SWISS CORPORATE TAX REFORM: T.R.A.F. IN A NUTSHELL

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INTRODUCTION

It has taken a while for the Swiss corporate tax reform to be adopted. As outlined in our previous articles, Swiss voters defeated the initial tax reform package by a majority of almost 60-40 in 2017.[1] In the aftermath of the defeat, a steering committee representing the cantons and the Swiss Federation issued Tax Proposal 17, recommending a modified version of corporate tax reform.[2] An analysis showed that important reasons for the defeat of the initial proposal were an adverse view of reform that was held by many and cantonal concerns over a loss of tax revenue.

More than one year later, on September 28, 2018, the Swiss parliament approved the amended bill, which was renamed the Federal Law on Tax Reform and Old-Age and Survivors' Insurance Financing ("Tax Reform and A.H.V. Financing" or "T.R.A.F."). As the modified name indicates, the law was newly linked to old-age and survivors' insurance ("A.H.V.").

T.R.A.F. was crafted to generate additional revenue for the cantons, enhance A.H.V. pensions, and reform corporate tax rules. As a result, the modified bill was approved by a large majority of Swiss voters, who went to the polls on May 19, 2019. The tax reform and A.H.V. financing provisions came into force on January 1, 2020.

T.R.A.F. IN A NUTSHELL

The final law follows the initial reform package. The existing tax regimes for companies, such as holding companies and mixed companies have been abolished, as they no longer are in line with international standards. No changes have been made to (i) the new cantonal and municipal patent box regimes based on the O.E.C.D. nexus approach, (ii) the additional deduction for research and development ("R&D") costs, and (iii) the step-up mechanism.

The following tables provide an overview of all measures adopted in T.R.A.F.

Measures Affecting Companies

Measure	T.R.A.F. Provision
Abolishment of Tax Regimes	At a cantonal level, tax regimes enabled certain Swiss companies, such as holding companies, to pay little or no corporate income tax. These tax privileges are abolished subject to a phase-in provision.

1. "Swiss Corporate Tax Reform Postponed," *Insights* 4, no. 2 (2017).
2. "New Proposal for Swiss Corporate Tax Reform," *Insights* 4, no. 4 (2017).

Measure	T.R.A.F. Provision
Patent Box	The profits from patents and comparable rights are separated from other profits and are taxed at a lower rate. Each canton has discretion to determine the extent of the minimum base to be taxed. As an example, the tax base in Zurich is 10%, which is the minimum permitted by Federal law.
Additional Deductions for R&D	Additional deductions of up to 50% may be claimed for R&D expenditures. Each canton has discretion to determine whether it will adopt the provision and, if so, the percentage increase for the additional deduction. As an example, the increased rate to expenditures in Zurich is 50%.
Notional Interest Deduction ("N.I.D.")	The cantons may allow an interest deduction on equity where the effective Federal, cantonal, and municipal income tax burden in the cantonal capital is at least 18.03%. At this time, the N.I.D. will be applicable only in the canton of Zurich, which is the only canton having a rate in excess of the threshold.
Limitation of the Aggregate Relief	The aggregate tax relief resulting from the patent box, the additional deductions for R&D, and the N.I.D. cannot exceed 70% of income prior to these deductions. Several cantons have introduced lower ceilings on the aggregated relief, among them Basel, where the ceiling is 40% of income prior to these deductions.
Adjustments to Capital Tax	All cantons levy capital tax on the equity of resident companies. The cantons may introduce a reduced tax rate on equity attributable to participations, patents, comparable rights, and intercompany loans.
Step-Up Mechanism	Companies that relocate their headquarters to Switzerland can benefit from a step-up in the base used to compute depreciation.
Extension of the Lump-Sum Tax Credit	The lump-sum tax credit prevents international double taxation. It allows a Swiss-resident company to claim a credit for foreign taxes under certain conditions, such as a receipt of dividends. Now, this credit may be claimed by a Swiss permanent establishment of a foreign company.

Measures Affecting Shareholders with Domicile in Switzerland

Measure	T.R.A.F. Provision
Partial Taxation of Dividends	Shareholders resident in Switzerland holding a participation of at least 10% of the capital of a company may profit from a special partial taxation of dividends received from such company. In other words, only 60% of a divided is taxed at the Federal level and at least 50% of is taxed at the cantonal and municipal levels.

Measure	T.R.A.F. Provision
Restrictions on Tax-Free Repayment of Capital Contribution	The principle that paid-in capital and capital reserves may be paid back to the local or foreign shareholder without any tax consequences was introduced to Swiss tax law in 2011. Swiss companies were free to decide whether a payment to a shareholder would be a dividend distribution or a repayment of such reserves. The reform restricts tax-free repayments of capital contributions for Swiss listed companies, as these companies will have to match every capital repayment with an equal dividend. This will ensure that some extent of dividends is taxed for income tax purposes. The new rule does not affect non-listed companies.
Capital Gains Tax	In general, no capital gains tax is levied on the sale of shares by an individual resident in Switzerland. Among other exemptions, the new law includes a stricter practice on capital gains tax when the shares are sold to a company controlled by the shareholder.

