The impact of Swiss Corporate Tax Reform III (CTR III)

Position paper of PwC Switzerland

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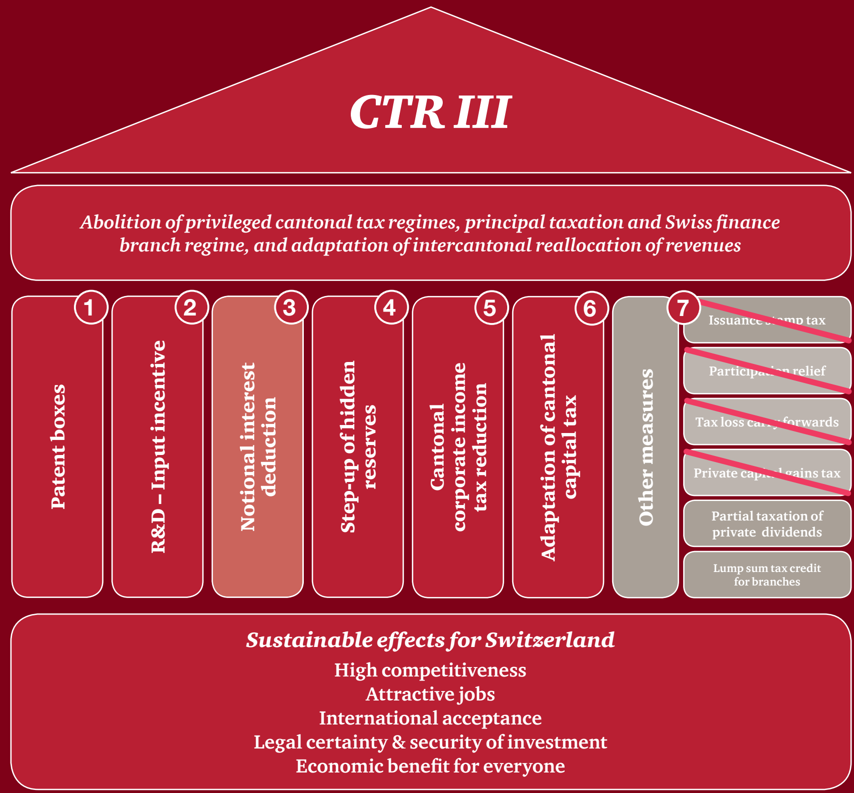
DEMANDS ON SWITZERLAND:

Conformity with OECD and EU standards. This includes equal treatment of domestic and foreign income, the abolition of privileges for certain types of companies and reconsidering tax reliefs.

TIMELINE

Switzerland has been in discussions with the EU and OECD since 2007. The Swiss Federal Council launched CTR III in 2012. On 1 April 2015, based on the results of the consultation process, the Federal Council defined the parameters for the parliamentary dispatch of CTR III. These were presented to Parliament by the Federal Council in its dispatch on 5 June 2015. After intensive debate in the Council of States and National Council, Parliament adopted the final reform text on 17 June 2016. It is anticipated that the new law will come into force in 2019 at the earliest, following the public vote that will be required due to the referendum initiated by the SP.



BACKGROUND

CTR III was triggered by the tax dispute between Switzerland and the EU and the internationalisation of tax competition. Switzerland bowed to increasing pressure and reached an agreement with the EU. It is now required to bring its corporate tax regime into line with international standards. Specifically, this initially involves the equal treatment of domestic and foreign income and the abolition of benefits for certain types of companies (particularly holding companies and mixed companies).

OBJECTIVES

With CTR III, the Federal Council has laid the foundations for establishing Switzerland as a robust business location. The new system is intended to strengthen Switzerland's position as a competitive tax location and a reliable partner providing added value for domestic and international groups and Swiss SMEs. This should help to create and maintain attractive jobs and secure the social wealth. In addition, the reform seeks compliance with international standards and aims to safeguard a balanced corporate tax base. Parliament has largely followed the proposal submitted by the Federal Council; however, it has also made a number of modifications.

1. **Patent box:** Used to tax income from the exploitation of patents and comparable intellectual property rights at a privileged rate.

2. **Higher deductions for R&D expenses:** The cantons will also be able to introduce a special deduction for R&D expenses.

3. **Interest-adjusted corporate income tax:** A tax reduction representing a notional interest deduction on the equity portion that is equivalent to the security interest.

4. **Disclosure of hidden reserves:** Any previously non-taxable hidden reserves that are realised within a period of five years after the reform comes into force shall be taxed by the cantons at a special (lower) rate.

5. **Cantonal tax rate reduction for all companies:** The cantons shall reduce tax rates for all companies, thereby retaining their attractiveness as business locations. The Confederation will support the cantons in this process by making an annual contribution of over CHF 1 billion.

6. **Capital tax adjustment:** In order to retain the low rate of capital tax even without tax-privileged status companies, the cantons may reduce the amount of taxable equity for investment rights, patents and comparable entitlements.

