

Principal companies and finance branches

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Two further practices completed the picture. Both rested on administrative practice of the Federal Tax Administration and were therefore applicable at the federal level as well. The first was the principal company. Under a circular issued in 2001, a Swiss company that acted as the entrepreneur of an international group could centralise functions such as purchasing, research management, production planning, marketing strategy and risk management, while contract manufacturers and limited-risk distributors in other countries received a modest, stable remuneration.¹ The Swiss principal earned the residual profit. Because a foreign distributor was regarded as a kind of dependent agent, part of the principal's trading profit was allocated to foreign countries for Swiss tax purposes, even where those countries did not tax it. In combination with mixed company status at the cantonal level, the result could be a very low effective rate on trading profit.

The second practice was the finance branch. A Swiss company could hold a branch abroad, typically in a low-tax jurisdiction, to which the group's internal financing activity was attributed. Under the federal practice, the Swiss head office was taxed on only a fraction of the interest income, because a notional interest expense on the equity of the branch was deducted.² Finance branches mattered for groups that lent large amounts to their subsidiaries and invested surplus cash. The Basel pharmaceutical groups, with their strong cash flows and international networks of subsidiaries, were natural candidates for such arrangements, although the precise structures used by individual companies were not published.

Principal companies and finance branches were among the practices that the international community later found most objectionable. The principal model separated the location of profit from the location of the activities that generated sales, and the finance branch reduced the tax on interest income below the level that most states considered appropriate. Neither practice was secret: both were described in circulars and handbooks, and

they were offered to any group that met the conditions. They were nevertheless criticised as "ring-fenced" because they benefited only income from abroad, and as harmful because they attracted paper profits.³

1 Notes

1. Federal Tax Administration, Circular No. 8 of 18 December 2001 on international tax allocation of principal companies (Kreisschreiben Nr. 8, Internationale Steuerauscheidung von Prinzipalgesellschaften). To be verified. ↩
2. The Swiss finance branch practice is described in practitioner literature and in the Federal Council's message on Corporate Tax Reform III; it was based on an unpublished practice of the Federal Tax Administration. To be verified. ↩
3. On the concept of "ring-fencing" as a criterion of harmful tax practices, see OECD, Harmful Tax Competition: An Emerging Global Issue, 1998, and the EU Code of Conduct for Business Taxation adopted by the ECOFIN Council on 1 December 1997. To be verified. ↩

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