11. Tax Benefits, Just The Icing on the Cake?

Johanna Friedl-Naderer, Vir Biotechnology International, Zug
Dr. Markus Frank Huber, MLL Meyerlustenberger Lachenal Froriep, Zurich


Introduction

US based large Multinational Companies ("MNC") generally prefer to segregate markets being centralized through Regional Headquarters ("HQs") based in Europe or Asia. There is a widely spread hypothesis that a strong correlation exists between tax incentives and the decision where to locate the HQs. The tax landscape has undergone and is still undergoing dramatic changes. Just think about the Organization for Economic Cooperation and Development ("OECD"), Base Erosion and Profit Shifting ("BEPS") project[1], US Inflation Reduction Act[2] and the Swiss Tax Reform and AHV Financing Act ("TRAF")[3]. What is common to all those projects is that they entail the consequence that the Effective Tax Rates ("ETR") for corporate taxpayers increases, and certain beneficial tax treatments are phased out. In line with the mentioned hypothesis this should lead to an exodus of HQs from Switzerland respectively to the consequence that Switzerland has become less attractive to locate HQs. However, this does not seem to be true, since in our daily practice we do neither recognize departures of HQs nor a standstill in companies setting up their HQs in Switzerland. Hence is the mentioned hypothesis wrong?

Background on Swiss HQ's of US Quoted Companies

In the 90'ies, supply chains became global and therefore the need arose to centralize business models. That was primarily possible for products that could easily be shipped targeting high net operating margins. One of the business segments prone for such structures is the pharmaceutical industry. Over the last 15-20 years, a substantial number of HQs companies were set-up in Switzerland. One of the draw backs was and still is that the operating costs are high, compared to other locations. To a certain extent, the high costs were balanced through attractive tax regimes, such as the principal company treatment (according to Circular Letter 8 dated December 18, 2001[4] and tax holidays. Under the relevant regimes, a Principal company, depending on the facts and circumstances, was subject to an Effective Tax Rate ("ETR") in Switzerland of approx. 5%. Under the tax holiday regime, it was possible at certain locations to get a tax holiday of 100% for 10 years. In consideration of the high costs, MNCs were staffing the HQs leanly. Nevertheless, optimizing operating costs through regular review and rightsizing of the organization was and is needed from a business and international tax scrutiny perspective. In the past, the primary focus was on the quantitative aspect - primarily headcount. That has changed substantially and for a few years now the focus is on the qualitative aspects. What leads to those changes?

- From a US tax perspective, the substantial contribution test to qualify for the manufacturing exception requires a US subsidiary's employees to engage in a certain minimum level of activities in connection with the third-party manufacturing in order to avoid pick-up under the US Controlled Foreign Corporation ("CFC") regime, i.e. the Subpart F rules. Otherwise, in broad terms the current income generated by the CFC from related party purchases or sales is subject to the US tax rates.
- In October 2015, the OECD published the report on "Aligning TP Outcomes with Value Creation". One of the cornerstones of the Report is that there must be a strong correlation between the Development, Enhancement, Maintenance, Protection and Exploitation ("DEMPE function") of IP to allow the owner to get an arm's length remuneration on the exploitation of the IP. The analysis of the DEMPE function added another layer of complexity to the review since it is based on the actual underlying economic aspects. In other words, under the DEMPE analysis, an offshore entity bearing all the risks, is only entitled to a return on the capital invested. In the past, the emphasis was on the contractual setup, so that the risk bearing entity was entitled to the bulk of the income.
- The Tax Cuts & Jobs Act of 2017 ("US tax reform") that was enacted with the intention to make the U.S. a more attractive location for business operations through a carrot and stick approach, including lowering the statutory US tax rate from 35% to 21%, creating the Global Low-taxed Intangible Income ("GILTI") regime resulting in current U.S. taxation at a minimum 10.5% rate (increasing to 13.125% in 2026) on CFC income that was previously not taxed until it was distributed to the U.S., and implementing the Foreign Derived Intangible Income ("FDII") regime that lowered the U.S. tax rate on US export income.
- Swiss tax reform of 2020 eroded tax incentives at the federal level by phasing out Circular 8 and at cantonal level the mixed company regime. There are transitional measures that aim at smoothing out the hike in the tax rate increase.
- With OECD's BEPS project in particular, Pillar II aiming at introducing a global minimum tax rate of 15% and the US tax reform the remaining tax advantage will further erode, and US HQs are analyzing the advantages and disadvantages of maintaining respectively setting up a Swiss based HQ.

