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Consultation for Corporate Tax Reform III Opened

On 22 September 2014, the Swiss Federal Government published draft legislation for the IIIrd Corporate Tax Reform ("CTR III") and invited the cantons and interested parties to submit comments until 31 January 2015. The proposed tax reform package abolishes the existing cantonal preferential tax regimes for holding, administrative, domiciliary and "mixed" companies. The proposal features a tax-free basis step-up of assets that previously benefited of the abolished preferential regimes and introduces a new license box regime at the cantonal and communal level, as well as a notional interest deduction regime at all taxation levels. Cantons would be allocated additional federal tax revenues, allowing them to reduce their corporate tax rates to further mitigate against the abolishment of their special regimes. At the Federal level, the draft bill proposes to abolish the capital stamp duty, reforms the participation deduction system and introduces new rules on the realization of hidden reserves and on tax loss carryover. The reform bill also includes tax measures affecting individuals, such as the introduction of capital gains taxation on securities held by private individuals and changes to the taxation of dividends received.

The Federal Council is expected to send a final draft bill to the two chambers of the Federal Parliament, which is likely to discuss the bill in 2015/16. It is anticipated that the final new law will enter into effect in 2017 or 2018 at the earliest, depending on whether a referendum will be taken.

Background and Objective of the Corporate Tax Reform III

The CTR III project has been heavily influenced by international tax developments such as the OECD's Base Erosion and Profit Shifting (BEPS) initiative and the EU's Code of Conduct for corporate taxation, as well as the EUs rules on state aid. Against the background of these developments Switzerland has in recent years come under increasing pressure for certain of its preferential tax regimes, in particular the existing cantonal tax privileges for holding companies, and "domiciliary", "auxiliary", "administration" and "mixed" companies, as well as certain federal tax practices pertaining to "finance branches" and "principal companies". In reaction thereto, the Federal Council is proposing a reform package that purports to be driven by the following main objectives:

a) Reinforcing the fiscal attractiveness of Switzerland as a place for doing business;

b) Ensuring the international acceptance of some key elements of the Swiss corporate tax system; and

c) Ensuring a sufficient level of tax revenues at the federal, cantonal and communal levels to finance the public sector activities.

Main Features of the Draft CTR III Bill

The proposed tax reform package includes an array of measures, some of which would be effective at the cantonal/communal tax level, some at the federal tax level and some at all three levels of taxation:

Measures at the Cantonal/ Communal Tax Level

At the core of the proposed reform package is the abolition of the preferential cantonal tax regimes for holding companies and for domicile / auxiliary / administration / mixed companies (which ultimately ring-fence Swiss companies and permanent establishments of foreign companies with predominantly foreign or "mobile" activities). In lieu of those regimes, the Federal Council proposes to introduce a "license box" regime and a notional interest deduction (NID) on "surplus equity". The NID regime would not only be introduced at the cantonal communal, but also at the federal tax level.

a) License Box

The proposed license box regime broadly follows the similar regime existing in the UK (and is thus considered "internationally acceptable", subject to further developments at the OECD and/or EU level). It would be applicable to income generated from patents, supplementary protection certificates, exclusive patent licenses and "first-notifier protection" according to art. 12 of the Federal Act on Therapeutic Products. Income from trademarks, trademark licenses and other intellectual property (IP) would not be covered by the regime. "Embedded" income from qualifying IP would be eligible through the application of the "residual profit" calculation method. Eligible IP income would be taxed to the extent of a fraction of at least 20%, resulting in an effective tax rate of some 2.4-4.8% depending on the company's location within Switzerland.

b) NID

The NID regime would be applicable at both cantonal and federal tax levels. NID would be applicable to "surplus equity" only, i.e. equity considered to exceed a certain minimum equity basis required for a "sound" financing of the business. It is expected that minimum equity funding ratios will be defined for different asset classes and published in a circular of the federal tax authorities. Certain asset classes such as investments, non-Swiss permanent establishments and goodwill would be excluded from NID. The interest rate for the NID would correspond to 1.5 times the yield of the 10-year Government bond, however, at least 2% p.a.

