

Substance and the international tax standards

*Dr Alexander Ressos, TEP
Attorney-at-Law (Switzerland), Solicitor (Hong Kong),
Solicitor (England & Wales)*

The legal requirements of company law are easily met. The requirements of the international tax standards are more demanding. A company in Zug that wishes to benefit from a tax treaty, to receive dividends from European subsidiaries without withholding tax or to be recognised as the owner of intellectual property and the recipient of the corresponding income must be able to show that it has real substance: that it is managed and controlled in Switzerland, that it has qualified personnel who perform the relevant functions, that it bears and controls the risks attributed to it, and that its costs correspond to these functions.

The principal purpose test introduced into Switzerland's tax treaties through the Multilateral Instrument of the OECD denies treaty benefits where obtaining them was one of the principal purposes of an arrangement, unless granting them would be in accordance with the object and purpose of the treaty.¹ The transfer pricing guidelines of the OECD require that profits be allocated according to the functions performed, the assets used and the risks controlled. The controlled foreign company rules of the states in which the parent companies of groups are resident attribute the income of low-taxed subsidiaries to the parent where the subsidiary lacks substance. The global minimum tax, described in Part B, sets a floor under the effective tax rate of large groups regardless of substance, but it grants a substance-based income exclusion that reduces the top-up tax for companies with significant payroll and tangible assets in the jurisdiction.²

The cumulative effect of these rules has been to reward real activity in Zug and to penalise its absence. A group that maintains in Zug a principal company with a real management team, a trading floor or a regional headquarters with hundreds of employees can defend its structure against challenges by foreign tax authorities, benefit from the substance-based exclusion under the minimum tax and rely on the low cantonal rate for the profits that exceed the minimum. A group that maintains in Zug only a

registered seat and a nominee director faces challenges in every direction. The international standards have thus accelerated the transformation of the canton from a location of registered seats into a location of real headquarters, as described in Chapter II.

1 Notes

1. Principal purpose test under Art. 7 of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI); Loyens & Loeff, "Switzerland deposits ratification instrument for the Multilateral Instrument (MLI) – entry into force on 1 December 2019", 4 September 2019, [loyensloeff.com](https://www.loyensloeff.com): instrument deposited on 29 August 2019, in force for Switzerland from 1 December 2019; Switzerland adheres to the PPT standard and, under a reservation pursuant to Art. 35(7) MLI, applies the MLI to a covered treaty only after completing its internal procedures for that treaty. ↩
2. OECD, "Global Anti-Base Erosion Model Rules (Pillar Two)", oecd.org: substance-based income exclusion based on payroll and tangible asset carve-outs; Council Directive (EU) 2022/2523 of 14 December 2022, eur-lex.europa.eu, implementing the Model Rules: carve-out rates for payroll and tangible assets, initially 10 and 8 per cent, declining over ten years. ↩

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