7. **Other measures:** The standardisation of partial taxation in conjunction with interest-adjusted corporate income tax. Cantons may only introduce this measure if during partial taxation they collect at least 60% of the private dividend income from major investments > 10% with income tax. Moreover, the lump-sum tax credit shall be extended to Swiss establishments.

The basic concept

The Swiss legislator's intention behind the planned reform is to optimise the current tax system. In order for this to succeed, the cantons must be given a great deal of flexibility to structure regulations. Enforcing rigid regulations across all cantons without considering their individual characteristics would jeopardise the successful implementation of CTR III, and be contrary to Switzerland's basic federalist principles. The package of reforms therefore has a modular structure and gives the cantons a certain degree of freedom. As a result, it can now be implemented rapidly by the cantons. This will ensure that the Helvetic model of success can be maintained in the long term. Over the past 30 years, Switzerland has attracted countless companies and brought prosperity to the country.

Measures

Within the framework of CTR III, the Federal Council intends to replace five forms of corporate taxation ("tax regimes") which have been subject to international criticism: holding companies, auxiliary companies, mixed companies, principal company taxation and the Swiss finance branch. The tax base from these forms of taxation accounts for approximately half of all direct federal corporate income tax revenue and, together with cantonal corporate income taxes, raises around five billion Swiss francs per year. The measures being taken are designed to prevent a massive drop in tax revenue as a result of corporate relocation. They should also help Switzerland to remain an attractive tax location for companies in future, and to avoid having to compensate with increased taxation of individuals.

An overview of the most important reform measures and their impact on Switzerland as a business location:

1. **Patent box:** Patent boxes will provide tax incentives on profits earned from patents and comparable property rights. These are earmarked to foster research and development activities and their value creation in groups and SMEs. Patent boxes are used and recognised worldwide. However, the OECD has drafted international regulations aimed at limiting their effect (referred to as the "nexus approach"). The new cantonal patent box solution takes the OECD specifications into consideration.

2. **Higher deductions for R&D expenses:** Because the nexus approach reduces the effectiveness of the patent box, the cantons may supplement the patent box with an input-based special deduction of up to 150% for research and development costs – this is another taxation tool that has been tried and tested on an international scale.

3. **Interest-adjusted corporate income tax:** This instrument, which is also used elsewhere, is designed to strengthen Switzerland as a location for group financing. It aims to partially put equity and debt financing on equal fiscal footing. In doing so, it counteracts the excessive indebtedness of companies, promotes investment and offers an incentive for strong equity financing. Interest-adjusted corporate income tax also facilitates other core group steering functions, such as treasury activities, regional or global headquarters and management functions (central procurement). This encourages the creation of highly qualified jobs in Switzerland, which in turn stimulate local demand. The introduction of interest-adjusted corporate income tax is definitive at the federal level. At the cantonal level,

its introduction is optional, provided that the cantons set a tax rate of at least 60% for the partial taxation of private dividend income from major investments. The partial taxation level is currently 50% in many cantons. This means that these cantons must envisage for an increase to the new level if they wish to introduce interest-adjusted corporate income tax. The link between this interest-adjusted corporate income tax and the partial taxation of private dividend income does not have an objective justification, but is the result of a political compromise.

4. **Disclosure of hidden reserves:** This regulation is intended to provide an appropriate definition of the transition from privileged taxation to ordinary taxation, as well as other cases of entry into, or exit from, tax liability. It grants companies necessary investment security in Switzerland as a business location and counteracts the threat of companies currently located here from either relocating or withdrawing individual activities from Switzerland. Should the current regime cease to apply, the previous law for the taxation of tax-free hidden reserves and surplus value would apply for a transitional period of five years, at a special lower tax rate defined by each of the cantons. This process will cushion the fiscal shock that would otherwise occur. On entering the patent box regime, the cantons may waive the one-time tax charge normally payable immediately at the start of box taxation, provided they ensure this tax burden is collected by another means within five years.

5. **Cantonal tax rate reduction for all companies:** Tax disadvantages resulting from the necessary abolition of current tax regimes are likely to cause companies with mobile activities to avoid Switzerland as a business location or even to leave the country altogether. This would result in significant tax losses for the cantons. Reducing cantonal corporate income tax rates should prevent this. The Confederation will provide the cantons with financial support by increasing the cantons' share in the income from direct federal tax to 21.2% (corresponding to an annual sum of approximately CHF 1.1 billion).

6. **Capital tax adjustment:** For companies with tax regimes, the capital tax is currently set at a more favourable rate than for a company without any specific tax treatment. It will therefore still be possible for cantons to reduce cantonal capital tax in future insofar as it applies to patents, comparable rights, shares and inter-company loans.

7. **Other measures:** The Parliament has removed the issuance stamp tax from CTR III, as suggested by the Federal Council. This is now part of a separate proposal, which will be advised upon at a later stage. The introduction of a "tonnage tax" for companies that operate marine transport services will also be subject to consultation in a separate proposal once a proper consultation procedure has been conducted on the matter.

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