PRAGER DREIFUSS

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Revised Swiss corporate tax reform will keep Switzerland a top corporate location

I. The background of the tax reform

In connection with the international pressure on the Swiss corporate tax location, especially in relation to the Cantonal exemption of income for holding companies as well as the status privileged companies ("*status privilege*") and the need of Switzerland to recover global recognition as a fair and attractive tax location, the Swiss Federal Council and the Swiss parliament developed a new corporate tax reform in 2015 ("*CTR III*"). CTR III was designed to be compliant with international tax standards such as the Base Erosion and Profit Shifting Project ("*BEPS-Project*") of the OECD. Amongst others, it included the abolition of the status privilege or holding company taxation and should have enabled Switzerland to remain competitive from an international tax perspective.

Swiss left-wing parties did not agree with the CTR III proposal and therefore launched a referendum. Swiss voters rejected the CTR III proposal on 12 February 2017. This raised the problem that the afore-mentioned criticized tax system has led to legal and planning uncertainties.

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After the rejection of the CTR III proposal, the Federal Council released a revised corporate tax reform called Tax Proposal 17 ("*TP 17 proposal*") on 21 March 2018. The majority of the measures of the TP 17 proposal were almost congruent with the measures of the CTR III proposal, but the new proposal appears to be more balanced in order to hopefully reach a political consent. The Swiss parliament included a new subsidy of CHF 2 billion per year for the Federal Social Security Scheme ("*AHV*") as a form of socio-political compensation to the TP 17 proposal. The now called 'Federal Act on Tax Reform and AHV Financing' ("*TRAF proposal*") was adopted with clear majority by the Swiss parliament on 28 September 2018.

The first measures of the TRAF proposal could already enter into force in 2019 if no referendum was held against it. Some parties have already announced that they will call (again) for a referendum against the TRAF proposal. In this case the TRAF proposal will be put to the people's referendum on 19 May 2019. Accordingly, the implementation of the TRAF proposal would enter into force as from 1 January 2020 onwards.

II. The measures of TRAF proposal

In the following we will discuss the key measures to provide an insight of this complex tax reform:

2.1 Replacing measures

2.1.1 Revocation of status privilege

One of the most important actions of the TRAF proposal is the abolition of the above mentioned status privilege, incl. the holding company taxation, on cantonal level so that the Swiss tax jurisdiction will be compliant with international tax standards and expectations.

2.1.2 Disclosure of hidden reserves for status privilege companies

In connection with the revocation of the status privilege, such companies that will stay in Switzerland will require to transition from privileged to ordinary taxation. Generally, the transition into the ordinary taxation should not entail tax costs. However, due to the transition, hidden reserves which were obtained under a status privilege would be subject to a deferred tax burden. In order to avoid an excessive taxation of such companies, the legislator introduced a harmonized regulation for all Cantons. Therefore, all hidden reserves which were obtained under a status privilege will not be disclosed in the tax balance sheet but by means of a ruling of the relevant tax authority. In the following five years the amortization of these disclosed hidden reserves will be subject to a low tax rate. Cantons will be free to determine the special tax rate. This disclosure of hidden reserves ensures a competitive income tax burden and is ought to motivate current status privilege companies to remain in Switzerland.

2.1.3 Step-up of hidden reserves for relocating companies

Companies migrating to Switzerland can disclose hidden reserves which were generated abroad for confirmation to the Swiss tax authorities. Relocated companies will therefore benefit from the step-up system with which they can amortize the tax-free disclosed hidden reserves annually at an applied rate for tax purposes to the respective assets. If such relocated companies would migrate from Switzerland overseas an exit tax on hidden reserves would become due (as is already the case nowadays).

2.1.4 Equity tax relief

Another measure to reduce the future tax burden of the current status privilege companies is the equity tax relief. As such companies now benefit from a low equity tax rate, the Cantons will in the future be allowed to lower the taxable equity on patents (and similar rights), qualifying participations and intra-group loans.

2.2 New measures

2.2.1 Patent box

The patent box is another key measure of the TRAF proposal and internationally still accepted. Net profits from patents and similar rights (e.g. supplementary protection certificates, varieties of plants etc.) are to be taxed in the excluded box with a maximum deduction of 90% on cantonal level. In order to be compliant with the "modified nexus approach" as developed by the OECD, the patent box is only applicable if the corresponding research and development ("*R&D*") expenditures have already been recaptured and taxed.

The calculation of the net profits from patents and similar rights is assessed according to the so called residual-method. Starting point of this method is the overall profit of the product related with the patent or the overall profit of the company. All profits which are not related to the patent itself are then deducted from the overall profit and subject to ordinary taxation. The remaining net profit will subsequently be taxed in the patent box. The residual-method is very similar to the calculation method of UK patent box profits.

2.2.2 Super-deduction for R&D activities

The TRAF proposal will further authorize the 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 broad by the legislator and is aligned with article 2 of the Swiss innovation law ("*FIFG*") as well as with common standards determined by the OECD. Therefore, basic research, scientific application and knowledge based R&D will 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. Please note that the invoiced third party R&D costs must be performed in Switzerland in order to be in line with the above mentioned nexus-approach.

2.2.3 Notional interest deduction

High-tax Cantons, such as Zurich (expected rate of 18.2%), may get the opportunity to implement a notional interest deduction ("*NID*") on excess capital. So far only the canton of Zurich would meet the requirements and thus be allowed to introduce NID (which is planned).

2.2.4 Relief restriction

The Legislator included a relief restriction to avoid 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 the depreciation costs associated with a former cantonal status privilege cannot exceed 70% of the taxable profit.

Despite the relief restriction, the overall tax burden for example in Zurich could still be reduced to 11.2% if all measures were applied.

2.3 Shareholder's income tax measures

2.3.1 Increased dividend taxation

The TRAF proposal would allow to increase the partial tax exemption of dividend income of individuals from qualifying participations at the federal level from now 50% (business investments) respectively 60% (private investments) to a standard rate of 70%. At cantonal level, the minimum taxation rate of 50% would be implemented.

2.3.2 Adjustment of the capital contribution principle

The TRAF proposal would introduce a repayment restriction on the capital contribution principle for companies listed on the Swiss Stock Market Exchange ("SIX"). Such corporations were only entitled to distribute tax exempt capital contribution reserves if they simultaneously paid ordinary taxed dividends of at least the same amount. This counter-measure would weaken the capital contribution principle as introduced in 2011.

III. Corporate tax rate reductions

It is planned that all Cantons will reduce their corporate tax rates. Although this measure is not directly covered by the TRAF proposal, this is of utmost importance for Switzerland to continue to offer an attractive corporate tax environment. The Cantons will receive money from the Federation to finance such cantonal rate reductions. Based on official announcements made by the cantonal governments, it is expected that the majority of the Swiss Cantons will provide effective tax rates between 12% and 18% (including 7.8% federal tax). Amongst others, Zurich will reduce its standard rate to 18.2 %, Geneva to 13.5% and Zug to 12 %.

IV. Conclusion

The TRAF proposal ensures that Switzerland regains legal and planning certainties for international companies and aims to re-establish the reputation of the alpine republic as a fair and attractive tax location. Hopefully the Swiss people will not accept the referendum in May 2019. We are at your disposal to analyze existing structures and to discuss planning opportunities.

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