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by Jason Connery, Douglas Poms, and Jennifer Blasdel

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SPECIAL REPORTS

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by Jason Connery, Douglas Poms, and Jennifer Blasdel

Jason Connery is a principal, Douglas Poms is a director, and Jennifer Blasdel is a manager in the International Corporate Services group of KPMG LLP's Washington National Tax practice.

To be entitled to benefits under income tax treaties, companies must satisfy eligibility requirements. This article includes flowcharts to help practitioners navigate the eligibility requirements of the Switzerland-U.S. income tax treaty applicable to Swiss companies.[1]

Income tax treaties may exempt business income from source country income taxes and eliminate or reduce domestic withholding taxes on payments between residents of countries that are parties to an income tax treaty. To be entitled to benefits under U.S. income tax treaties, a company must not only be a resident of the tax treaty partner's country, but generally must also satisfy at least one of the tests in the treaty's limitation on benefits provision, if applicable.

The flowcharts in this article focus on the eligibility of Swiss companies claiming benefits on income that would otherwise be subject to U.S. taxation. This article does not address the eligibility for treaty benefits of entities that are partnerships or are otherwise transparent for U.S. or Swiss tax purposes. The flowcharts do not address ''triangular cases'' under article 22.4 of the treaty. This article is based on the treaty, the protocol to the treaty, the memorandum of understanding to the treaty, a competent authority agreement concerning the treaty, and the U.S. Treasury technical explanation to the treaty.

This article is the ninth in a series[2] that provides flowcharts to assist practitioners in determining a company's eligibility for tax treaty benefits under the LOB

[1]Convention Between the United States of America and the Swiss Confederation for the Avoidance of Double Taxation With Respect to Taxes on Income, Oct. 2, 1996.

[2]*See* Jason Connery, Douglas Poms, and Jennifer Blasdel, ''Eligibility for Treaty Benefits Under the Japan-U.S. Income Tax Treaty,'' *Tax Notes Int'l*, Sept. 6, 2010, p. 789, *Doc 2010-18355*, or *2010 WTD 172-12*; Connery, Poms, and Blasdel, ''Eligibility for Treaty Benefits Under the 2009 Protocol to the France-U.S. Income Tax Treaty,'' *Tax Notes Int'l*, Apr. 12, 2010, p. 149, *Doc 2010-5809*, or *2010 WTD 69-14*; John Venuti, Connery, Poms, and Blasdel, ''Eligibility for Treaty Benefits Under the Netherlands-U.S. Income Tax Treaty,'' *Tax Notes Int'l*, Nov. 23, 2009, p. 601, *Doc 2009-24084*, or *2009 WTD 223-11*; Venuti, Connery, Poms, and Alexey Manasuev, ''Eligibility for Treaty Benefits Under the Canada-U.S. Income Tax Treaty,'' *Tax Notes Int'l*, June 15, 2009, p. 967, *Doc 2009-11815*, or *2009 WTD 113-15*; Venuti, Ron Dabrowski, Poms, and Manasuev, ''Eligibility for Treaty Benefits Under U.K.-U.S. Income Tax Treaty,'' *Tax Notes Int'l,* Mar. 23, 2009, p. 1095, *Doc 2009-4590*, or *2009 WTD 56-9*; Venuti, Connery, Poms, and Manasuev, ''Eligibility for Treaty Benefits Under the Luxembourg-U.S. Income Tax Treaty,'' *Tax Notes Int'l*, July 21, 2008, p. 285, *Doc 2008-14359*, or *2008 WTD 142-8*; Venuti, Dabrowski, Poms, and Manasuev, ''Eligibility for Treaty Benefits Under the France-U.S. Income Tax Treaty,'' *Tax Notes Int'l*, Feb. 11, 2008, p. 523, *Doc 2008-773*, or *2008 WTD 33-10*; and Venuti and Manasuev, ''Eligibility for Zero Withholding on Dividends in the New Germany-U.S. Protocol,'' *Tax Notes Int'l*, Jan. 14, 2008, p. 181, *Doc 2007-27516*, or *2008 WTD 12-10*.

provisions of specific U.S. income tax treaties and, when applicable, in determining eligibility for a 0 percent withholding tax rate on cross-border intercompany dividend payments to the company.

This article contains nine flowcharts that analyze the LOB provision of the treaty as applied to Swiss companies. Although the flowcharts provide a comprehensive review of applicable provisions under the treaty, taxpayers and their tax advisers should carefully evaluate each case and determine whether the requirements of the treaty are met based on all facts and circumstances. ◆

Chart 1. Eligibility for Treaty Benefits Under Article 22 (LOB) of the Switzerland-U.S. Tax Treaty

