examining the transfer pricing studies submitted as evidence of the arm's length principle, but must now - if they are of the opinion that the arm's length principle has not been verified - determine the effective market interest rate. It is true that the taxpayers' (attempted) proof of arm's length interest rates, as opposed to the SFTA interest rates, involves additional work for the tax authorities. However, this in itself only partially limits the purpose of administrative simplification. This purpose is only completely thwarted by the TA ZH's position, now confirmed by the Federal Court, that it is the tax authority's task to determine the specific market interest rate to be applied (and not merely a range of arm’s length interest rates). If it is indeed (only) a matter of administrative simplification, there is no obvious reason why the SFTA interest rates could no longer be used as a basis (for simplification reasons) if the arm's length interest rate cannot be proven. Instead, the tax authorities will have to determine the arm's length rate in accordance with best practice.

With regard to the requirements for the tax authorities to provide evidence of what they consider to be the arm's length interest rate, it seems reasonable to apply the same requirements for the evidence of the arm's length principle or the transfer pricing study as those defined in the SFTA applicable to taxpayers. The transfer pricing study to be carried out by the tax administration would

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7 Cf. GRETER, Der Beteiligungsabzug im harmonisierten Gewinnsteuerrecht, Diss., Zurich 2000, p. 142.

8 Cf. ATTENHOFER, in: Klöti-Weber/Schudel/Schwarb, Kommentar zum Aargauer Steuergesetz, 5th edition, Bern 2023, para. 35 to § 27b; VITALI, ibid., para. 86 to § 76.

therefore have to include the following elements, whereby the taxpayer's duty of cooperation could be invoked for the first two points[9]:

- A detailed description of the main features of the relevant transaction that could affect the interest rate.
- An analysis of the borrower's credit rating.
- A search for comparable transactions, which is created taking into account the most important comparability factors.

In terms of applicable transfer pricing methods, the Comparable Uncontrolled Price Method (CUP Method) is the primary transfer pricing method to be used for interest rates. In addition, the cost of funds method is also recognised in Swiss practice and appears to have been used by TA ZH in the present case. According to this method, the interest rate is determined on the basis of the lender's cost of funds plus a risk premium and a profit margin. The determination of the margin requires a case-by-case assessment, taking into account the borrower's credit rating. Against this background, the Federal Court's decision to refer the case back to the Administrative Court with regard to the 0.25% interest margin applied by TA ZH, which in turn is based on the SFTA's interest rate circular, is only consistent in the light of the other considerations.

Lastly, the statement by the Federal Court that it is the task of the tax authority to determine a specific interest rate to be applied and not (merely) a range of interest rates also raises questions. This statement cannot be reconciled with state-of-the-art transfer pricing methodology. The Federal Court fails to recognise that, in principle, only a range can be determined for the market interest rate or that it is unlikely that there is only one market interest rate for a specific transaction.[10] The principle applies that a correction to the actual terms agreed between related parties is only permitted at the upper or lower end of the identified arm’s length range. This principle has now been unnecessarily called into question by the Federal Supreme Court, at least as far as interest rates are concerned. It is also questionable to what extent the interest rates published by the SFTA correspond to the arm's length principle, if they cannot be used as a basis for determining deemed dividends. In this context, it should be noted that some tax administrations have taken the view that the range of arm's length interest rates is relatively narrow, meaning that a deviation of more than 25% from the SFTA interest rates is per se inconsistent with the arm's length principle and that the taxpayer is (effectively) denied the opportunity to provide rebuttal evidence.[11] This position can no longer be maintained if the case law of the Federal Court is consistently applied.

CONCLUSION

With regard to the specific facts of the present case, it can be said that the deviation of the TA ZH from the SFTA interest rates can be regarded as appropriate in individual cases. However, the reasoning chosen by the Federal Supreme Court to justify the deviation from the SFTA interest rates is not convincing and leads to unnecessary uncertainties. It would have been more appropriate to emphasise the special nature of the individual case at hand and thus follow a factual line of reasoning. In this respect, the Federal Supreme Court could have referred to the general

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9 See https://www.estv.admin.ch/estv/de/home/internationales-steuerrecht/verrechnungspreise.html, question 23.

10 See https://www.estv.admin.ch/estv/de/home/internationales-steuerrecht/verrechnungspreise.html, question 32.

11 See HARBEKE/HUG/SCHERRER, Verrechnungspreisrecht der Schweiz, Grundlagen und Praxis, Zurich, 2022, para. 1188.

rule that the interest rate circulars of the SFTA can (only) be deviated from if they do not convincingly specify the applicable legal provisions, which could certainly have been argued in the present case.

It would now be desirable for the SFTA to take the present decision of the Federal Court as an occasion to amend its interest rate circular and, in particular, to define more precisely the scope of application of the safe harbour rules.[12] This would increase legal certainty for taxpayers, and the expected additional workload for the tax authorities could be mitigated. In this context, it should be noted that the credit rating of the borrower and the specific structure of the financing are of considerable importance in determining an arm's length interest rate on a case-by-case basis. For example, the impact of collateral, maturity and prepayment rights (or lack thereof), as well as whether and how implicit group support or a group rating should be taken into account, must be assessed.

Since deviation from the SFTA's interest rate circulars has always led to a de facto obligation to provide evidence of the arm’s length of the interest rates used, it is still recommended - also in light of the discussed decision - that groups prepare a robust transfer pricing analysis and documentation.

Zurich, August 23, 2024

[12] See also the criticism of the SFTA interest circulars in HARBEKE/HUG/SCHERRER, a.a.O., para. 1226.