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

Position paper of PwC Switzerland

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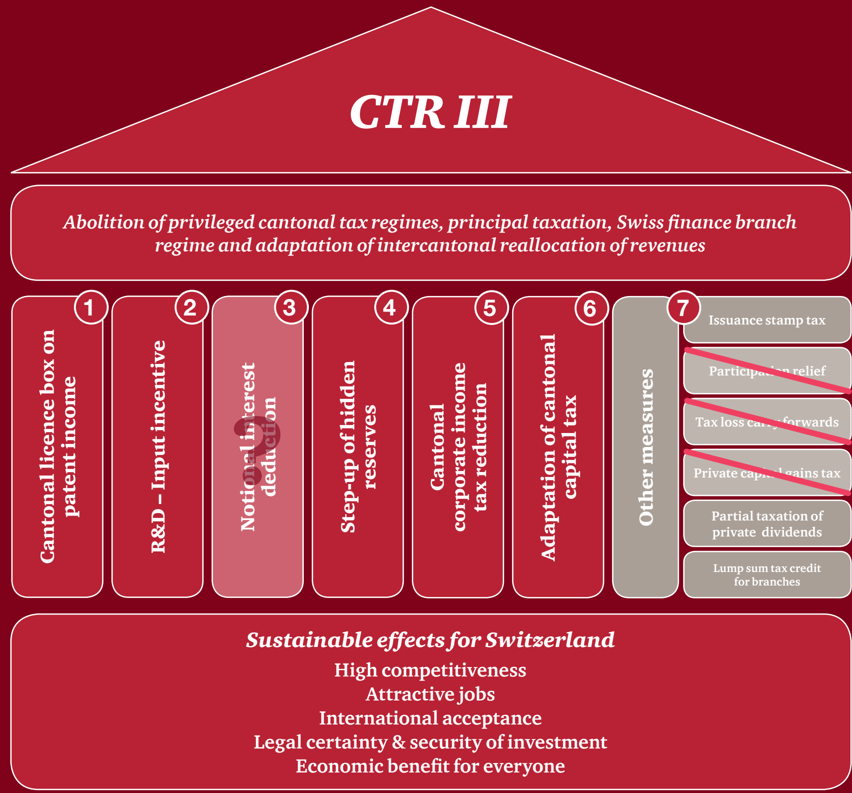
DEMANDS ON SWITZERLAND:

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 relief.

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, on the basis of the results of the consultation, the Swiss Federal Council set the main parameters to be addressed in the CTR III proposal. These were set out in the proposal to the Swiss parliament of 5 June 2015. The new regulations will enter into force at the earliest in 2017 at federal level and 2019 at cantonal level.



BACKGROUND

CTR III is a consequence of the tax dispute between Switzerland and the EU and a response to the internationalisation of tax competition. In the face of increasing pressure, Switzerland relented and reached an agreement with the EU, under which it must align its corporate taxation with international standards. Specifically, this involves the equal treatment of foreign and domestic income and the abolition of tax benefits for certain types of company.

OBJECTIVES

With CTR III, the Swiss Federal Council has laid the foundations for Switzerland as an attractive business location. The new system is intended to strengthen Switzerland's position as a competitive tax location and a reliable partner for domestic and international groups and Swiss SMEs. This should help to create and maintain attractive jobs and to consolidate the prosperity of Swiss society. In addition, the system seeks compliance with international standards and the safeguarding of a balanced corporate tax base. There is room for improvement in parts of the package during the parliamentary process.

1. **Cantonal licence box on patent income:** Used to tax income from the exploitation of patents and similar intellectual property rights more favourably.

2. **R&D – input incentive:** In addition, cantons can also introduce a special deduction for R&D expenses.

3. **Notional interest deduction:** This measure aims at a partial equation of the tax treatment of equity and debt financing. It thereby incentivises self-financing, counteracts excessive indebtedness and stimulates investments. The Swiss Federal Council has removed this measure from the reform package. In our opinion, it should be reintroduced in the course of the parliamentary debate.

4. **Step-up of hidden reserves:** Previously non-taxable hidden reserves which are realised within five years of the reform entering into force will be taxed at a special low rate.

5. **Cantonal corporate income tax rate reduction:** The cantons will reduce their tax rates for all companies and thus maintain their attractiveness as locations. The federal government will assist the cantons with an annual contribution of over CHF 1 billion.

6. **Adaptation of cantonal capital tax:** In order to keep the capital tax burden low without granting tax privileges to particular companies, the cantons will be able to reduce taxable equity for ownership rights, patents and comparable rights.

7. **Other measures:** Due to justified criticism, the Swiss Federal Council has proposed to only keep the abolition of the issuance stamp tax and the standardisation of partial taxation on private dividend income in the reform package. In addition, foreign tax credit relief is to be extended to Swiss branches.

Basic principles

With this planned reform, Swiss legislators intend to optimise the current tax system. In order to succeed, the cantons must be afforded a high level of flexibility with regard to structuring the regulations. Enforcing rigid regulations across all cantons without considering their individual needs would impede the successful implementation of CTR III and contradict Switzerland's federalist principles. Furthermore, the measures must be implemented quickly and with the support of all political parties. This is the only way in which Switzerland's success story, which has attracted countless corporations and brought prosperity to the country over the past 30 years, can continue in the long term.