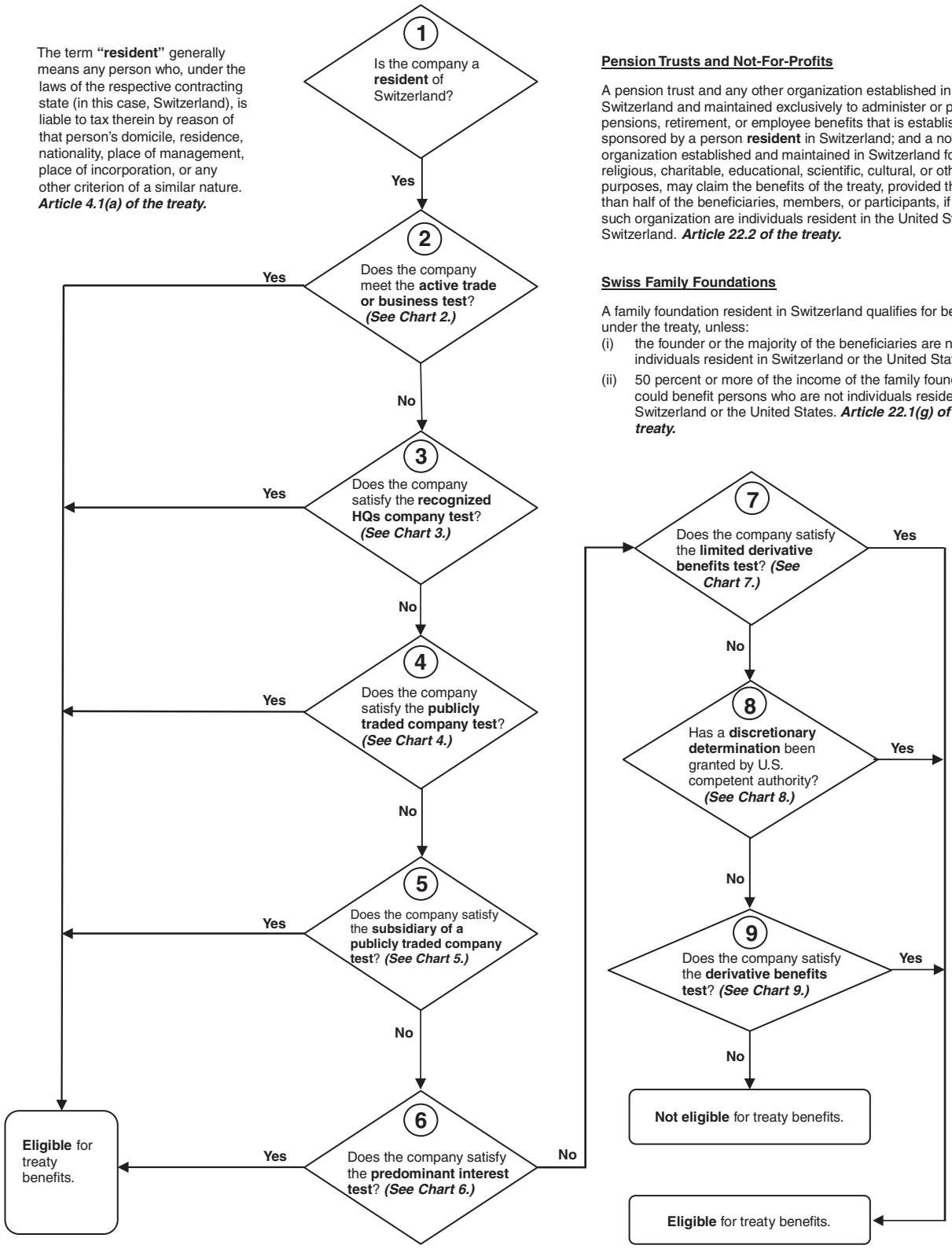


Chart 2. Active Trade or Business Test Under Article 22.1(c) (LOB) of the Switzerland-U.S. Tax Treaty (Test Applied Separately for Each Item of Income)

Is the Swiss company (or a person related to the Swiss company) engaged in the **active conduct of a trade or business** in Switzerland (other than the business of making, managing, or simply holding investments for the Swiss company's own account, unless these activities are banking, insurance, or securities activities carried on by a bank, insurance company, or registered securities dealer)? ***Article 22.1(c) of the treaty.***

No

Yes

Is the item of income under consideration **derived in connection with**, or **incidental to**, that trade or business? ***Article 22.1(c) of the treaty.***

No

Yes

Does the Swiss company derive the item of income arising from the United States from a related party? ***Paragraph 7.b of the protocol to the treaty; paragraph 4 of the MOU to the treaty.***

For these purposes, the recipient of income is related to the payer of the item of income if it owns, directly or indirectly, 10 percent or more of the shares (or other comparable rights) in the payer. ***Article 7.b of the protocol to the treaty.***

No

Yes

Is the trade or business in Switzerland **substantial** in relation to the activity carried on by the related party in the United States that gave rise to the income in respect of which treaty benefits are being claimed? ***Article 7.b of the protocol to the treaty; paragraph 4 of the MOU to the treaty.***

No

Yes

Not eligible for treaty benefits.

(Go to Chart 3.)

Eligible for treaty benefits.

Income is considered **"derived in connection with"** an active trade or business in Switzerland if the income-generating activity in the United States is a line of business that forms a part of, or is complementary to, the trade or business conducted in Switzerland. The line of business in Switzerland may be "upstream" to that going on in the United States (e.g., providing inputs to a manufacturing process that occurs in the United States), "downstream" (e.g., selling the output of the manufacturer resident in the United States) or "parallel" (e.g., selling in Switzerland the same sorts of products that are being sold by the trade or business carried on in the United States). ***Paragraph 4 of the MOU to the treaty.***

It is intended that a business activity generally will be considered to "form a part of" a business activity conducted in the other contracting state (in this case, the United States) if the two activities involve the design, manufacture, or sale of the same products or type of products, or the provision of similar services. In order for two activities to be considered to be "complementary," the activities need not be related to the same types of products or services, but they should be part of the same overall industry and be related in the sense that the success or failure of one activity will tend to result in the success or failure of the other. ***U.S. Treasury technical explanation to the treaty.***

Income derived from the United States would be considered **"incidental to"** the trade or business carried on in Switzerland if the income is not produced by a line of business that forms a part of, or is complementary to, the trade or business conducted in Switzerland by the recipient of the income, but the production of such income facilitates the conduct of the trade or business in Switzerland. An example of such "**incidental**" income is interest income earned from the short-term investment of working capital of a Swiss resident company in securities issued by persons in the United States. ***Paragraph 4 of the MOU to the treaty.***

