

Benefiting from a Swiss-based IP company

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This article outlines the non-tax and tax advantages of Switzerland as a location for an intellectual property (IP) company. It furthermore provides some examples of how to structure the set-up of a Swiss IP company tax effectively.

In general, the Swiss corporate tax environment for foreign investors may be considered advantageous. Swiss-registered companies or Swiss branches of foreign companies may benefit from the low corporate income tax rates as well as from a number of favourable tax regimes on cantonal and communal level. Under certain circumstances the federal corporate income tax of 7.83% of the after-tax profit can be further reduced by using the principal company structure or the so-called IP branch rulings. As Swiss-resident corporations a Swiss-based IP company may benefit from the large number of double tax treaties entered into by Switzerland with more than 60 countries. More than 25 double tax treaties provide for 0% rate withholding tax on royalties which allows the Swiss IP company to collect royalty payments with no foreign taxes imposed. Swiss-resident companies or branches are also subject to an annual capital tax on the shareholders equity on cantonal and communal level. As the communal and cantonal corporate income tax levels differ from canton to canton to a substantial extent the choice of where a Swiss IP company is set up must be reviewed carefully.

Concentration of IP management

A concentration of the IP rights and the management of such rights in one company in a group of companies does not only provide the opportunity to profit from tax advantages but also has considerable advantages on the management level. Among those advantages are the following:

Improved information

In larger groups of companies, a commonly observed feature is that certain IP rights are registered more than once, which may become rather expensive, in particular in the case of patents which are upheld during their entire term. A centralized holding and administration of the IP rights in a group allows the group to only register the rights actually needed. The improved information on the rights available to the group will also help to prevent gaps in the protection structure of the intellectual assets of the group which may occur if departments informally rely on other departments for organizing the protection of intellectual assets. Finally, the improved information will also ensure that in particular patents will only be kept registered for as long as they are needed. A group can thereby, for example, avoid having to pay the annual fees for patents unnecessarily during the last years of their term (which is usually 20 years), which is rather costly as the amounts that need to be paid each year to keep a patent valid increase during the term of the patent. Therefore, centralization helps to ensure a more effective and cheaper protection of the intellectual assets of the group.

Central administration

Centralization of the IP management in a group leads to a central administration, which helps to save administrative costs and to acquire additional know-how in the

administration and protection of intellectual assets by the persons concerned. This will also help to avoid costly mistakes in the protection structure and to provide the management with better information on the available protected intellectual assets.

Better control over the intellectual assets

Centralization of IP management will also help management to implement corporate identity programmes and to control better the management of enforcement or infringement proceedings, which improves the cost-monitoring of the group's litigation. In addition, the enhanced control ensures that in any restructuring, the relevant IP rights are allocated to the proper entity (through transfers in case of a sale or licensing agreements in case of restructurings within the group) and helps to limit the risk that in the case of a sale of certain enterprises, IP rights later found to be needed by other group companies are transferred to a third party without appropriate licensing agreements in place.

Better transferability

The centralization of IP rights will not only allow an easier transferability in case of any restructurings, but will also make it easier for the group to, for example, pledge its IP rights to creditors as a security or to start securitization programmes. In recent years, in particular banks more and more often requested that the IP rights of a group were pledged as a security for credits granted. Such pledge of IP rights is cumbersome, as pledges can not be executed through international registration systems, but need to be registered individually in the respective national registry of each country concerned. As a rule, registration can only be made through local representatives, which will further increase the costs of any such registration of a pledge. The centralization of IP rights allows a group to pledge instead of the individual rights the shares of the legal entity holding the IP rights (as a special purpose vehicle), thereby improving the security granted to the lenders which may grant the group easier access to capital.

Therefore, even without any additional tax advantages, any group relaying for its business on IP rights should earnestly consider centralizing the management and the holding of its IP rights in a special IP company.

Tax-efficient Swiss structures for IP management

To optimize any IP company structure from a tax perspective on a cantonal and communal level a favourable tax regime should be negotiated with the competent tax authorities.

Holding companies

The taxation as a holding company requires that the company's main purpose is to hold substantial equity investments in other foreign and domestic companies. Qualifying holding companies are exempt from cantonal and communal income taxes. A company qualifies for the holding company regime if its articles of association reflect the above mentioned main purpose and if at least two-thirds of its assets or its income is

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derived from substantial holdings or participations. A business activity in Switzerland is not permitted. Nevertheless, most of the cantons allow holding companies to own trade marks and patents as long as the qualifying criteria for a holding company are met. The licensing of IP rights by a holding company is restricted to intra-group licensing due to the fact that no business activity is allowed within Switzerland. Holding companies are fully exempt from corporate income tax on cantonal and communal level. The overall tax burden on intra-group licensing income is therefore 7.83 % of the profit after tax.

