REVISED SWISS CORPORATE TAX REFORM WILL KEEP SWITZERLAND A TOP CORPORATE LOCATION

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INTRODUCTION

This article focuses on the latest developments in the long-awaited Swiss corporate tax reform. In order to give an overview of the reform in its latest iteration, this article offers historical background, presents the key measures of the new reform, assesses the current outlook for the project, and summarizes its results for corporations.

BACKGROUND ON THE REVISED TAX REFORM

Swiss Corporate Tax Reforms I and II

In the first iteration of its corporate tax overhaul, the Swiss Corporate Tax Reform 1997 ("C.T.R. I"), Switzerland introduced various measures to improve its reputation as an attractive jurisdiction based on corporate tax rules. Included in the C.T.R. I were measures such as a comprehensive exemption for participation income and participation profits of holding, mixed, and principal companies and finance branches ("Status Privilege"). These measures resulted in a substantial or complete exemption from income tax on the cantonal and communal levels for status privilege companies.

After the implementation of C.T.R. I, Switzerland experienced an influx of holding companies and companies qualifying for Status Privilege, which prompted a new corporate tax reform in 2007 ("C.T.R. II"). C.T.R. II was intended to improve upon C.T.R. I and to further establish Switzerland as a holding company location. Notably, C.T.R. II led to a partial tax exemption for qualifying participations in order to prevent double taxation on dividends for substantial shareholders and to the implementation of the capital contribution principle.

International Pressure on the Swiss Corporate Tax System

Simultaneously, Switzerland's corporate tax law became the focus of attention from the O.E.C.D., the G-20, and the E.U. The main criticism of these international institutions was that Switzerland enabled multinational companies with Status Privilege to shift profits globally without being taxed at the base where the income was obtained. At the peak of the tax dispute, the O.E.C.D. put Switzerland on a "grey list" of countries that were not compliant with commonly agreed-upon O.E.C.D. standards

Rejection of Swiss Corporate Tax Reform III

In connection with this international pressure and Switzerland's desire to recover its position as a fair and attractive tax location, the Federal Council and the Federal Assembly developed a new corporate tax reform that was introduced initially in 2015 ("C.T.R. III"). The initial version of C.T.R. III was compliant with international tax standards, including the O.E.C.D.'s B.E.P.S. Project, and contained, among other things, the required abolition of the Status Privilege. At the same time, it would have enabled Switzerland to be competitive from an international tax perspective.

Nevertheless, Swiss left-wing parties did not agree with C.T.R. III and launched a referendum to prevent adoption. Switzerland has a long history of placing certain legislative proposals to a vote by all citizens as a means of enhancing participatory democracy. Ultimately, Swiss voters rejected C.T.R. III in a referendum held in February 2017.

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This allowed Status Privilege to remain in force, notwithstanding international pressure. For companies that were active on a cross-border basis, this situation lead to legal and planning uncertainties.

T.P. 17 and T.R.A.F.

After the rejection of C.T.R. III, the Federal Council released a revised corporate tax reform called Tax Proposal 17 ("T.P. 17") on March 21, 2018. The majority of the measures in T.P. 17 corresponded to measures in C.T.R. III but were more balanced in order to reach a political consensus. Nonetheless, before T.P. 17 reached a vote in the Federal Assembly, it was unclear whether the parties would reach an agreement on the matter.

For this reason, a new CHF 2 billion per year subsidy for the Federal Social Security Scheme ("A.H.V.") was added to the T.P. 17 proposal as a form of socio-political compensation. With this addition, the new corporate tax reform, now called the Federal Act on Tax Reform and A.H.V. Financing ("T.R.A.F."), was adopted with a clear majority by the Swiss Federal National Assembly on September 28, 2018.

The first measures of T.R.A.F. could enter into force in 2019 if no referendum is held challenging its enactment. Some small parties have already announced that they will call for a popular referendum against T.R.A.F. In this case, T.R.A.F. would most likely be put to the people's vote in May 2019. Accordingly, implementation of T.R.A.F. would be delayed by at least a year.

T.R.A.F. – KEY MEASURES

Revocation of Status Privilege, Disclosure of Hidden Reserves, and Capital Tax Relief

Revocation of Status Privilege

One of the most important actions of T.R.A.F. is the abolition of Status Privilege on a cantonal level so that the Swiss tax jurisdiction is again compliant with international tax standards (*e.g.*, the B.E.P.S. Project).