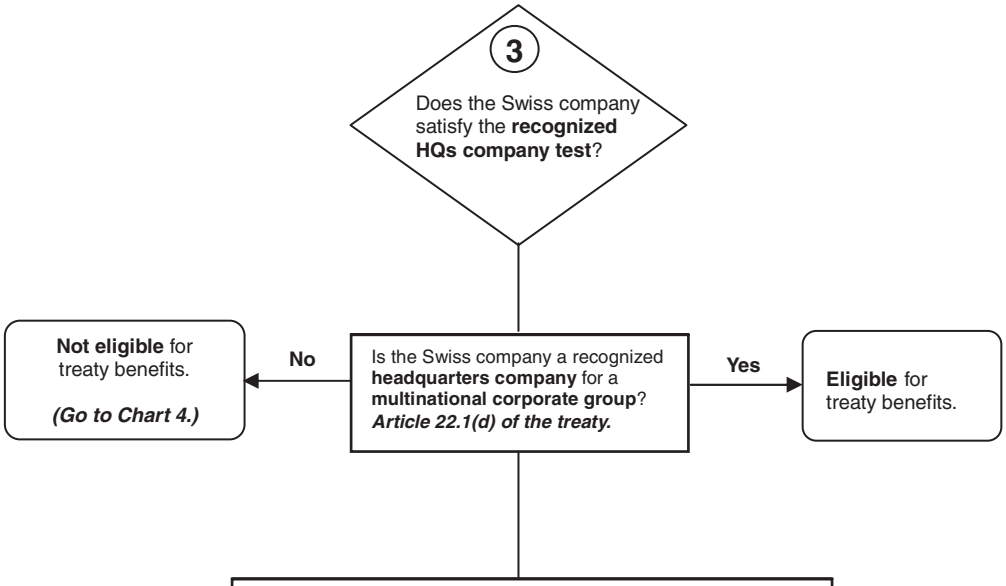
Whether the activities of a Swiss company constitute an **active trade or business** is determined under all the facts and circumstances. In general, a trade or business comprises activities that constitute (or could constitute) an independent economic enterprise carried on for profit. To constitute a trade or business, the activities conducted by the resident ordinarily must include every operation that forms a part of, or a step in, a process by which an enterprise may earn income or profit. A Swiss company actively conducts a trade or business if it regularly performs active and substantial management and operational functions through its own officers or staff of employees. In this regard, one or more of such activities may be carried out by independent contractors under the direct control of the resident. However, in determining whether the corporation actively conducts a trade or business, the activities of independent contractors are disregarded. ***Article 7.a of the protocol to the treaty.***

The active conduct of a trade or business need not involve manufacturing or sales activities but may instead involve services. However, income that is derived in connection with, or is incidental to, the business of making, managing, or simply holding investments for the resident's own account generally will not qualify for benefits under this provision, whether or not those activities would otherwise constitute an active trade or business. Therefore, a company the business of which consists solely of managing investments (including group financing) will not be considered to be engaged in an active trade or business. However, if such company also engages in activities such as active licensing or leasing that would otherwise qualify under this test, it will be entitled to the benefits of article 22.1(c) to the extent provided therein. The limitation relating to investments does not apply to banking, insurance, or securities activities carried on by a bank, insurance company, or registered securities dealer in the ordinary course of business. Of course, this rule does not affect the status of investment advisers or others who are actively conducting the business of managing investments that are beneficially owned by others. ***Paragraph 4 of the MOU to the treaty.***

An item of income will be considered to be earned **in connection with** or to be **incidental to** an **active trade or business** in Switzerland if the resident claiming the benefits is itself engaged in business, or it is deemed to be so engaged through the activities of related persons that are residents of one of the contracting states. Thus, for example, a Swiss resident company could claim benefits with respect to an item of income earned by an operating subsidiary in the United States but derived by the resident indirectly through a wholly owned holding company resident in the United States and interposed between it and the operating subsidiary. ***Paragraph 4 of the MOU to the treaty.***

Whether a trade or business is **substantial** is determined on the basis of all the facts and circumstances. Such determination takes into account the comparative sizes of the trades or businesses in each contracting state (measured by reference to asset values, income, and payroll expenses), the nature of the activities performed in each contracting state, and, in cases where a trade or business is conducted in both contracting states, the relative contributions made to that trade or business in each contracting state. In making each determination or comparison, due regard will be given to the relative sizes of the U.S. and Swiss economies. ***Article 7.b of the protocol to the treaty.***

Chart 3. Headquarters Company Test Under Article 22.1(d) (LOB) of the Switzerland-U.S. Tax Treaty



A **multinational corporate group** includes all corporations that the **headquarters company** supervises, but the companies being supervised need not include the entire multinational group, but may be part of a larger group of companies. The **headquarters company** does not have to own shares in the companies that it supervises. ***U.S. Treasury technical explanation to the treaty.***

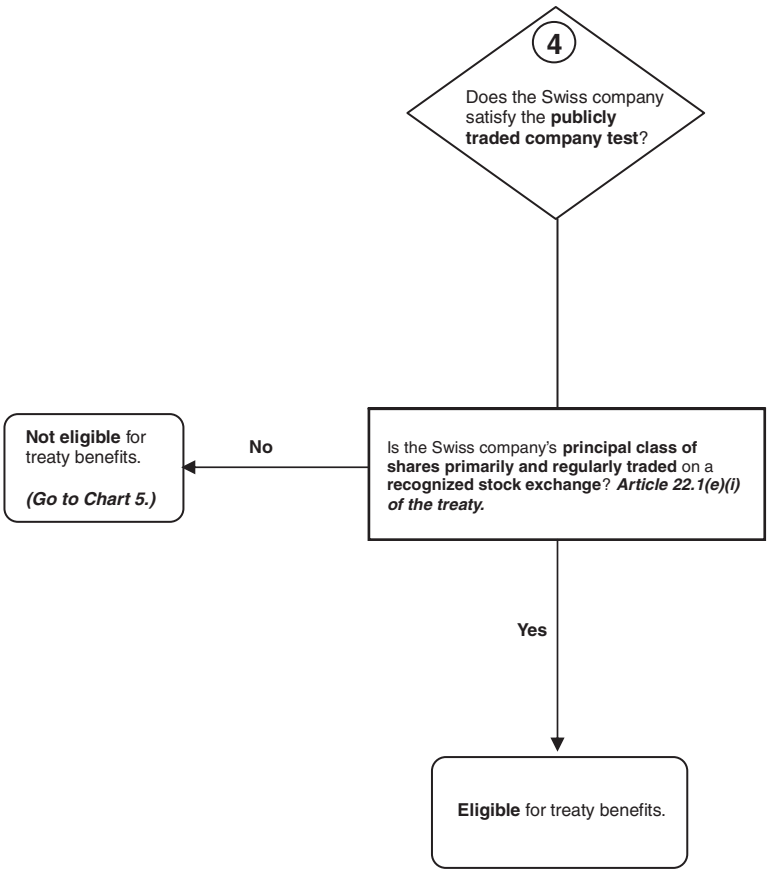
A Swiss company will be considered a recognized **headquarters company** only if**:**