Mixed companies

A mixed company is defined as a Swiss resident company whose business is predominantly related to abroad. Qualifying mixed companies are performing the exploitation of intangible or other assets, invoicing, group financing and similar activities. In the case of licensing it is essential that the exploitation of the IP rights takes place abroad and on foreign markets. The ownership of the IP rights, however, remains with the Swiss company. A qualifying mixed company is benefiting from the following tax regime on cantonal and communal level:

- Foreign source income is taxed in relation to the Swiss-based activities required to realize this income. In general, 5% to 30 % of the foreign source income is subject to ordinary taxation at the cantonal and communal level. This results in a substantially reduced cantonal and communal corporate income tax rate.
- Dividends as well as capital gains on participations are fully tax-exempt as for holding companies.
- Any Swiss source income is taxed at the ordinary rate. Swiss source income should not be more than 20 % of total

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income. In some cantons the same requirement applies on the company's expenses.

Holding companies and mixed companies are fully taxed on a federal level. To reduce the federal corporate income tax certain tax efficient structure may benefit from a favourable regime for the determination of the taxable profit:

Principal company structure

The principal company structure as outlined in the Circular Letter No 8 of the Swiss Federal Tax Administration issued on December 18 2001 has basically been drawn up for production and sale activities within a group of companies where the distribution is made by way of commissionaire agreements. The Swiss-based principal company collecting all the profits from distribution is then granted an allocation of 50% of the profits from the distribution to the deemed permanent establishment abroad. This structure may apply also to the development of IP rights seen as production activity and the licensing seen as distribution activity. If the condition of a risk allocation with the Swiss IP company based on agreements similar to commissionaire agreements is fulfilled this international allocation of profit should also apply to IP companies. Based on the above-mentioned circular letter 30% of the IP company's profit would be attributed for production to the Swiss principal company and 50% of the remaining 70% of distribution

Switzerland's non-tax advantages as a IP company location

Switzerland is an ideal location for any IP company, as it not only offers various tax advantages as explained, but also an advantageous political and business environment, a stable and well recognized legal and court system, liberal IP rights regulations, a well established IP treaty network and, finally, the headquarters of the World Intellectual Property Organization which is located in Geneva in Switzerland.

Political and business environment

Switzerland is a politically very stable country located in the centre of Europe. It has an exceedingly high quality of living, is one of the leading financial centres, has various universities and is well known for its reliable transportation, highly qualified workforce with language and social skills.

Switzerland is also considered by various companies as a representative test market for Europe due to its diversity and manageable market environment.

Legal system

The Swiss legal system is stable and well respected. Swiss law is often chosen by non-Swiss business partners as the law of choice, due to its reputation of high standing and neutrality. In particular for contracts between companies in the former Soviet Union, in Arabian or African countries on the one hand and companies in western countries on the other hand, Swiss law is often the law of choice. The Swiss state court system enjoys a reputation of impartiality and efficiency, granting low-cost access to the enforcement system to both Swiss and non Swiss companies. Switzerland is also an internationally recognized centre of and location for internal arbitration and has a significant number of specialists for arbitration proceedings; as Switzerland is party to the relevant treaties, recognition of Swiss arbitration decisions in other countries is ensured.

Favourable IP regulations

Swiss IP law is characterized by an open and tolerant regime, which, for example, allows service marks, permits holding companies and other non-manufacturing companies to enjoy full rights as owners of trade marks and which does not impose undue conditions for registration of Swiss IP rights (which may subsequently serve as a basis for an international registration). Furthermore, there are no restrictions under Swiss law to transfer registered or non-registered IP rights, which may be done by way of sale, licensing, franchising, by granting of a security right or by other means. Swiss international private law respects a choice of law made in such contracts by the parties, provided the choice-of-law clause is in writing. Switzerland is member of all the major international IP treaties, among others, the Paris Convention, the revised Berne Convention, the Madrid Agreements, the Patent Cooperation Treaty and the Hague Agreement. Through adherence to those treaties, it is possible for any Swiss company to register IP rights in a large number of jurisdictions through centralized registration systems, without the need to mandate local representatives in each jurisdiction. Furthermore, the treaties guarantee on the basis of reciprocity protection rights equal to the rights enjoyed by nationals of the respective country and enable the Swiss registrant to claim, during a certain term, the priority date of his Swiss basis registration for registration of IP rights in other countries.

The combination of the above features renders Switzerland an ideal location for any IP management and holding company even without taking into consideration the favourable Swiss tax regime.

profit would be attributed to abroad. This allocation of profit to deemed permanent establishments abroad reduces the corporate income tax on federal level substantially.

IP branch ruling

If the Swiss IP owner is a branch of a foreign entity, in some cantons a tax favourable ruling may be obtained. The determination of the Swiss taxable profit takes into account the allocation of costs incurred in the headquarters abroad and therefore the taxable basis is reduced substantially. The percentage of profit subject to tax depends on the specific company structure and is subject to negotiation with the competent cantonal tax administration.

