

Taxation of US LLCs in Switzerland – Federal Court rules against hybrid treatment

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The Federal Court recently issued a key decision on the fiscal treatment of a US limited liability company (LLC). The court ruled that the LLC should be qualified as a partnership from a Swiss tax perspective. This assessment was based mainly on fiscal pass-through treatment in the United States. Consequently, the LLC's payments to the Swiss partner were taxed as income derived from independent services in Switzerland.

Background

A US LLC is a hybrid business entity with certain characteristics of both a corporation and a partnership. An LLC has legal personality and its partners benefit from limited liability. However, for US income tax purposes, the pass-through taxation of a partnership generally applies – though the LLC may elect to be taxed as a corporation (known as 'check-the-box regulation').

Swiss civil law is not tailored to such hybrid entities. It is dominated by the dichotomy between partnerships on the one hand and corporations on the other, while only corporations are recognised as legal persons. The same applies to Swiss tax law, as it is generally based on civil law (known as the 'authoritative principle'). Therefore, until now it has been uncertain which rules US LLCs should be qualified under.

This unclear legal situation persisted even after the Swiss Tax Conference (an association of the Swiss federal and cantonal tax administrations) issued guidelines in 2011 on the fiscal treatment of US LLCs because of their non-binding nature. Contrary to the Federal Court judgment, these guidelines state that, in principle, LLCs must be equated with Swiss corporations, regardless of the fiscal treatment in the United States. This leads to the conclusion that distributions from an LLC cannot be taxed as income derived from personal services. They qualify either as dividend income or as return on moveable assets (or, as the case may be, as a return of capital).

Federal Court considerations

Qualification of US LLC under Swiss law

The court initially outlined the general rules regarding the taxation of partnerships under Swiss law. As a matter of principle, partnerships are transparent for fiscal purposes. Therefore, each partner is taxed personally and proportionally on his or her share of the partnership profits (Article 10 of the Federal Income Tax Act). Thus, partners derive income from independent personal services even if they are not actively involved in the partnership's business.

With regards to foreign partnerships, Article 11 provides for a specific regulation, whereupon foreign partnerships with an economic link to Switzerland are taxed according to the rules applicable to corporations. However, in this case, the court denied the application of this regulation for lack of an economic link to Switzerland. Thus, the question of whether a US LLC could be qualified as a foreign

AUTHORS

[David Brönimann](#)



[Andrea Opel](#)



partnership remains open.⁽¹⁾

Because of the lack of legal precedents regarding the qualification of foreign entities without an economic link to Switzerland, the court had to develop general rules. In a previous judgment regarding the taxation of a general partnership incorporated in Guernsey, the court had stated that the civil law qualification is crucial. In that case, due to the lack of legal personality, the general partnership could not be recognised as a corporation for Swiss tax purposes. In the present case, the court clarified this statement insofar as the qualification under civil law cannot be decisive on its own. According to the court, a "pragmatic mix of methods" is appropriate. First, the foreign entity should be compared with the Swiss entities (partnerships and corporations). Second, the fiscal treatment abroad is decisive for the tax treatment in Switzerland. However, the court clarified that foreign entities without legal personality cannot be recognised as taxable entities.

In light of this, the court concluded that the relevant LLC qualified as a partnership for Swiss tax purposes. The decision was based both on the civil law elaboration of the LLC (eg, no share capital, distribution of profits via capital accounts) and on the fiscal treatment in the United States (pass-through taxation).

Qualification of US LLC under double taxation treaty

According to the court, the rules regarding the qualification of US LLCs are consistent with the double taxation treaty between Switzerland and the United States. Considering that the fiscal treatment of an LLC in the United States supports avoiding double taxation, it corresponds to the common intention of both contracting states.