1) it provides in Switzerland a substantial portion of the overall supervision and administration of a group of companies (which may be part of a larger group of companies) (for example, pricing, marketing, internal auditing, internal communications, and management), which may include, but cannot be principally, group financing;
2) the group of companies consists of corporations resident in, and engaged in an active business in, at least five countries, and the business activities carried on in each of the five countries (or five groupings of countries) generate at least 10 percent of the gross income of the group;
3) the business activities carried on in any one country other than in Switzerland generate less than 50 percent of the gross income of the group;
4) no more than 25 percent of its gross income is derived from the United States;
5) it has, and exercises, independent discretionary authority to carry out the functions referred to in subparagraph 1) above;
6) it is subject to the generally applicable rules of taxation in Switzerland; and
7) the income derived in the United States either is derived **in connection with,** or is **incidental to** ***(see Chart 2 for definition)***, the active business referred to in subparagraph 2) above.

Article 22.7(b) of the treaty.

If the gross income requirements of subparagraphs 2), 3), or 4) above are not fulfilled, they will be deemed to be fulfilled if the required ratios are met when averaging the gross income of the preceding four years. ***Article 22.7(b) of the treaty.***

Chart 4. Publicly Traded Company Test Under Article 22.1(e)(I) (LOB) of the Switzerland-U.S. Tax Treaty



The term **"principal class of shares"** is not defined in the treaty, but will be interpreted by the United States to mean that class of shares that represents the majority of the voting power and value of the company. In most cases, this class will be the ordinary or common shares of the company. If the company has more than one class of shares, it is necessary as an initial matter to determine whether one of the classes accounts for more than half of the voting power and value of the company. If so, then only those shares are considered for purposes of the regular trading requirement. If no single class of shares accounts for more than half of the company's voting power and value, it is necessary to identify a group of two or more classes of the company's voting power and value, and then to determine whether each class of shares in this group satisfy the regular trading requirement. Although in a particular case involving a company with several classes of shares it is conceivable that more than one group of classes could be identified that account for more than 50 percent of the shares, it is only necessary for one such group to satisfy the requirements of this subparagraph for the company to be entitled to benefits. Benefits would not be denied to the company even if a second, non-qualifying group of shares with more than half of the company's voting power and value could be identified. ***U.S. Treasury technical explanation to the treaty.***

The term **"regularly traded"** is not defined in the treaty. It is understood to have the meaning it has under Treas. reg. section 1.884-5(d)(4)(i)(B), relating to the branch tax provisions of the Internal Revenue Code. Under these regulations, a class of shares is considered to be **"regularly traded"** if two requirements are met: trades in the class of shares are made in more than de minimis quantities on at least 60 days during the taxable year, and the aggregate number of shares in the class traded during the year is at least 10 percent of the average number of shares outstanding during the year. Treas. reg. sections 1.884-5(d)(4)(i)(A), (ii) and (iii) are not taken into account for purposes of defining the term **"regularly traded"** under the treaty. ***U.S. Treasury technical explanation to the treaty.***

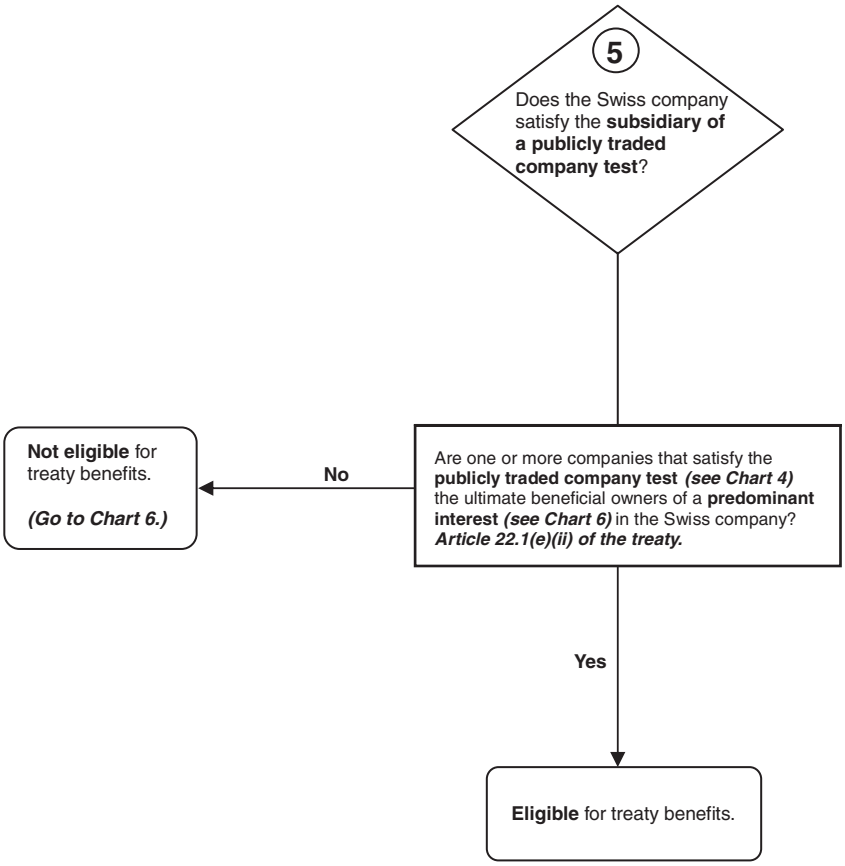
The **regular trading** requirement can be met by trading on any recognized exchange or exchanges located in either contracting state. Trading on one or more recognized stock exchanges may be aggregated for purposes of this requirement. Thus, a Swiss company could satisfy the regularly traded requirement through trading, in whole or in part, on a recognized stock exchange located in Switzerland or certain third countries. Authorized but unissued shares are not considered for purposes of this test. ***U.S. Treasury technical explanation to the treaty.***

