Corporate Tax Reform III (17 June 2016)

Let's talk

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Swiss parliament passes final corporate tax reform package to enhance global competitiveness

The Swiss parliament on June 17, 2016, following several back and forth debates, passed the final corporate tax reform package (CTR III) to strengthen Switzerland's competitiveness as business location. CTR III includes several notable tax reform measures related to federal and cantonal tax laws, included expected reductions to certain cantonal tax rates.

a) CTR III's key changes to Swiss federal tax law include the following.

- CTR III introduces an interest deduction calculated based on equity exceeding a certain threshold (excess equity), known as the notional interest deduction (NID). This measure was controversially discussed in the parliament and the optional introduction on cantonal level is linked to conditions (see below). The interest rate used to calculate the NID is based on the long-term Swiss bond rate. As there is currently a negative yield in long-term federal bonds and as the originally proposed surcharge of 50 base points was dropped in the parliamentary debate, the introduction of NID considering today's interest rate level, should not result in tax costs for the Swiss government.
- For inter-group receivables, the applicable interest rate is based on the arm's-length principle. Accordingly, the NID calculation on the excess equity includes a higher interest rate than the Swiss federal bond rate. This measure makes Switzerland a more attractive location and helps to avoid the migration of already established financing activities that are subject to taxation under the current rules. The legislature has instructed the Federal Department of Finance (FDF) to enact corresponding implementation rules.
- CTR III introduces a systematic concept for the exposure of hidden reserves at the beginning and the end of the tax liability. When assets or functions are transferred from another country into Switzerland, the hidden reserves and added values can be disclosed in the tax balance sheet. The disclosed hidden reserves can be deducted according to the applicable tax depreciation rates in subsequent years. Goodwill is to be amortized over 10 years. However, the hidden reserves and added values must also be accounted for at the end of the tax obligation, such as when the taxpayer leaves Switzerland or is transferring assets or functions abroad.
- **The cantonal share in direct federal tax** will be increased from currently 17% to 21.2%. This means that the cantons receive about CHF 1.2 billion more financial resources from the federal government than before. Through these funds, the federal government wants to support the cantons to (partially) finance the reductions in the cantonal corporate income tax rate.

b) CTR III's key changes to the tax harmonization law include the following.

- This measure allows the cantons to release the result, to the extent derived from patents and similar intangibles, from cantonal corporate income tax up to a maximum of 90%. The provision of the patent box profit is in line with the so-called residual profit rate required under the OECD's modified nexus approach. Upon entry into the patent box, a canton can waive taxation of previously asserted research and development expenditures if they assure their taxation within five years by other means. The legislature has instructed the Federal Council to enact the corresponding implementation rules.

- CTR III introduces an optional deduction of 150% of research and development (R&D) expenditures incurred in Switzerland. The proposal to include foreign R&D expenditures borne by a Swiss company has not been accepted by the Swiss parliament. The Federal Council will enact provisions defining qualifying R&D expenditures.
- As per the federal measure discussed above, this measure introduces an NID on excess equity. However, a canton may only introduce the NID if, dividend income of private individuals from investments of >10% is taxed at least 60% under individual income tax.
- To date, 16 out the 26 cantons apply taxation of only 50% or less of dividend income of individuals and would thus need to increase this threshold in order to be able to introduce NID on cantonal level. The remaining 10 cantons have met the requirements to introduce the NID because they have partial taxation of private dividend income of at least 60% already in place.
- Besides the equity on investment rights, patents and comparable rights, the cantons can envisage a capital tax reduction also for loans vis-à-vis group companies.
- The benefits derived from the patent box, the special deduction for R&D expenditures, the NID, and depreciation deductions for exposed hidden reserves (step up) can only reduce a taxpayer's total cantonal corporate income tax by up to 80%. The cantons can choose to implement a lower maximum percentage. This measure is intended to ensure a minimum tax assessment at the cantonal level for companies that qualify for one or more of the new benefits.
- CTR III eliminates the special cantonal tax regimes for holding, mixed, and auxiliary companies and introduces a five-year transitional period after the new law comes into effect. During the transition period, the cantons can record the realization of hidden reserves and goodwill separately with a lower special tax, provided such items would not have been taxable under prior law. This will prevent unconstitutional sudden tax changes of a fiscal shock for companies affected by elimination of a cantonal special regime. The amount of hidden reserves and goodwill subject to this special rate must be recorded on application by the affected companies of the cantonal tax authorities by a declaratory ruling. The cantonal legislature will determine the special tax rate.
- The cantons can finance a reduction of the cantonal corporate income tax (cf. below) by making use of the **higher portion in the direct federal tax** of 21.2% (instead of the current 17%)

c) Finance and Tax Equalisation Act

- The effects of the early, voluntary abandonment of a cantonal special tax regime by taxpayers are taken into consideration when **calculating** the **resource potential** decisive for the inter-cantonal financial equalization. In addition, while the beta-factor will be maintained over five years, there is an annual one-fifth reduction.

d) Postponed measures

- Elimination of the issuance stamp tax was postponed in a separate bill and will be revisited at a later date.
- Introduction of a tonnage tax for shipping companies was removed from the reform package and moved to a separate bill to be revisited at a later date. Parliament must carry out a proper consultation procedure with respect to this provision.

e) Reduction of cantonal corporate income tax

Some cantons are planning to lower their corporate tax rate. Canton Vaud on March 20, 2016, already passed a resolution to reduce the corporate tax rate. Other cantons have communicated the target tax rate but others, such as Canton Zurich, have not yet decided on their new rates. However, these cantons plan to make a decision and announce their decision this summer. The CTR III in the appendix includes an overview of each canton's current and target tax rates.

