SWISS CORPORATE TAX REFORM POSTPONED

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Corporate Tax
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INTRODUCTION

Besides its beautiful mountains and lakes, Switzerland is traditionally known as an attractive and stable location with regard to corporate income taxation. However, in recent years, Switzerland has been under high international pressure from organizations including the E.U. and the Organisation for Economic Cooperation and Development ("O.E.C.D."), which claim that the Swiss tax system is not in line with international best practices. In particular, the E.U. has expressed the opinion that the tax regimes granted by Switzerland to certain companies – such as holding or mixed companies – represent prohibited State Aid and violate the 1972 free trade agreement between Switzerland and the E.U.

In 2014, this dispute was settled by a joint statement on business taxation between Switzerland and the E.U. In the settlement, Switzerland agreed to abolish five preferred tax regimes (see below for details), prompting a proposal for broader reform the Swiss corporate tax system. However, the E.U. has stipulated that it will re-impose sanctions against Switzerland should the agreed-upon obligations under the joint statement not be fulfilled within a reasonable amount of time or should Switzerland introduce new harmful tax regimes.

In 2012, the O.E.C.D. launched the B.E.P.S. Project, which deals with tax avoidance strategies used by multinational enterprises ("M.N.E.'s"). M.N.E.'s try to shift profits from jurisdictions that have high taxes – such as the U.S. and many countries in western Europe – to jurisdictions that have low or no taxes, even though there is little or no economic substance (*i.e.*, business activities, employees, office premises, etc.) in the latter jurisdictions. The B.E.P.S. Project has led to the publication of several reports and actions plans by the O.E.C.D. Since Switzerland is a member state of the O.E.C.D. and its goal is to be in line with international best practices, compliance with B.E.P.S. Project recommendations is an essential component of the proposed reform of Swiss corporate income taxation.

In the summer of 2016, the two chambers of the Swiss parliament formally approved new legislation that would have led to a tax system consistent with international standards. However, on Sunday, February 12, Swiss voters defeated the tax reform package known as the Corporate Tax Reform III ("C.T.R. III").

This article describes the state of the proposed reform that was put before Swiss voters and ponders steps that may be taken in order to fulfill all obligations under the settlement between Switzerland and the E.U. Even though the proposal did not find final approval by voters, substantial portions are expected to form part of a new proposal that will be submitted to the Swiss Parliament.

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CURRENT CORPORATE INCOME TAXATION IN SWITZERLAND

Switzerland is comprised of 26 states (cantons). Taxes are levied at the Federal and cantonal/municipal levels. As a result, there is no standard tax rate since the cantonal/municipal rates differ. Federal corporate income tax is levied at a flat rate of 8.5% of net income. Since a company may deduct its taxes in the respective year, the effective Federal corporate income tax rate is approximately 7.8%. The aggregate effective income tax rate for Federal and cantonal/municipal taxes for ordinarily taxed companies – as opposed to preferred companies (see next paragraph) – varies from 12% to 24%, depending on the canton and municipality in which it will be taxed.

The current Swiss tax system provides for preferred tax regimes enabling certain companies (*i.e.*, holding, administrative, mixed, and principal companies and Swiss finance branches) to reduce their effective tax burdens significantly:

- Swiss holding companies are exempt from cantonal/municipal income taxes ("Holding Company Status"), provided they fulfill certain conditions:
    - At least two-thirds of the holding company's total assets must consist of substantial investments in participations, or at least two-thirds of the company's total income must be derived from such investments.
    - The company may, in general, not engage in an active business in Switzerland.
    - The company's statutory purpose is investing in subsidiaries.

  Thus, a holding company typically receives dividend income and/or realizes capital gains. On a Federal level, holding companies may profit from a participation exemption on dividends and capital gains if certain conditions are satisfied (*i.e.*, at least 10% shareholding, or the value of the shares equals more than CHF 1,000,000 with respect to dividends). In practice, such dividends are typically 90%- to 95%-exempt from corporate income tax. As a result, Swiss holding companies are currently taxed marginally or not at all.

- If a Swiss company is engaged primarily (*i.e.*, a mixed company) or fully (*i.e.*, an administrative company) in activities abroad, income from non-Swiss sources may be taxed at substantially reduced rates at a cantonal/municipal level. These companies are typically used for the sales, financing, or holding of intellectual property ("I.P.") or other activities in relation with non-Swiss markets. Although there is no preferred tax rate on a Federal level, the overall corporate income tax rate can be reduced to approximately 8% to 10%.