In other words, should the above hypothesis be true, then there should be an exodus of US controlled HQs out of Switzerland, respectively no new HQs should be set-up in Switzerland.

Location Criteria

For obvious reasons, MNCs generally assess the location of their foreign operations on a combination of cost and quality factors. Latest trends in Foreign Direct Investments suggest that costs are not as important as other factors in the context with HQs[5].

As regards to quality factors, the ranking may vary from one group to the other. One of the very decisive factors is the availability of labor forces and the quality of the skills of the employees. To have a sustainable setup, the living environment is important, as this has a close correlation with the ability to attract and retain the necessary talents, including employees from abroad. This is interlinked with the educational system, such as Universities as well as School of Engineers. In the context of HQs also the presence of International Schools is highly ranked, as this will facilitate the transfer of families. An important factor in particular in the pharma and biotech industry are industry clusters with access to world class talent. Obviously, those have an impact on the availability of qualified employees[6]. But also from an educational aspect, as the demand for specialists may make the offering of special educational curricula more attractive for Universities or Schools of Engineers.

Other important factors are political stability, monetary stability, strong Swiss Franc as one of the most stable and leading currencies and an enabling business environment comprising all the factors that make the life easier for HQs of MNCs, such as access to the governmental bodies, e.g. department of labor for working permits, department of construction, and tax administration.

Since the executives of HQs are traveling frequently, the physical infrastructure is important such as roads, railways, and airports. To successfully operate HQs, the reliability of the infrastructure and technology is essential. The recent disruptive factors such as the Covid 19 pandemic and the resulting impact on the global supply chain have led to a shift in strategic priorities and location criteria as companies look to a location strategy to actively build agile and resilient business models[7]. Considering the above factors, one may draw an interim conclusion that tax incentives alone may not be decisive.

Considerations

One may expect that companies should re-evaluate the business case. Depending on the outcome and the potential Effective Tax Rate ("ETR") differential, there are other important reasons why US MNCs would continue to have Swiss HQs. The most important being that they can still get and retain talents. Further US MNCs still need a presence in EMEA to run non-US HQ and will obviously check on alternatives to understand the relative strengths and opportunities of those locations. Controversy is likely to increase. Support in achieving tax certainty is critical, therefore a central element of those US MNCs will be the assessment of the efficiency of the Competent Authority Procedure.

One element in the assessment is also the fact that unwinding is tough, expensive, and disruptive and needs a clear sustainable vision for a new organization structure. However, the business model is the key consideration, and a re-thinking could lead to Switzerland as a HQ presence being put at risk.

Alternatives

A recent EU Study[8] has highlighted that at the beginning of the Single Market, harmonized tax rules had a very beneficial impact on the economic development. However, EU Member States have found it much easier to agree on curbing international tax planning than on reducing tax and administrative barriers in the Single Market. Consequently, leeway for international tax planning has decreased significantly in recent years, but at the cost of a complexity explosion. In contrast, the US tax policy has long been characterized by a greater awareness of the realities of international tax competition, providing also carrots and not only the stick for investors.

Conclusion

What are the opportunities for Switzerland? The Swiss Domestic Top Up Tax is set to be 15%. ETRs of 15% are the new 0%. Accordingly, MNCs located in the low taxing cantons have a good starting position. Those cantons are well advised to consider the above EU Study and to identify measures how to "circle back" the funds to the MNCs that contributed to the top-up tax in a way that is compliant with OECD rules.

