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Switzerland

Corporate Tax Reform III

Swiss parliament approved the Corporate Tax Reform III on 17 June 2016. The main objective of the reform is to align Swiss tax law with international standards while preserving and enhancing Switzerland's attractiveness for international mobile companies. The reform will phase out some preferential corporate tax regimes (the mixed, domiciliary and principal company regimes) that were in the focus of dispute by the EU and the OECD. A bundle of new measures will strengthen Switzerland's attractiveness as a hub for international business.

The legislation includes the following main elements:

✓ Patent Box

The introduction of a Patent Box regime on cantonal/communal level is designed to privilege income from patented intellectual property for which the R&D spend occurred in Switzerland. Income from qualifying intellectual property will benefit from a reduction of up to 90% that may result in an effective combined tax rate of approx. 8.5% on all income tax levels. The effective tax rate considering depreciation, interest deduction and further measures may be significantly lower at typically 5-6%. The new provision reflects the OECD nexus approach.

✓ R&D super-deduction

The cantons may introduce an excess deduction for R&D activities conducted in Switzerland, which allows a corporation to deduct up to 150% of the actual R&D spend for cantonal/communal income tax purposes. R&D super-deductions are accepted under international taxation standards.

✓ Notional Interest Deduction / NID

On federal and cantonal/communal level, a deemed interest may be deducted from a defined excess equity basis, resulting in an OECD conform tax base erosion. The NID is introduced as a replacement measure for financing activities out of preferential tax regimes such as finance branches and as a general measure to reduce income tax for highly equity financed entities. It will benefit mobile financing functions to be retained and will attract new finance activities to Switzerland. The notional interest rate is based on the yield of a ten year Swiss federal bond rate, whereby alternatively an arm's length interest rate can be claimed for receivables from related parties. By applying the NID the effective tax rate for financing activity may be in the range of 2-6% depending on the financing volumes.

✓ Reduction of corporate tax rates

Several cantons have announced to reduce their corporate tax rates. Selected examples of ordinary tax rates (combined federal and cantonal/communal tax): canton of Zug 12%, Schaffhausen 12.5%, Geneva 13%, Vaud 13.8%. Other cantons, such as Appenzell, Lucerne, Nidwalden, Obwalden and Schwyz already have competitive effective tax rates for companies of 12% to 14%.

✓ **Reduction of the cantonal capital tax**

The cantons may reduce the annual capital tax on participations and patented intellectual property that qualifies for the Patent Box. In most cases the capital tax is not an economic burden but a nominal expense only.

✓ **Step-up upon migration**

Foreign corporations may benefit from a tax-free step-up in basis to fair market value for direct federal and cantonal/communal tax purposes when migrating their legal seat, effective place of management or upon transfer of functions and assets to Switzerland. The step-up can be amortized tax effectively according to the amortization period pertaining to the individual assets. The reform basically confirms the current tax practice of a tax-free step-up.

✓ **Grandfathering rules for preferential cantonal tax regimes**

With the changes of the existing cantonal tax regime (e.g. mixed company), companies may release hidden reserves and self generated goodwill created under the preferential tax regime in a tax-exempt manner. The amount of the hidden reserves and goodwill will be determined upon transition and any release within a 5-year transitory period will be taxed at the historic rate of typically 9%. Companies also have the option to voluntary withdraw from the privileged taxation before the reform becomes effective to benefit from the current practice, as confirmed by Federal Court decision that allows a tax-neutral step-up with a tax deductible amortization over the following 10 years.

✓ **Maximum limitation of combined tax reliefs of 80%**

All measures such as Patent Box, R&D super-deduction, step-up and NID may not exceed 80% of pre-tax profits before offsetting losses, ensuring a minimum income tax base.

Timeline

The reform will likely come into effect as per 1 January 2019 or possibly per 1 January 2020, depending on an already announced public vote. Grandfathering rules may factually extend the application of the existing tax privileges for another 5-10 years.

Observations and planning

Against this background, companies are well advised to familiarize themselves with the new framework based on their specific circumstances. The following actions may be considered:

- Filing of an application for a tax privilege that will fade out, e.g. securing a mixed company status in light of broad grandfathering planning opportunities; specifically the tax-exempt step-up option;
- Effect examination of a change in taxation status for tax privileged companies/branches;
- Analysing potential opportunities resulting from the introduction of new measures;
- Impact analysis of reduced tax rates in an international context (e.g. impact on CFC rules);
- Assessment of the existing group structure and potential reorganizations (e.g. onshoring, migration of functions or assets to Switzerland) to encounter BEPS measures while benefitting from advantageous income taxation;
- Cost/benefit analysis (e.g. tracking and tracing of patent income, potential tax costs entering into Patent Box, transparency aspects, reorganization costs vs. tax savings).

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