The term **"recognized stock exchange"** means:

i) any Swiss stock exchange on which registered dealings in shares take place;
ii) the NASDAQ system owned by the National Association of Securities Dealers, Inc., and any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for purposes of the Securities Exchange Act of 1934;
iii) the stock exchanges of Amsterdam, Frankfurt, London, Milan, Madrid, Paris, Tokyo, and Vienna; and
iv) any other stock exchange agreed upon by the U.S. and Swiss competent authorities.

Article 22.7(a) of the treaty.

Chart 5. Subsidiary of a Publicly Traded Company Test Under Article 22.1(e)(ii) (LOB) of the Switzerland-U.S. Tax Treaty

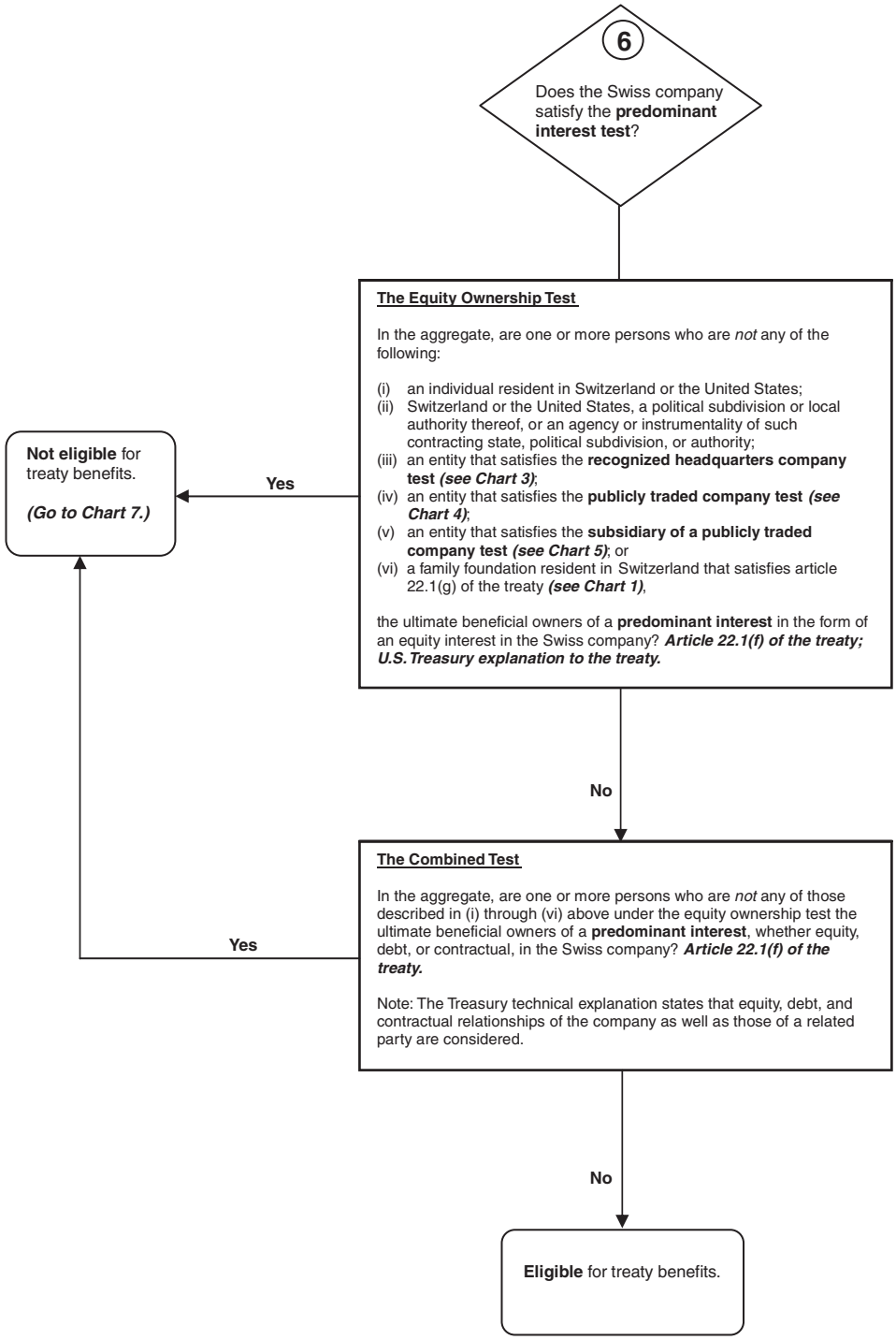


It is understood that a company is described in the **publicly traded company test** ***(see Chart 4)*** within the meaning of the **subsidiary of a publicly traded company test** only if that company is a resident of Switzerland or the United States that is entitled to the benefits of the treaty by reason of the **publicly traded company test** ***(see Chart 4)***. ***Paragraph 5 of the MOU to the treaty.***