- In a principal company, functions, responsibilities, and risks of a group are centralized in one company while the distribution of products is carried out by group entities or agents. On a cantonal/municipal level, the above-mentioned rules regarding mixed companies apply. On a Federal level, foreign trading activities are allocated to the profit of the principal company. In other words, foreign profits may be shifted to Switzerland. On an aggregated level, these companies are able to reduce their corporate income tax rate to approximately 5% to 6%.

- A branch of a foreign company providing finance services to group members may profit from qualifying as a Swiss finance branch for Federal tax purposes. On a cantonal level, the above-mentioned rules regarding mixed companies apply. Further, there is a deemed interest deduction on the cantonal and Federal level. On an aggregated level, these companies are able to reduce their corporate income tax rate to approximately 2% to 3%.

Due to the increase in international pressure, the Swiss government approved a new law – the C.T.R. III – in 2016, in order to adapt the Swiss corporate tax system to international standards. The tax reform was not only expected to be internationally acceptable, but it would also have allowed the Swiss tax system to remain one of the most competitive and attractive tax systems in Europe. Since companies benefiting from the above-mentioned tax regimes create jobs and demand for services, they contribute to Switzerland's economy. In addition, they pay a significant part of the overall corporate income and capital taxes. It is estimated that all companies benefiting from the outgoing preferred tax regimes pay approximately half of all direct Federal corporate income taxes collected in Switzerland. Therefore, the two of the main goals of the C.T.R. III were keeping these companies in Switzerland and attracting new companies to Switzerland.

CORPORATE TAX REFORM III

Under the C.T.R. III, the above-mentioned preferred tax regimes would be abolished and holding, administrative, and mixed companies would be taxed at ordinary tax rates. Furthermore, the favorable principal allocation scheme and the Swiss finance branch taxation regime would be abolished on a Federal level. For Switzerland to remain attractive to companies profiting from these regimes, the C.T.R. III provided for a number of countermeasures. The cantons could then decide if and how the countermeasures would be implemented on a cantonal/municipal level.[1] Proposed measures regarding Federal and cantonal level taxation are outlined below.

Step-up Mechanism to Reveal Hidden Reserves

During a transition period of five years, the cantons would have the option to impose a tax on the realization of undisclosed hidden reserves and self-generated goodwill (*i.e.*, a step-up in basis) at a special low tax rate, provided neither was taxable under the previous tax rules. Assets such as buildings or trademarks typically bear hidden reserves since the book value is lower than the actual fair market value. The special low tax rate would lead to a fair and predictable transition for companies formerly profiting from the preferred tax regimes.

A corporation's undisclosed hidden reserves and self-generated goodwill would be determined by the cantonal tax administrations at the time of enactment of the C.T.R. III. Companies transferring assets or functions from abroad to Switzerland would be permitted to disclose hidden reserves and self-generated goodwill in the tax balance sheet. The disclosed hidden reserves would be deductible in subsequent years according to the applicable tax depreciation rates. Goodwill could be amortized over a maximum period of ten years.

To illustrate the step-up mechanism, consider a Swiss company that is currently

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[1] This substantial flexibility is a consequence of the Swiss concept of federalism.

benefiting from the tax regime as a mixed company, which divides its profits into a Swiss part and a foreign part. The average profits in the years 2016 to 2018 (*i.e.*, prior to the implementation of the reform) amount to CHF 8,000 for the Swiss part and CHF 2,000 for the foreign part, totaling CHF 10,000. Additionally, the company has CHF 40,000 in hidden reserves and CHF 100,000 in equity, totaling CHF 140,000 in equity including hidden reserves. Based on a two/one ratio of capitalized income (*i.e.*, average annual profits plus interest) to equity including hidden reserves, the tax administration would calculate a weighted company value. Assuming a 5% interest rate, this would result in a weighted company value of CHF 180,000.

	SWISS	FOREIGN	TOTAL
Average Profits 2016 to 2018	CHF 8,000	CHF 2,000	CHF 10,000
Equity Including Hidden Reserves			CHF 140,000
Weighted Company Value			**CHF 180,000**

As a next step, the tax administration would calculate the goodwill by taking the difference between the weighted company value and the equity including hidden reserves, resulting, in this example, in CHF 40,000 in goodwill.

Finally, the hidden reserves and the goodwill would be divided into a Swiss part and a foreign part according to the allocation of profits from the years 2016 to 2018 (*i.e.*, an 80/20 ratio). The Swiss part would be subject to a special (lower) tax rate. Further, the total hidden reserves and goodwill could be included in the future tax balance sheet and amortized over subsequent years.