Next steps

The Federal Council determines when the reform measures will take effect. However, the referendum period of 100 days is first to be passed after the official publication of the legislation. If no referendum is requested, certain federal tax measures in CTR III could go into effect as early as the beginning of 2017. The cantons must then separately pass the measures related to the tax harmonization law as part of their cantonal tax legislation. Cantonal legislation changes, and any decision to reduce the cantonal corporate tax rate, would require additional approval by the cantonal electorate in case cantonal referendum would be requested as well.

A referendum opposing the federal government's CTR III bill seems likely, as repeatedly announced by the country's left parties. The cantonal electorate would likely have to vote on the bill in February 2017. In the event of a passing vote, the reform could take effect effective at the federal and cantonal levels starting in 2019.

The takeaway

Passage of CTR III marks an important milestone in Swiss tax legislation. Subject to approval by the Swiss electorate and subsequent implementation in the cantons, Switzerland will have an internationally recognized corporate tax system. The period of uncertainty is herewith ended and Switzerland can offer a stable tax and legal system outlook. The reform will have both, winners and losers. Switzerland will continue to have an internationally competitive federal tax system, independent of the decisions made by the cantons. Using the building blocks available under CTR III, each canton can design its own rules, tailored to its particular circumstances and requirements. However, inter-cantonal tax competitiveness is likely to increase due to diverging cantonal income tax rates.

Overall, CTR III's reform measures are expected to keep Switzerland competitive globally for MNEs operating and domiciled in the country.

Despite maintaining tax-related location competitiveness in international comparison, the big **winners of the reform** will, however, **be the Swiss SMEs**. They will be able to benefit the most from the envisaged relief with the patent box, the R&D special deduction, the NID and the cantonal reductions in corporate income tax. The increase in partial taxation, as far as the cantons envisage this in connection with the introduction of the NID, should be bearable for entrepreneurs, as the overall burden for SME owners should not increase if one sets off the lower burden at company level against the additional burden at ownership level.

The reform is **of pivotal importance for the medium- and long-term future of Switzerland**. This awareness should be considered within the scope of the referendum and will be the decisive factor during the national referendum which seems to be an extremely likely possibility.

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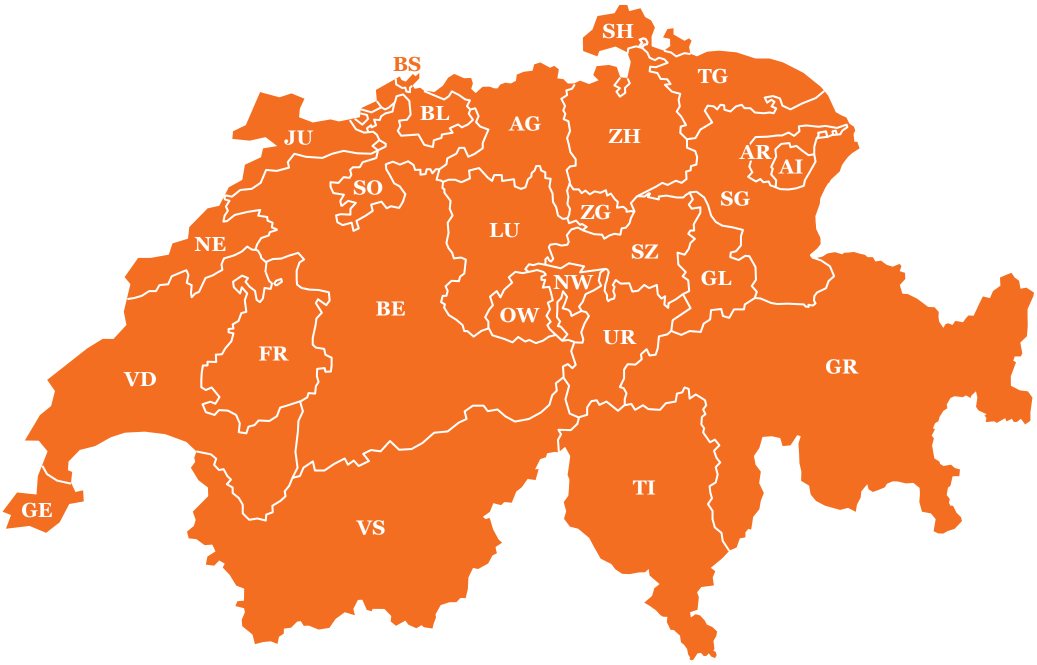
Corporate taxes in Switzerland



Current tax rates and anticipated tax rates with CTR III

		Current	CTR III
AG	Aargau	18.61%	
AR	Appenzell A.	13.04%	
AI	Appenzell I.	14.16%	
BL	Basel Land	20.70%	
BS	Basel Stadt	22.17%	
BE	Berne	21.64%	16.37 / 17.69%
FR	Freiburg	19.86%	13.72%
GE	Geneva	24.16%	~13%
GL	Glarus	15.70%	
GR	Graubunden	16.68%	
JU	Jura	20.66%	
LU	Lucerne	12.32%	
NE	Neuchâtel	15.61%	15.6%
NW	Nidwalden	12.66%	12.66%
OW	Obwalden	12.74%	
SG	St. Gallen	17.40%	
SH	Schaffhausen	16.04%	12-12.5%
SZ	Schwyz	15.72%	
SO	Solothurn	21.85%	
TG	Thurgau	16.43%	
TI	Ticino	20.67%	16-17%
UR	Uri	15.01%	
VS	Valais	21.57%	
VD	Vaud	22.09%	13.79%
ZG	Zug	14.60%	12%
ZH	Zurich	21.15%	18.20%

Reference date for current rates: January 2016
Reference date for anticipated rates following CTR III: March 2016
The rates quoted are the effective income tax rates in each canton's main urban centres.
The rates in effect in the individual municipalities may vary.

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