The test of **predominant interest** will be interpreted consistently with the test of predominant interest that applies for purposes of the **predominant interest test** ***(see Chart 6)***. The test of **predominant interest** that applies for purposes of the **predominant interest test** ***(see Chart 6)*** generally requires a direct, or indirect, interest of more than 50 percent. Thus, for example, a Swiss resident corporation, all the shares in which are owned by another Swiss resident corporation, will qualify for benefits under the treaty if the **principal class of shares** ***(see Chart 4 for definition)*** of the Swiss parent are **primarily and regularly traded** ***(see Chart 4 for definition)*** on the Frankfurt stock exchange unless one or more persons who do not qualify for benefits under the treaty are the beneficial owners of other types of interests in the subsidiary that constitute a predominant interest under the principles of the **predominant interest test** ***(see Chart 6).*** However, the Swiss company would not qualify for benefits under the **subsidiary of a publicly traded company test** if the publicly traded parent company were a resident of Germany, not of the United States or Switzerland. ***U.S. Treasury technical explanation to the treaty.***

The **predominant interest** test differs from the test of **principal class of shares (*see Chart 4 for definition)*** included under the **publicly traded company test** ***(see Chart 4)*** in that 50 percent of the aggregate interests, not merely the class or classes accounting for more than 50 percent of the company's votes and value, must be held by publicly traded companies described in the **publicly traded company test** ***(see Chart 4)***. Thus, the **subsidiary of a publicly traded company test** considers the ownership of every class of shares outstanding, as well as debt and contractual interests, while the **publicly traded company test** ***(see Chart 4)*** only considers those classes that account for a majority of the company's voting power and value. ***U.S. Treasury technical explanation to the treaty.***

Chart 6. Predominant Interest Test Under Article 22.1(f) (LOB) of the Switzerland-U.S. Tax Treaty



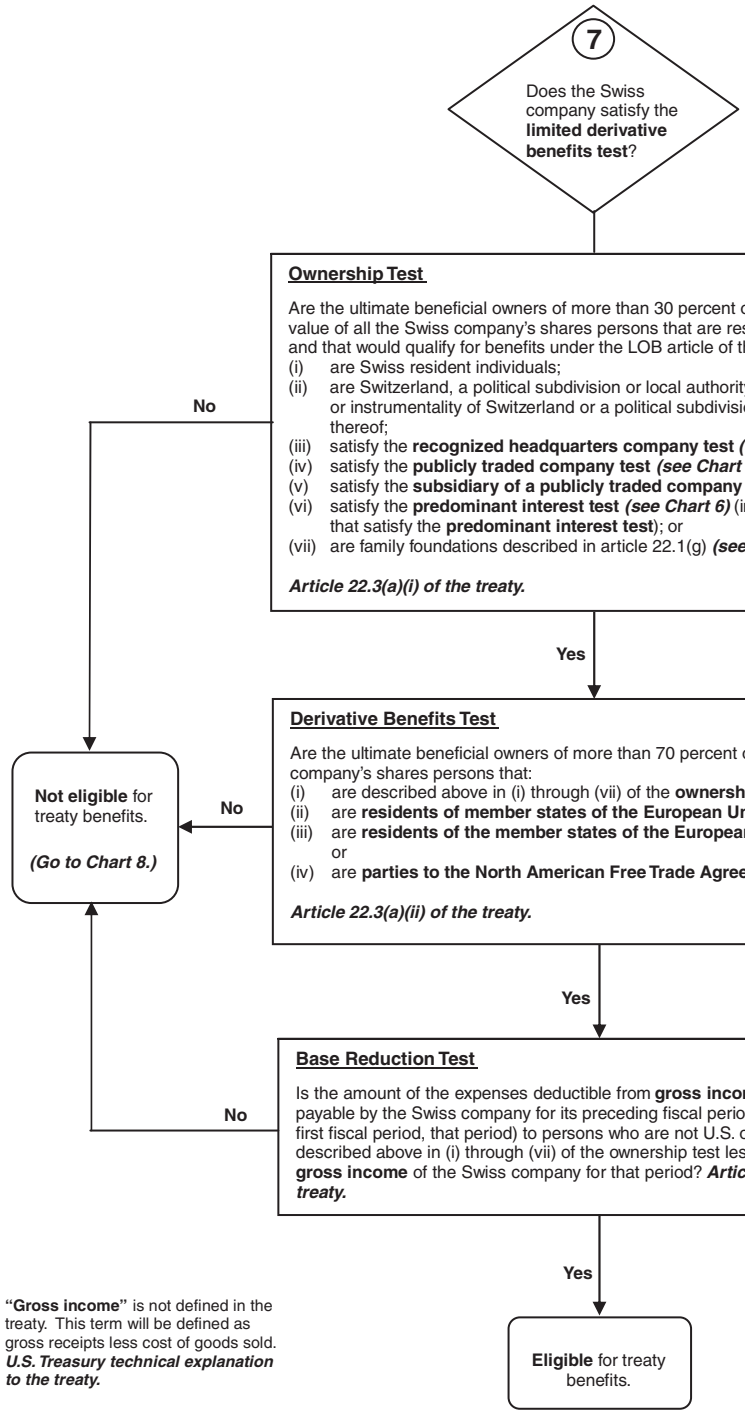
A **predominant interest** is a direct or indirect interest of more than 50 percent. ***U.S. Treasury technical explanation to the treaty.***

For purposes of the **combined test**, the United States shall take into account, in addition to equity interests that such persons may hold in the company, other contractual interests that the person or persons may have in the company and the extent to which such person or persons receive, or have the right to receive, directly or indirectly, payments from that company (including payments for interest or royalties, but not payments at arm's length for the purchase or use of or the right to use tangible property in the ordinary course of business or remuneration at arm's length for services) that reduce the amount of the taxable income of the company, in order to deny benefits to a person that would otherwise qualify for benefits under the **predominant interest test**. ***Paragraph 8 of the protocol to the treaty.***

In determining the amount of deductible payments, depreciation and amortization deductions, which are not "payments," are disregarded. ***U.S. Treasury technical explanation to the treaty.***

Note: It is possible that no person would have a predominant interest in a company, in which case it would satisfy the requirements of the **predominant interest test**. Accordingly, a company whose shares and debt obligations are widely held by unrelated persons generally would satisfy the **predominant interest test.** ***U.S. Treasury technical explanation to the treaty.***