	SWISS (80%)	FOREIGN (20%)	TOTAL
Hidden Reserves	CHF 32,000	CHF 8,000	CHF 40,000
Goodwill	CHF 32,000	CHF 8,000	CHF 40,000
Amount Taxed at Special Rates	**CHF 64,000**		
Amount Taxed at Ordinary Rates		**CHF 16,000**	
Amount Included in Future Balance Sheet			**CHF 80,000**

Introduction of Federal and (Optional) Cantonal Notional Interest Deductions

While cantons would be given the option to introduce a deemed interest deduction on excessive shareholder's equity – known as a notional interest deduction ("N.I.D.") – such N.I.D. would be mandatory on a Federal level. This measure is intended to encourage companies with highly mobile financing functions to remain in Switzerland.

A similar concept is already used in European countries such as Belgium and Luxembourg. For the time being, the N.I.D. has not been addressed as a harmful tax practice by the O.E.C.D. or E.U. However, in 2016, the U.S. Department of the Treasury issued a revised U.S. Model Income Tax Convention, which provides

that an N.I.D. may fall under the provisions of a preferred tax regime and will result in disadvantages with regard to U.S. withholding taxes. However, the currently applicable convention between the U.S. and Switzerland does not yet include such a clause.

"While cantons would be given the option to introduce a deemed interest deduction on excessive shareholder's equity . . . such N.I.D. would be mandatory on a Federal level."

To illustrate the application of the N.I.D., consider a Swiss company operating a power plant that has taxable equity of CHF 80,000,000. The balance sheet shows liquid assets of CHF 10,000,000 and real estate valued at CHF 90,000,000. The taxable profits for the given year amount to CHF 1,000,000.

The N.I.D. would be calculated taking the different types of assets into account. First, each type of asset would be linked to a base equity capital ratio determined by the tax administration. The assets of the company would also be weighted by a ratio determined by the tax administration. Since these ratios are not outlined in the C.T.R. III, assumptions will be used in the following example.

The asset ratio illustrates the risk linked to the asset in question and the equity needed for such assets. In the example, the estimated ratio of 55% shows that the tax administration requires equity of at least CHF 49,500,000 in order to finance the real estate.

ASSET	VALUE	ESTIMATED RATIO	BASE EQUITY
Liquid Assets	CHF 10,000,000	0%	CHF 0
Real Estate	CHF 90,000,000	55%	CHF 49,500,000
Total Base Equity			**CHF 49,500,000**

In the example, the Swiss company has an equity surplus of CHF 30,500,000. The notional interest rate would be based on the rate of return of a ten-year Federal government bond, which is currently 0%. For illustration purposes, we assume an N.I.D. rate of 1%. Therefore, the company could include a deduction of 1% of the surplus equity (*i.e.*, CHF 305,000 for (notional) interest from its taxable income for Federal corporate income tax purposes) on its tax return.

Finally – after the deduction of the N.I.D. – the taxable profits for the given year would amount to CHF 695,000. On a cantonal/municipal level, the deduction would be granted if the applicable canton introduced the N.I.D. in its cantonal law.

Taxable Equity	CHF 80,000,000
Total Base Equity	CHF 49,500,000
Surplus Equity	CHF 30,500,000
Estimated 1% N.I.D.	CHF 305,000
Taxable Profit after N.I.D.	**CHF 695,000**

Introduction of a Patent Box Regime at the Cantonal Level

By introducing an I.P. or "Patent Box" regime, revenues from specific I.P. rights could

be excluded from taxable profits up to a maximum of 90% of cantonal/municipal taxes.

The Patent Box regime is also used in other European countries such as Luxembourg and the U.K. However, it should be noted that these regimes are under international pressure from the O.E.C.D. Luxembourg has already announced its plan to abolish the current regime since it is not in line with international standards.

To ensure legal certainty, the Swiss Patent Box regime would follow the approach recommended by the O.E.C.D. and thus fulfill international standards. Action 5 of the B.E.P.S. Project requires companies to have substantial activity in a jurisdiction in order to benefit from this type of preferred tax regime.

Introduction of an Optional Deduction for Research and Development at the Cantonal Level

In addition to the Patent Box regime, the C.T.R. III would introduce an optional deduction of 50% for research and development ("R&D") costs incurred in Switzerland. Since the optional deduction was limited to costs incurred in Switzerland, it was anticipated that the measure would be in line with the prospective standards of the O.E.C.D. and E.U. This incentive was intended to encourage entities with innovative activities to move to or remain in Switzerland.

Consider, as an example, a Swiss company that sells watches, parts of which are researched and developed by the Swiss company. The taxable net profit amounts to CHF 2,000,000 and the costs for R&D incurred in Switzerland amount to CHF 300,000. The final taxable profit would be calculated as follows:

Taxable Net Profit for Federal Tax Purposes	CHF 2,000,000
50% Deduction for R&D	CHF 150,000
Taxable Profit for Cantonal/ Municipal Tax Purposes	**CHF 1,850,000**

Introduction of an Overall Limitation at the Cantonal Level

The measures of the reform would have allowed for up to an 80% reduction of profits at the cantonal/municipal level. However, individual cantons could introduce lower thresholds in order to allow for more planning possibilities.