A tax-effective structure for IP management companies located in Switzerland requires that any incoming royalties are not subject to foreign withholding taxes. Therefore, it is essential that the Swiss IP management company is entitled to benefit from the extensive Swiss double tax treaty network. The entitlement to treaty benefits requires, however, that there is no abuse of such treaties. According to the *Swiss Anti-Abuse Decree* of 1962 a directly or indirectly foreign-controlled Swiss entity may be entitled to treaty benefits if the following conditions are met:

- Not more than 50% of income that is subject to treaty benefits must be paid, directly or indirectly, to non-residents; the amortization of IP rights bought from non-residents is treated similar to a payment to a non-resident.
- A minimum of 25% of the income subject to treaty relief in the previous year must be distributed as dividend.
- The company has to be in line with the Swiss debt/equity ratio rules.
- The interest rates on interest-bearing loans have to comply with the interest rates published annually by the Swiss Federal Tax Administration for loans and advances between related parties.

If the Swiss IP company, however, qualifies as a so-called active company the company is allowed to pay more than 50% of its treaty-protected income to non-residents (other payments than dividends) provided that such payments are commercially justified. As long as the company is making regular and adequate dividend distributions the obligation to distribute 25 % of the treaty-protected income does not apply either. An IP management company is considered active within the meaning of the *Swiss Anti-Abuse Decree* if it carries out in Switzerland an independent business activity with the objective of making profits and which includes rendering services through own employees and in own offices. The burden of proof for an active company is with the Swiss IP company. Similar conditions are included in the limitation-on-benefits clause of the Swiss-US double tax treaty. According to the published information of the Swiss Federal Tax Administration an IP management company usually does not qualify as active within the meaning of the *Swiss Anti-Abuse Decree*. The simple administration of IP rights such as licens-

ing, management of registrations and protection is insufficient. If, however, the management of the IP rights is made with a substantial number of employees or other means by which an economic added value is achieved, the company may qualify as an active company. Also, if certain patents are developed in Switzerland that requires an active management of licences, patents or trade marks including new developments and further developments. It should not be excluded that these activities may be performed to a certain extent by third parties on a contractual basis. However, the exact requirements, such as number of employees and their qualification and the activities carried out in Switzerland, depend on the specific facts and the negotiations with the competent cantonal tax administration. Therefore it is advisable to go for a binding tax ruling for the entitlement of treaty protection. The double tax treaties with Belgium, France and Italy provide for special anti-abuse provisions.

The exploitation of IP rights abroad is usually not subject to Swiss value-added tax (VAT). The Swiss IP management company, however, will be allowed to apply for optional VAT registration, which entitles the Swiss company to recover input VAT.

For a Swiss-resident IP company qualifying as an active company within the meaning of the *Swiss Anti-Abuse Decree* the collected income can be further distributed and transferred to non-Swiss group entities. This can be made by the following structures:

Head licence

Any payment under a head licence agreement is tax deductible if commercially justified. Switzerland does not levy any withholding tax on licence payments. On the recipient side of the structure the licence income most likely will be taxable.

Interest payment

As long as the interest payment is in line with the safe-haven rules it is accepted for a tax deduction. On debt instruments usually there is no withholding tax. The recipient will be subject to income tax abroad.

Dividend distribution

Distributions of profit subject to tax is generally subject to a 35% Swiss withholding tax (*Verrechnungssteuer*), which is eliminated or reduced by the application of the respective double tax treaty. Furthermore, should the agreement between the EU and Switzerland providing for measures equivalent to those laid down in the *EU Savings Directive* enter into force Swiss resident companies will also benefit from the *EU Parent-Subsidiary Directive*. In connection with this elimination of withholding taxes the Swiss Federal Tax Administration is planning a reporting procedure which will replace the present deduction of Swiss withholding tax.

Hybrid financing

Under certain conditions a hybrid finance instrument could be put in place. Such instrument is treated as debt instrument

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in Switzerland and qualifies as participation income in the recipient's jurisdiction.

Transfer of IP assets to Switzerland

The transfer of IP rights to Switzerland usually does not trigger any Swiss taxes. However, the country of origin of such rights usually levies substantial taxes on the exit of IP depending on the respective value. For tax purposes it is therefore recommended that new IP should be developed at the tax-efficient location or at least the costs for such development should be incurred in that jurisdiction. Some foreign countries have already put in place a legislation to avoid the exit of IP. A complete transfer of existing IP is also most likely costly because of separate registration of individual patents and trade marks. Therefore, it is generally recommended to transfer key rights as soon as possible and register new rights at the desired new location. Expiring patents or trade marks may be left abroad and any further development resulting in a new patent should be registered at the desired location. In the case of a Swiss-registered company the contribution of assets

against shares is subject to the one time capital duty of 1% of the fair market value or the contribution. In the case of a registered branch, however, no such capital duty is levied. In the case of reorganization of a business it is possible to get a favourable tax ruling from the Swiss Federal Tax Administration avoiding the one-time capital duty on the incorporation of a company.

A company should check and calculate various options of a Swiss IP company if it is active in the following businesses:

- A strongly brand-driven business
- Businesses that traditionally provide for strong IP rights protection such as pharmaceuticals and biotechnology
- Very innovative businesses.

Additional decision criteria could be the additional value of IP, a substantial turnover based on IP and finally, a profit where a reduction of the corporate income tax rate between 5% and 10 % is relevant.

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