Chart 7. Limited Derivative Benefits Test Under Article 22.3 (LOB) of the Switzerland-U.S. Tax Treaty (Only Applies to Dividends, Interest, and Royalties)



"Gross income" is not defined in the treaty. This term will be defined as gross receipts less cost of goods sold. ***U.S. Treasury technical explanation to the treaty.***

The terms **"resident of a member state of the EU or of the EEA"** and **"party to the NAFTA"** mean a person that:

(I) Is a resident of a country ("Country X") with which the United States has a comprehensive income tax treaty and that person is entitled to all of the benefits provided by the United States under that treaty; ***article 22.3(b)(i) of the treaty.***

(ii) Would qualify for benefits under paragraph 1 of article 22 (LOB) of the treaty because such person is a resident in Country X that:
a. is an individual;
b. is Country X, a political subdivision or local authority thereof, or an agency or instrumentality of Country X or a political subdivision or local authority thereof;
c. satisfies the **active trade or business test** ***(see Chart 2);***
d. satisfies the **recognized headquarters company test** ***(see Chart 3)***;
e. satisfies the **publicly traded company test** ***(see Chart 4)***;
f. satisfies the **subsidiary of a publicly traded company test** ***(see Chart 5)***;
g. satisfies the **predominant interest test** ***(see Chart 6)***; or
h. is a family foundation that qualifies for benefits under the treaty ***(see Chart 1)***;
if references in such paragraph 1 to the first-mentioned contracting state were references to that person's state of residence (in this case Country X); and ***article 22.3(b)(ii) of the treaty.***

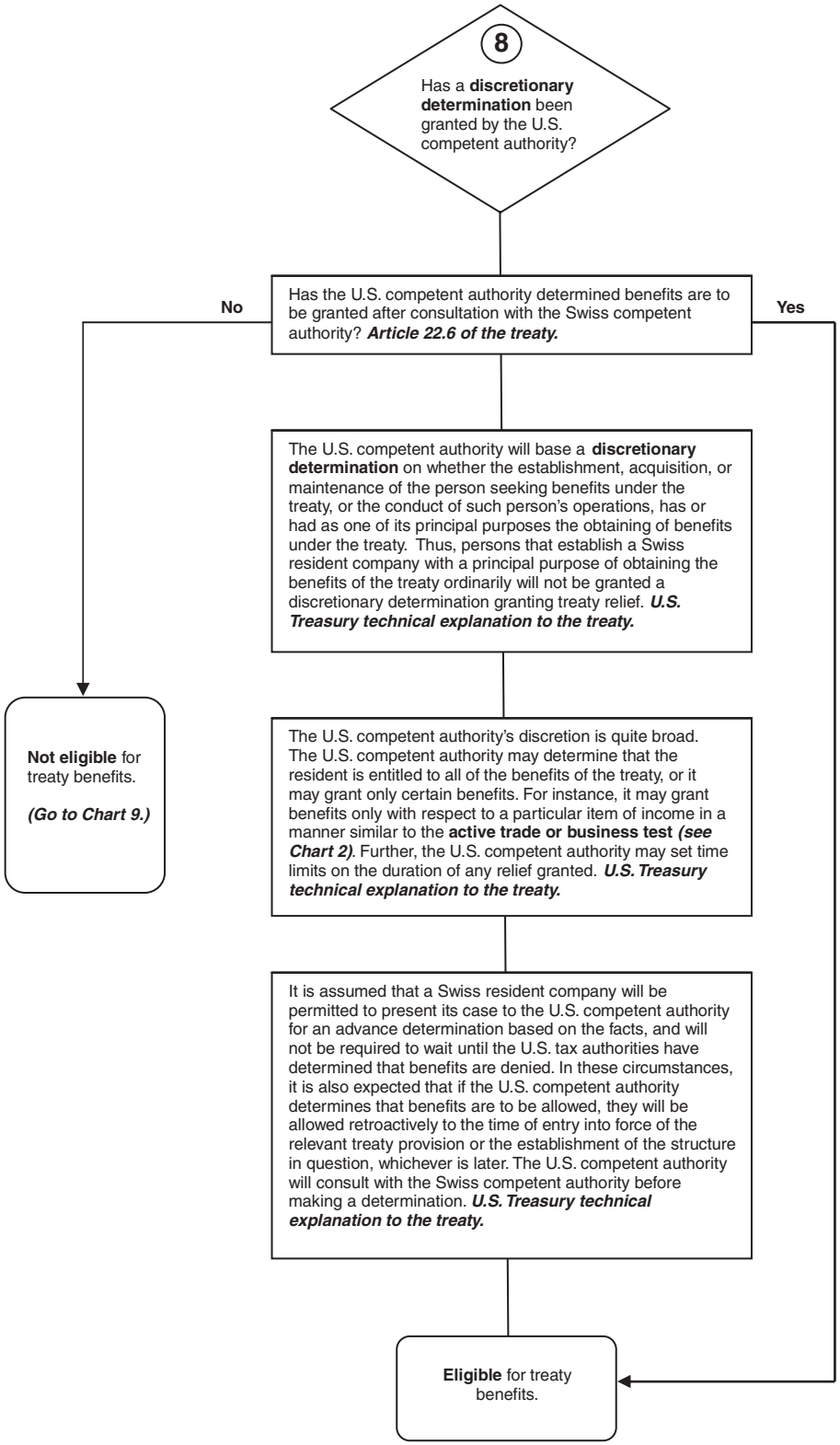
(iii) Would be entitled to a rate of tax in the United States under the treaty between that person's country of residence (in this case, Country X) and the United States in respect of the particular class of income for which benefits are being claimed under the treaty, that is at least as low as the rate applicable under the treaty. ***Article 22.3(b)(iii) of the treaty.***

The U.S. and Swiss competent authorities agreed a U.S. resident will qualify as a **resident of a party to NAFTA** if that person is a **resident** ***(see Chart 1 for definition)*** of the United States and also:

(i) an individual who is a resident of the United States (as determined under article 4 of the treaty);
(ii) the United States or a political subdivision of the United States, an instrumentality of the United States, or political subdivision thereof; or
(iii) a company incorporated in the United States that satisfies the **publicly traded company test** ***(see Chart 4).***

Competent authority agreement between the United States and the Swiss Confederation (Aug. 25, 2003).