Disclosure of Hidden Reserves for Status Privilege Companies

As a result, status privilege companies remaining in Switzerland will be forced to transition from privileged to ordinary taxation. In such a case, a so-called two-rate system is applicable. Profits relating to hidden reserves obtained under Status Privilege will be subject to a five-year limited special rate. Cantons will be free to determine this special tax rate. The disclosure of hidden reserves ensures a competitive income tax burden and is intended to encourage current status privilege companies to remain in Switzerland.

Step-up of Hidden Reserves for Companies Relocating to Switzerland

Companies relocating to Switzerland can disclose foreign hidden reserves to the Swiss tax authorities. These companies will benefit from a step-up in basis and can amortize the tax-free disclosed hidden reserves annually at an applied rate, thereby reducing taxable income during the amortization period. If these companies later relocate from Switzerland to a foreign jurisdiction, an exit tax will be due on the hidden reserves (as is already the case under preexisting law).

Capital Tax Relief

Another measure to mitigate the future tax burden on status privilege companies is capital tax relief. As such companies now benefit from a low capital tax rate, the cantons will in the future be allowed to lower the taxable capital on patents (and similar rights), qualifying participations, and intra-group loans to maintain their international corporate tax attractiveness.

PATENT BOX AND DEDUCTIONS FOR RESEARCH AND DEVELOPMENT ACTIVITIES

Patent Box

The Patent Box regime is another key measure of T.R.A.F. Net profits from patents and similar rights such as supplementary protection certificates and varieties of plant rights are to be taxed in a metaphorical box in which up to 90% of the cantonal-level tax can be eliminated. To be compliant with the modified nexus approach developed by the O.E.C.D., the Patent Box is applicable only if the corresponding tax-reduced research and development ("R&D") expenditures have already been recaptured and taxed.

Net profits from patents and similar rights are calculated according to the so-called residual-method. The starting point for this method is the overall profit of the product associated with the patent or the overall profit of the company. All profits that are not related to the patent itself are deducted from the overall profit and subject to ordinary taxation. The remaining net profit will be taxed in the Patent Box. The residual-method is very similar to the calculation used for the U.K.'s Patent Box regime.

The Patent Box regime provides benefits for cantonal tax only. All cantons must adopt the regime.

DEDUCTIONS OF R&D ACTIVITIES

In addition to the Patent Box, T.R.A.F. will authorize cantons to introduce an R&D Super-Deduction of up to an additional 50% of business-related costs for R&D activities undertaken in Switzerland. The term R&D activities was outlined very broadly when introduced and is aligned with Article 2 of the Swiss innovation law ("F.I.F.G.") as well as with common standards determined by the O.E.C.D. Basic research, scientific application, and knowledge-based R&D will all be deductible.

The R&D Super-Deduction will be calculated by adding 135% of labor costs plus 80% of invoiced third-party R&D costs to the general R&D costs. The total amount will then be multiplied by a maximum factor of 1.5, resulting in the deductible R&D costs. The invoiced third-party R&D costs must be performed in Switzerland.

RELIEF RESTRICTION

T.R.A.F. includes a restriction to prevent excessive deductions, which could erode the cantons' tax base. Hence, the aggregate tax relief based on the Patent Box, the R&D Super-Deduction, and deductions for self-financing cannot exceed 70% of the taxable profit. The 70% relief restriction also includes depreciation costs associated with a cantonal Status Privilege.

Increased Dividend Taxation and Adjustments to the Capital Contribution Principle

Increased Dividend Taxation

T.R.A.F. will increase the partial tax exemption for dividend income of individuals from qualifying participations introduced by C.T.R. II at the Federal level from 50% (for business investments) or 60% (for private investments) to a standard rate of 70%. At the cantonal level, the relief method will be harmonized and a compulsory tax rate of at least 50% will be implemented. The cantons will have the discretion to set the actual rate, provided that it is at least 50% of the standard rate.

Adjustments of the Capital Contribution Principle

T.R.A.F. will apply a repayment restriction on the capital contribution principle introduced by C.T.R. II for companies listed on the SIX Swiss Exchange. Those listed corporations will be entitled to distribute tax-exempt capital contribution reserves only if they simultaneously pay ordinarily-taxed dividends of at least the same amount. Intra-group dividends are not affected by this adjustment. Moreover, the same rules will be applied to the issue of bonus shares and nominal value increases from capital contribution reserves.

Extension of the Lump-Sum Foreign Tax Credit for Permanent Establishments

In order to prevent double taxation, Swiss permanent establishments of foreign companies will be entitled to claim relief for withholding taxes on income from third countries. The amount claimed will be set at a flat rate notwithstanding the actual withholding tax imposed.