General Lowering of Cantonal Corporate Income Tax Rates

Under the C.T.R. III, the cantons would be free to decrease their cantonal/municipal corporate income tax rates, and prior to the public vote, certain cantons had already announced plans for substantial rate reductions. In Geneva, for example, the aggregate tax rate (including Federal taxes) was expected to be lowered from approximately 24% to as low as 13.5%. The canton of Zug, known as one of the most attractive cantons in Switzerland, also announced a plan to further reduce its aggregated tax rate from approximately 14.6% to 12%. However, other cantons, such as the canton of Zürich, were expected to adjust their aggregate tax rates only slightly, from 21.1% to 18.2%, while introducing the other above-mentioned measures in order to remain attractive.

Abolishment of Stamp Duty and Introduction of Tonnage Tax

In the course of Parliamentary review, other measures, such as abolishing the stamp duty of 1% on equity, were rejected or postponed. Additionally, the introduction of a so-called tonnage tax for shipping companies that operate marine transport services was deferred for further analysis within a consultation procedure and was expected to be dealt with in a separate proposal.

Tax Holidays

As a side note, the Federal and cantonal tax holidays would not affected or altered by the reform. Therefore, newly established businesses could continue to profit from a tax holiday of up to ten years in designated areas in Switzerland.

Companies Affected by the C.T.R. III

For Swiss-resident companies, the specific consequences and opportunities created under the C.T.R. III would require individual assessment. In general, all Swiss-resident companies would profit from the lower corporate income tax rates. In certain cases, a relocation of activities to a low-tax canton may have proved beneficial. For companies currently profiting from preferred tax regimes, direct implications of the C.T.R. III would have been as follows:

Holding companies would be subject to ordinary taxation on a cantonal/municipal level. However, the participation exemption, as currently applied for Federal taxes, would also become applicable on a cantonal/municipal level. Thus, the reform would, in most cases, not have a significant impact, as most holding company income is derived from participations.

Mixed, administrative, and principal companies would also be subject to ordinary taxation on the cantonal/municipal and Federal levels. During a transitional period, such companies could profit from depreciations and/or amortizations on hidden reserves and self-generated goodwill, and lower tax rates would apply. In cases where such companies have I.P. rights, they could also profit from the Patent Box regime.

Swiss finance branches would be subject to ordinary taxation on a cantonal/municipal level. While the same consequences as for mixed and administrative companies apply, Swiss finance branches may profit from the N.I.D.

OUTLOOK

On February 12, 2017, 59.1% of Swiss voters rejected the fundamental overhaul of the Swiss tax system under the C.T.R. III. Supporters argued that the reform would help to attract and keep multinational companies in Switzerland. Opponents said that taxpayers, especially of the middle class, would pay higher taxes because the lower tax rates will lead to a shortfall in revenue.

The C.T.R. III would have led to a tax system consistent with international standards. Although the C.T.R. III included significant changes to Swiss Federal and cantonal tax legislation, the measures were aimed at keeping Switzerland competitive for multinational companies operating globally. At the same time, Switzerland would have retained an internationally competitive and attractive tax system that should

have held up to the new standards under B.E.P.S. and the European Commission's State Aid investigations. Small- and medium-sized companies may also have benefitted from the reform.

Accordingly, in a statement issued shortly after the referendum, E.U. Commissioner for Economic and Financial Affairs Pierre Moscovici expressed the Commission's disappointment with the outcome, saying "the rejection of the reform and referendum means we need to redouble our efforts when it comes to taxation. The Commission plans to consult the member states so we can decide together how to proceed." O.E.C.D. Tax Director Pascal Saint-Amans cautioned that "Switzerland's partners will expect it to implement its international commitments within a reasonable time period," noting that "this need not happen within the context of a wider reform, which could take longer than the two years originally foreseen for these changes." Though the consequences of not abolishing the preferential tax regime within a reasonable time are understood, neither official mentioned a potential blacklisting of Switzerland.

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It is expected that after an in-depth analysis a new reform proposal will be submitted to Parliament as soon as possible. While it may not include the N.I.D. (one of the most debated items), the patent box regime and tax incentives for R&D could remain subject to a consensus between proponents and left-wing opponents of the recent reform proposal. It is estimated that the main core of the above outlined C.T.R. III will be included in the reassessed reform and the anticipated 2019 effective date may be postponed. Finally, Swiss cantons may reassess their plans to reduce their corporate income tax rates since this was one of the main reasons the reform did not pass the vote.

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