Measures

With CTR III, the Swiss Federal Council intends to replace five internationally criticised specific forms of corporate taxation ("tax regimes"): Holding companies, auxiliary companies, mixed companies, principal company taxation and the Swiss Finance Branch. Together, companies with such tax regimes account for approximately half of all direct federal corporate income tax revenue and, together with cantonal corporate income taxes, the taxes raise some five billion Swiss francs per year. The planned measures are designed to prevent a major decline in corporate tax revenue as a result of companies relocating to other countries. They should also help Switzerland to remain an attractive tax location for companies in the future and to avoid having to compensate with increased taxation of individuals.

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

1. **Patent box:** The patent box provides tax incentives on profits earned from patents and comparable rights. It is intended to foster R&D activities and their value creation in corporate groups and SMEs. Patent boxes exist in many countries and are internationally recognised. Their scope is set to be limited, however, by the international requirements in relation to the "nexus approach" currently being drafted by the OECD.

2. **Increased deductions for R&D expenses:** Because the nexus approach limits the impact of the patent box, the cantons will be able to supplement the patent box with a special input-based deduction for research and development costs – a tried-and-tested international taxation tool. We recommend replacing the mechanism of increased deductibility of R&D costs proposed by the Swiss Federal Council with an R&D tax credit system which is in line with OECD best practice.

3. **Notional interest deduction:** This measure, already implemented in other jurisdictions, is intended to strengthen Switzerland as a location for group financing activities. It aims to partially equate equity and debt financing for tax purposes and therefore counteracts excessive corporate indebtedness, stimulates investment, and incentivises companies to rely more on their own resources. In addition, a notional interest deduction also encourages other core group functions, such as group treasury activities, regional or global headquarters and management functions or procurement. This encourages the creation of highly qualified jobs in Switzerland, which in turn stimulates local demand. Unfortunately, the Swiss Federal Council has removed this measure from the CTR III package. We strongly recommend its reintegration into the package in the course of the parliamentary debate.

4. **Step-up of hidden reserves:** This regulation aims to appropriately define the transition from privileged to ordinary taxation as well as other cases of entry into, and exit from, tax liability. It provides companies with the necessary investment security in Switzerland as a business location and counteracts the threat of companies established here either relocating or withdrawing individual activities from Switzerland. In our view the duration of the transitional provisions when the current regime is abolished should be extended from the five years proposed by the Swiss Federal Council to ten years.

5. **Reduction of cantonal corporate income tax rates:** This measure supplements those already described. Tax disadvantages resulting from the necessary abolition of current tax regimes are likely to cause companies with mobile activities to avoid Switzerland as a location or even to leave the country altogether. This would result in substantial tax losses for the cantons. A general reduction in corporate income tax rates should prevent such an effect. The federal government will assist the cantons financially by raising the cantons' share of revenues from the direct federal corporate income tax from 17% to 20.5%, which represents an amount of around CHF 1 billion annually.

6. **Capital tax adjustments:** The capital tax of companies benefitting from tax regimes is currently set at a more favourable rate than for companies without a specific tax treatment. CTR III aims to align capital tax at cantonal level for all companies. The cantonal capital tax on patents, comparable rights and equity investments should be reduced. Without such a reduction there would be a substantial increase in capital tax for the companies concerned. Furthermore, the relocation of companies from abroad would be unnecessarily hampered.

7. **Other measures:** The CTR III consultation draft proposed a number of further individual measures. Due to justified criticism, the Swiss Federal Council has removed several of these individual measures, such as the introduction of a private capital gains tax and amendments to the participation relief and the tax-loss carry-forward regulations. For constitutional reasons the Federal Council has also decided against introducing a tonnage tax for shipping companies.

On the other hand the Federal Council is proposing to extend the eligibility for tax credit relief for foreign withholding taxes to the Swiss branches of foreign companies for the first time.

The following measures remain in the reform package:

a) the abolition of issuance stamp tax on equity.
b) the standardisation of partial taxation of dividend income with a limitation of 30% at federal and cantonal level for private individuals holding an interest of more than 10%, i.e. 70% of dividends from equity stakes of over 10% will in future be subject to income tax on a uniform basis throughout Switzerland.

Contacts

Andreas Staubli
Partner, Leader Tax & Legal,
PwC Switzerland
Tel. +41 58 792 44 72
andreas.staubli@ch.pwc.com

Armin Marti
Partner, Leader Corporate Tax,
PwC Switzerland
Tel. +41 58 792 43 43
armin.marti@ch.pwc.com

Benjamin Koch
Partner, Leader Transfer Pricing
and Value Chain Transformation,
PwC Switzerland
Tel. +41 58 792 43 34
benjamin.koch@ch.pwc.com

Remo Küttel
Director, Corporate Tax,
PwC Switzerland
Tel. +41 58 792 68 69
remo.kuettel@ch.pwc.com

Laurenz Schneider
Director, Corporate Tax,
PwC Switzerland
Tel. +41 58 792 59 38
laurenz.schneider@ch.pwc.com

Claude-Alain Barke
Partner, Tax & Legal Romandie,
PwC Switzerland
Tel. +41 58 792 83 17
claude-alain.barke@ch.pwc.com

Gil Walser
Senior Manager, Tax & Legal Romandie,
PwC Switzerland
Tel. +41 58 792 67 81
gil.walser@ch.pwc.com