Additional Measures

High-tax cantons (*e.g.*, Zurich, Geneva, and Berne) will have the opportunity to implement a notional interest deduction ("N.I.D.") on excess capital. So far, only the canton of Zurich would meet the requirements for introducing the N.I.D.

With respect to private restructurings, the scope of future tax-free capital gains or repayments of contributed reserves associated with share transfers to wholly controlled holding companies will be limited.

The cantons' share of the Federal direct tax revenue will be raised from 17% to

21.2%. In return, the cantons are obliged to consider the needs of cities and communes in connection with the increase of their share.

Finally, and as mentioned above, the Federation will be obligated to pay a higher share of the A.H.V. since it benefits from T.R.A.F. It is expected that over CHF 2.0 billion per year will be raised for financing the A.H.V.

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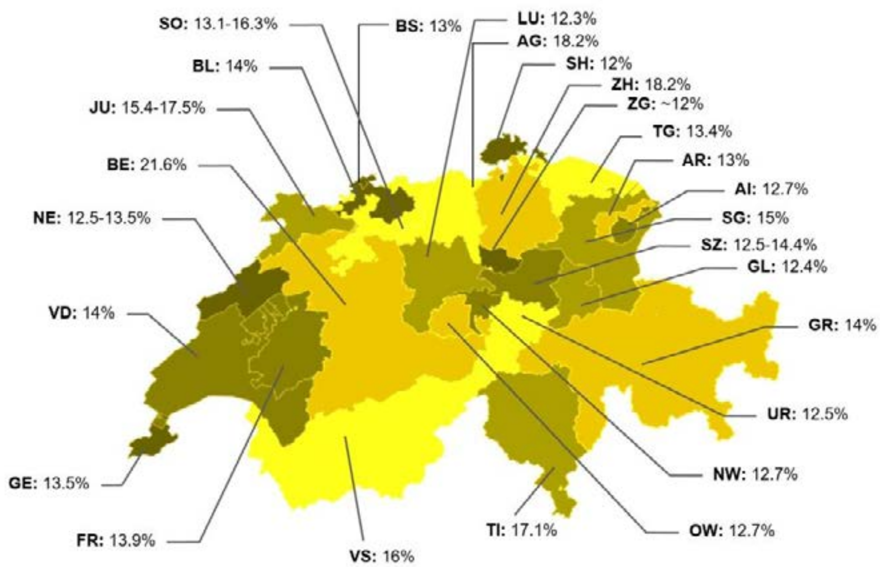
REDUCED CANTONAL TAX

Although not directly covered by T.R.A.F., another key part of the planned tax reform is that the cantons will also generally reduce their cantonal profit tax rates. This will enable Switzerland to remain attractive to former status privilege companies as well as companies planning to relocate to Switzerland or incorporate in Switzerland. The above-mentioned increase of the canton's share of the Federal direct tax enables the cantons to further reduce their tax rates. Based on official announcements made by the cantonal governments, it is expected that the majority of the Swiss cantons will provide tax rates on pre-tax income between 12% and 18% including (direct Federal taxes). The map below illustrates the reduced profit tax rates anticipated in each canton:



OUTLOOK FOR CORPORATIONS

T.R.A.F. is intended to achieve several goals for Switzerland:

- It restores legal and planning certainty for Swiss companies that operate on a cross-border basis.
- It reestablishes the reputation of Switzerland as a fair and attractive tax location in a way that is consistent with B.E.P.S. and the demands of the E.U.
- With the abolition of Status Privilege, T.R.A.F. ensures that all companies in Switzerland will be taxed at the same rate, with the exception of those eligible for the Patent Box regime and the R&D Super-Deduction.

Switzerland intends to continue an active ruling practice to provide certainty as to Swiss tax imposed on certain cross-border transactions. This will allow corporations to request an advance ruling from the competent tax administration on the tax treatment of a contemplated transaction. If the tax authorities approve the ruling, the tax treatment is binding, provided the taxpayer strictly follows the fact pattern on which the ruling is based. Note that a tax ruling cannot result in an obvious deviation from clear tax rules. In addition, it is not a binding contract. Therefore, if a new law is enacted that mandates a different result, the ruling will no longer bind the competent tax administration.

Nonetheless, the ruling practice will enable customized tax solutions based on best practices and promote a positive relationship between taxpayers and tax authorities.