Fiscal Policy Measures

Measure	T.R.A.F. Provision
Cantonal Share of Direct Federal Tax	The cantons' share of direct Federal tax revenue will be increased from 17% to 21.2%, limiting the cantons' risk of a loss of tax revenues.
Municipality Clause	The cantons will compensate the municipalities for the financial effects of tax reductions at the cantonal level.
Adjustments in Financial Equalization Between Cantons	The fiscal equalization aims to mitigate cantonal differences regarding financial capacity. When calculating financial equalization between the cantons, the profits of companies having certain status are now to be given lesser weight than other profits.
A.H.V.	As originally proposed, the corporate tax reform favored Swiss corporations to the exclusion of individuals. This gave rise to an apprehension that individuals would face a tax increase in order to make up for a shortfall in tax revenue, which led to its defeat at the polls. To make T.R.A.F. attractive to voters, it includes additional financing for the Swiss social security system. Starting in 2020, an additional C.H.F. 2 billion per year will be paid into the A.H.V. system, of which approximately C.H.F. 800 million will be funded by the Swiss Confederation. Employers and employees will contribute another C.H.F. 1.2 billion.

EFFECT ON COMPANIES

The following two examples illustrate the ways companies are affected by T.R.A.F.

Example 1: Swiss Holding Company

A Swiss corporation has its registered seat in Zurich. As the corporation met the cantonal requirements for the holding company privilege, it was exempt from corporate income tax on a cantonal and municipal level until the end of 2019. With the implementation of the tax reform, the holding privilege has been abolished at the cantonal and municipal levels. The corporation will become subject to ordinary corporate income taxes. It is allowed to claim the benefit of the participation deduction as currently applicable for Federal taxes.

The company's assets consist mainly of 10% or greater participations and some cash and securities. At the end of 2019, various securities are accounted at acquisition cost, although the fair market value was higher as a result of unrealized capital gains.

Provisional Balance Sheet 2019			
Assets		**Liabilities and Equity**	
Cash	$100	Liabilities	$100
Securities*	$1,000	Loans	$3,000
Participations	$3,000	Equity	$1,000
Total	$4,100	*Total*	$4,100
* Market value $3,000 (unrealized capital gain = $2,000)			

According to Swiss accounting rules, a company may choose to account for securities at acquisition or fair market value. If fair market value is used, all securities must be accounted for at fair market value in one entry in the balance sheet. Reference must be made in the notes to the accounts.

As the holding privilege is still applicable in 2019, the company may choose to increase the value of the securities from acquisition to fair market value, resulting in a realized gain.

Final Balance Sheet 2019			
Assets		**Liabilities and Equity**	
Cash	$100	Liabilities	$100
Securities	$3,000	Loans	$3,000
Participations	$3,000	Equity	$1,000
		Income 2019	$2,000
Total	$6,100	*Total*	$6,100

> ***"A Swiss company may reduce its tax burden significantly if unrealized gains are included in the balance sheet for 2019."***

On the level of cantonal and municipal tax, the company may apply the holding privilege in the year 2019. Consequently, the realized gain of $2,000 is not taxed. However, beginning with the financial year 2020, the book values that were reported at the end of 2019 will be recognized for tax purposes.

The company will report taxable income including the realized gain of $2,000 for direct Federal taxes in 2019, and tax will be paid.

In summary, a Swiss company may reduce its tax burden significantly if unrealized gains are included in the balance sheet for 2019. From 2020 on, realized gains will be fully taxed on all three levels. See simplified example as follows, effective tax rate included.

	2019	2020
Direct Federal Tax	7.8%	7.8%
Cantonal/Municipal Tax*	0.0%	13.5%
Aggregated Tax Burden	7.8%	21.3%
Profit on Securities	$2,000	$2000
Profit Tax	$156	$426

* The canton of Zurich will reduce its tax rate in 2021 slightly (aggregate tax rate as of 2021 will be approximately 20%).

With regard to the participations (shareholdings of >10%), there is – in general – no need for a revaluation. Income arising from such participations will be subject to the participation relief, as currently applied for Federal taxes, also on the cantonal and municipal levels.

The participation exemption is a percentage deduction from corporate income tax that is equal to net participation income (gross participation income from qualifying dividends and capital gains, less related administration and financing costs) divided by taxable income. In most cases, the participation relief results in a full exemption from corporate income tax for all or most of the participation income. The participation relief applies to dividends and capital gains. No significant tax consequences should be applicable. If participations have been depreciated in the past, it must be determined whether a step-up is possible.

In summary, Swiss holding companies should analyze their assets for unrealized gains and may decide to realize them in the final 2019 financial accounts. If so, they should act immediately since the transition must be addressed with the competent tax authorities (*i.e.*, via ruling request) and/or should be included in the final balance sheet and profit and loss statement for 2019.