Broadening the scope and looking at the latest developments in the tax global landscape, BEPS is likely to impact companies depending on their footprint differently.

- Some smaller companies might exit Switzerland, respectively not consider as a HQ location with ETR differential decreasing. However, they most likely would have always struggled to bring the substance to Switzerland.
- Medium sized companies might experience less of a change as they are already operating with appropriate and cost-effective substance. This under the assumption that they have a broad business case. Those are likely to stay to avoid disruption.
- Larger companies are looking at 15% which is the new 0%. Accordingly, they have a favorable position if they are in Switzerland and this is a beneficial outcome, considering that migrating larger HQs has a substantial disrupting effect.

So, it may be assumed that the BEPS project should not lead to an exodus of robust HQs, nor should it discourage US based MNCs to set-up their HQs in Switzerland, albeit ETRs may increase. Our analysis is supportive of the fact that over the time, the correlation between tax incentives and the location where HQs may be located has eroded substantially. Other factors are of much more importance. Our recent experience indicates that for US based MNCs in the pharmaceutical and biotech industry, Switzerland is, despite the latest developments, an attractive place to locate their OUS HQs. As a result of the recent disruptive events, tax incentives will the longer be of a lesser importance. Tax incentives that "circle back" the additional tax revenue are nice to have or to put it in other words, are «the icing on the cake».

1) OECD, Understanding tax avoidance, https://www.oecd.org/tax/beps/, visited on April 16, 2023.
2) IRS, Inflation Reduction Act of 2022, https://www.irs.gov/inflation-reduction-act-of-2022, visited on April 16, 2023.
3) Federal Department of Finance FDF, Tax proposal and AHV financing (TRAF), https://www.efd.admin.ch/efd/en/home/the-fdf/legislation/votes/tax-reform-ahv-financing/fb-steuervorlage17.html, visited on April 16, 2023.
4) Swiss Federal Tax Administration, International Tax Allocation for Principal Companies, https://www.swisstaxlaw.ch/en/knowledge-base/circular-letter-no-8-principal-allocation/, visited on April 16, 2023.
5) VIOLA CAON, A guide to the key FDI drivers, https://www.investmentmonitor.ai/analysis/a-guide-to-the-key-fdi-drivers, visited on April 17, 2023.
6) MARTIN NAVILLE, RAPHAEL BUCK, FELIX WENGER, JAN MISCHKE, ALEXANDER KLEI, Switzerland Wake Up, Reinforcing Switzerland's Attractiveness to Multinationals, April 2019, https://www.mckinsey.com/ch/~/media/McKinsey/Featured%20Insights/Europe/Reinforcing%20Switzerlands%20attractiveness%20to%20multinational%20companies/Switzerland-wake-up-Full-report.ashx, visited on April 17, 2023, p. 27.
7) JACOB DENCIK, KOEN GIJPERS, ROEL SPEE, PATSY VAN HOVE, DAVID ZAHARCHUK, Global Location Trends, Special Edition 2020, Location strategy in a post-COVID-19 world, https://www.ibm.com/downloads/cas/2M3LVRXO, visited on April 21, 2023, p. 1.
8) JOST HEINRICH HECKEMEYER, Study, Removal of taxation-based obstacles and distortions in the Single Market in order to encourage cross border investment, 26 July 2022, https://www.europarl.europa.eu/thinktank/en/document/IPOL_STU(2022)733964, visited on April 16, 2023, p. 9 et seq.

About the authors:

Johanna Fried-Naderer is Chief Operating Officer at Vir Biotechnology, Inc. Before she was President Europe, Canada and Partner Markets, Biogen.

Markus Frank Huber, PhD (law) is Partner Tax at MLL legal in Zurich. Before, he was until his retirement Head of European Tax of Biogen International GmbH in Zug. He is the Chairman of the Tax Chapter Board of the Swiss-American Chamber of Commerce.

This article reflects the personal view of the authors.