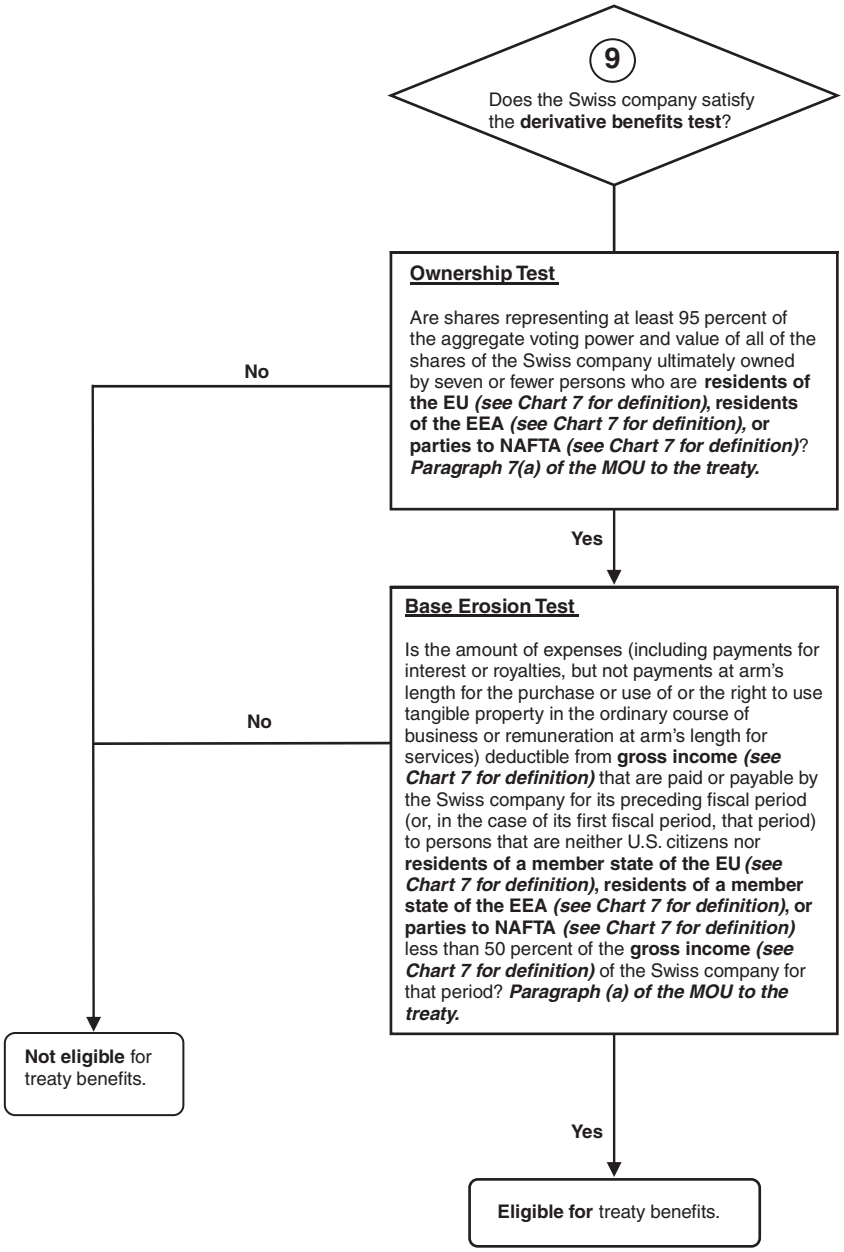
Chart 8. Discretionary Determination by U.S. Competent Authority Under Article 22.6 (LOB) of the Switzerland-U.S. Tax Treaty



Requesting competent authority assistance -- A taxpayer may request the assistance of the U.S. competent authority under Rev. Proc. 2006-54.

There is a US $15,000 user fee for requesting a **discretionary determination** under the LOB provision. If a request is submitted for more than one entity, a separate user fee is charged for each entity. ***Section 14.02 of Rev. Proc. 2006-54.***

Chart 9. Derivative Benefits Test Under Article 22.6 (LOB) and Paragraph 7 of the MOU of the Switzerland-U.S. Tax Treaty



However, a company otherwise entitled to benefits under this **derivative benefits test** is not entitled to the benefits of the treaty if that company, or a company that controls such company, has outstanding a class of shares: i) the terms of which, or which is subject to other arrangements that, entitle its holders to a portion of the income of the company derived from the United States that is larger than the portion such holders would receive absent such terms or arrangements (for example, alphabet or tracking stock); and ii) 50 percent or more of the vote and value of which is owned by persons who are neither U.S. citizens nor **residents of a member state of the EU** ***(see Chart 7 for definition)***, **residents of a member state of the EEA** ***(see Chart 7 for definition)***, **or parties to the NAFTA** ***(see Chart 7 for definition)***. ***Paragraph 7(b) of the MOU to the treaty.***

The U.S. and Swiss competent authorities agreed a U.S. resident will qualify as a **resident of a party to NAFTA** ***(see Chart 7 for definition)*** if that person is a **resident** ***(see Chart 1 for definition)*** of the United States and also:

(I) an individual who is a resident of the United States (as determined under article 4 of the treaty);

(ii) the United States or a political subdivision of the United States, an instrumentality of the United States, or political subdivision thereof; or

(iii) a company incorporated in the United States that satisfies the **publicly traded company test** ***(see Chart 4).***

Competent authority agreement between the United States and the Swiss Confederation (Aug. 25, 2003).