Finally, since tax rates vary from canton to canton, management may wish to relocate the headquarters location and functions to a more tax-favorable canton such as Zug, where the aggregate effective tax rate is approximately 12%.

Example 2: Swiss Industrial Company

A Swiss corporation has its registered office in Zurich. Until the end of 2019, the company paid ordinary corporate income taxes at the cantonal and municipal levels. The company invents industrial products in R&D centers that are located principally in Europe (outside Switzerland) and the U.S. Consequently, the operation in Switzerland has been limited to distribution activities.

The company explores whether it can benefit from T.R.A.F. It identifies that new product A will be fully developed in Switzerland and that new product B could be developed in Switzerland. If so, the Swiss contributions to R&D is expected to be 52.5%.

Additional Deductions for R&D

One of the measures provided by T.R.A.F. is the allowance of an additional deduction for R&D performed in Switzerland. The cantons may allow a deduction for up to 50% of the R&D expenses incurred by the taxpayer directly or indirectly through third parties in Switzerland. The additional deduction is allowed on the directly attributable personnel expenses for R&D plus a surcharge of 35% as well as 80% of expenses for R&D invoiced by third parties.

In our example, the canton of Zurich introduced the additional deduction for R&D. Therefore, the company may apply this additional deduction to reduce taxable income. If the company had its research facility in Basel-Stadt, it could not claim the deduction, as Basel-Stadt has not introduced the additional deduction. Again, consideration should be given to a move of headquarters and functions from Basel-Stadt.

Patent Box

Another measure of T.R.A.F. to be considered is the introduction of a patent box tax regime. Philosophically, R&D is a tax benefit that is realized at the time expenditures are made whereas the patent box regime provides benefits at a later point in time when revenue is realized. It is inappropriate to claim both benefits. Consequently, when adopting the patent box tax regime, the benefit of R&D expenses that have been deducted must be recaptured. Consequently, a corporation must analyze whether it is worthwhile to switch to the patent box regime. In our example, this question is irrelevant, as no R&D has been carried out in Switzerland in the past.

In making an analysis, the first step is to identify the patents that generate income qualifying for the patent box regime. Covered patents include

- patents registered under the European Patent Convention,
- patents registered under the Swiss Patent Act, and
- foreign patents corresponding to European or Swiss patents.

Intellectual property such as trademarks or know-how are not included for the patent box calculation.

When computing the benefit under the patent box regime, profits from intellectual property must be adjusted using the modified nexus approach. Under this approach, the expenditures for qualifying R&D performed in Switzerland is divided by

total R&D expenditures. The resulting percentage is applied to the net income from patents to determine the portion that qualifies for the benefit.

In our above-mentioned very simplified example, the company has a 100% nexus for product A and a 52.5% nexus for product B. Therefore, future profits from such patents should benefit from the patent box mechanism. Note that the computations required to be made under the patent box regime are quite complex, including analysis of functions, relations to products, and proper use of transfer pricing concepts to identify the enhanced return attributable to the application of the patented technology in the manufacture of the product.

Step-Up in Basis

Where moving a foreign company's seat to Switzerland or transferring certain business operations or functions to Switzerland is feasible, the availability of a tax neutral step-up in the depreciable basis of transferred assets should be analyzed. Under the new rules, a tax-neutral realization of unrealized capital gains or other hidden reserves is possible as a result of the transfer. Again, tax rates vary from canton to canton. Consequently, identification of the most tax-favorable canton is important.

OUTLOOK

"Companies having no operation or location in Switzerland may consider building R&D centers in Switzerland to profit from the advantageous tax and business environment."

With the approval of T.R.A.F. by Swiss voters, a tax system based on internationally acceptable measures came into force effective January 1, 2020. Switzerland remains an interesting tax location for individuals and companies looking to expand operations to Europe.

For companies already conducting operations in Switzerland, T.R.A.F. rewards those companies that are located in cantons with favorable tax rules. Important tax benefits may be lost for those companies that are unwilling to undergo the proper study. Companies having no operation or location in Switzerland may consider building R&D centers in Switzerland to profit from the advantageous tax and business environment, including the patent box regime illustrated in Example 2 above.

Having implemented T.R.A.F. does not mean that all tax can be eliminated through operations within a tax favored jurisdiction. Additional global reforms are under consideration by the O.E.C.D. At the end of 2019, the O.E.C.D. published a proposal to ensure that large and highly profitable multinational companies, especially I.T. companies, must pay a minimum level of tax. The proposal is currently under review and is expected to be finalized by the close of 2020.[3] Adopting a market-based approach to tax jurisdiction, the O.E.C.D. proposes that part of the profits should be taxable in jurisdictions with significant consumer-facing activities and where profits are generated. The upcoming discussions of the O.E.C.D. proposal will be interesting, as European companies may face increased taxation abroad by reason of the proposals.

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[3] See "Statement by the O.E.C.D./G-20 Inclusive Framework on B.E.P.S. on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy," as approved by the O.E.C.D./G-20 Inclusive Framework on B.E.P.S. on January 29-30, 2020.

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