Taxation of distributions

Based on the qualification as a partnership and the assumption of business activity conducted by the LLC, the court qualified the payments from the LLC to the Swiss resident partner as income derived from independent services under Swiss tax law. According to the court, this is consistent with the double taxation treaty. From a Swiss perspective, the distributions cannot be treated as dividend payments in terms of Article 10 of the treaty. Because of the pass-through taxation in the United States, no US withholding taxes have to be taken into account. However, income derived from independent services is taxable only in Switzerland, unless the business activity is carried on through a permanent establishment in the United States (*cf* Article 14(1) in connection with Article 7(1) of the treaty). In this case, the existence of a US permanent establishment was not evidenced.

Critical appraisal

Swiss tax law is generally based on civil law, even regarding the qualification of taxable entities. Article 49(3) of the Federal Income Tax Act provides that foreign legal entities are taxable as corporations under Swiss law. Thus, US LLCs, due to their legal personality, must be treated as corporations for Swiss tax purposes. Qualification as a partnership shall be precluded. Therefore, it is doubtful whether the court's 'pragmatic mix of methods' approach is consistent with Swiss tax law. The Swiss Tax Conference guidelines seem to be more in line with Swiss domestic law, even if they no longer apply because of their non-binding nature.

The decision is also not convincing in other respects. If a US LLC is qualified as a partnership for Swiss tax purposes, its profits are, due to the pass-through treatment, directly taxable as income of the (Swiss resident) partners. Consequently, later distributions should be fiscally irrelevant. Nevertheless, in this case, the court qualified the payments from the LLC as taxable income. Apart from that, the legal basis of the LLC's payments remained unclear. The decision raises new questions that will have to be subject to future decisions and advance tax rulings of the Swiss authorities.

Comment

Even if a 'pragmatic mix of methods' approach generally fails to stand for legal certainty, the court's first statement on fiscal treatment of US LLCs under Swiss tax law outlines the most important principles. The LLC's civil law elaboration and its fiscal treatment in the United States are crucial. Depending on this assessment, LLCs can be regarded as either partnerships or corporations under Swiss tax law.

Treatment of LLC as partnership for Swiss tax purposes

If an LLC qualifies as a partnership, its profits are attributed to the partners. Thus, the LLC's profits are taxable in Switzerland insofar as and provided that one or more partners reside in Switzerland. However, business profits attributable to a permanent establishment in the United States are exempt from taxation in Switzerland. The gain received by the LLC is taxable (due to the pass-through treatment). Later distributions should be fiscally irrelevant.

In the absence of a permanent establishment in the United States, the Swiss resident partners derive income from independent services, even if they are not actively engaged in the LLC's business. This leads to a relatively high tax burden of up to 46%, depending on their residence in Switzerland. Income from independent services is also subject to social contributions of approximately 10%, which are of a parafiscal nature when above a certain limit.

The profit of non-operative LLCs (ie, LLCs engaged in asset management activities only) should also be taxable in Switzerland (*cf* Article 21(1) of the double taxation treaty).

Treatment of LLC as corporation for Swiss tax purposes

The profit of an LLC classified as a corporation is generally taxable only in the United States. However, tax liability of the LLC in Switzerland may arise based on its place of effective management in Switzerland, the maintenance of a permanent establishment or the ownership of real estate in Switzerland.

Distributions received should be treated as dividend income. Under Swiss tax law, dividend income qualifies for partial taxation, provided that the resident partner owns a share of more than 10% in the LLC's capital. Under the double taxation treaty, the distributions are covered by Article 10(4). Thus, US withholding taxes should be partly recoverable or credited against the Swiss taxes on the dividends.

Recommendations

In light of the Federal Court's key decision, it is recommended that structures, including LLCs with a link to Switzerland, are carefully reviewed. The court's decision even invalidates existing rulings.

For further information on this topic please contact [David Brönimann](#) or [Andrea Opel](#) at Meyerlustenberger Lachenal by telephone (+41 44 396 91 91) or email (david.broenimann@mll-legal.com or andrea.opel@mll-legal.com). The Meyerlustenberger Lachenal website can be accessed at www.mll-legal.com.

Endnotes

(1) According to the main doctrine, insofar as partners reside in Switzerland, the partnership is regarded as a Swiss partnership. A partnership may appear as both a foreign and Swiss partnership at the same time, based on the different residencies of its partners.

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