c) Step-up of Tax Basis

As part of broader new rules regarding realization and depreciation of hidden reserves as well as carry-forward of net losses, the draft bill provides for a deemed realization of hidden reserves and self-created goodwill upon their "switch" from the tax-privileged sphere into the ordinary cantonal taxation regime, which under the proposed transition rules may effectively be stepped up to market values on a tax-free basis. After the step-up (which excludes substantial equity investments), depreciation according to generally applicable depreciation schedules may be taken against the ordinarily taxable net profit. Capitalized self-created goodwill shall be depreciated over ten years, using the straight-line method. Losses resulting from such goodwill depreciation may not be carried forward for tax purposes. This step-up mechanism is expected to "perpetuate" the low effective tax rates under the currently existing privileged regimes for a substantial period of time after entry into force of the tax reform.

d) Reduction of Cantonal Tax Rates

It is generally expected that the cantons will cut their ordinary corporate tax rates to some extent, to mitigate against the effect of abolishing the cantonal tax privileges. The Federal Government would support these cantonal tax rate cuts with a contribution of CHF 1 billion.

Measures at the Federal Tax Level

a) Abolition of Capital Stamp Duty

The draft bill proposes to abolish the 1% capital stamp duty on equity capital contributions to Swiss corporate entities by their shareholders or members.

Measures Affecting Federal and Cantonal/Communal Taxes

In addition to the introduction of an NID, the following proposed measures would apply at both federal and cantonal/communal tax levels:

a) Reform of the "Participation Deduction" System

Under the proposal, the current system of relieving dividends and capital gains earned by Swiss corporate taxpayers from substantial corporate equity investments from multiple taxation through the "participation deduction" would be replaced by a genuine participation exemption system. Any dividends and capital gains (including revaluation gains) from investments in corporate equity of other companies would be exempt from taxable income (however, capital gains on shares held by banks as current assets would remain taxable). Capital losses, depreciation and value adjustments on equity shares would likewise be excluded from the taxable net result.

b) New Rules on Realization of Hidden Reserves and Tax Basis Step-up

The draft bill clarifies that any hidden reserves and self-created goodwill (which cannot be capitalized under Swiss accounting rules) shall be deemed to be realized upon the end of corporate tax liability (including upon corporate exit from Switzerland, such as re-allocation of assets to a non-Swiss permanent establishment) and upon any move into a tax-exempt regime. On the other hand, it is clarified that any "immigration" of assets, including self-created goodwill from outside Switzerland entitles the taxpayer to a tax-free basis step-up. "Immigration" and corresponding start of Swiss corporate tax liability is deemed to include the migration of the legal or management seat of a foreign company to Switzerland, the re-allocation of assets or business functions of a foreign business to a Swiss business operation or permanent establishment, and the termination of a tax-exempt status. The stepped-up self-created goodwill must be amortized straight-line over ten years; annual net losses caused by such amortization cannot be carried forward for tax purposes.

c) New Rules on Tax Loss Carryover

The draft bill proposes to amend the current regime which allows for a limited tax loss carryover period of seven years. Under the revised regime, all losses from prior years may be deducted from the current year's taxable profit with no time limitation. However, the current year's net profit before losses of the same period may only be charged with losses from prior periods to the extent of 80 percent.

Furthermore, the proposal features the introduction of a consolidated group loss deduction broadly along the lines of the "Marks & Spencer" case. This would allow Swiss parent companies that control Swiss or foreign group subsidiaries to deduct losses of their controlled subsidiaries in proportion to their ownership interest, if and to the extent that such losses could not be deducted at the level of the loss-making subsidiary or of another entity of the consolidated group.

Measures Affecting the Taxation of Individuals

The reform bill also features some individual tax measures, which are meant to contribute to the compensation of revenue losses caused by the measures on the corporate side.

a) Tightening of Dividend Received Relief

The reform bill proposes to limit the partial relief from dividend taxation of individuals to 30% (i.e. 70% of dividends received by individual taxpayers would be taxable). On the other hand, the existing minimum participation threshold (of 10 percent) for the dividend tax relief would be abolished.

b) New Capital Gains Tax on Equity and Debt Securities

This is likely to become the politically most contentious part of the tax reform, as Swiss resident individuals are at present principally exempt from capital gains taxation on their privately held securities. Under the proposed new rules, a distinction would be drawn between equity securities (shares etc.) and any other types of securities.

All realized capital gains on securities of any nature other than equity shares would become taxable as ordinary income. Exit (termination of personal tax residence in Switzerland) would crystallize taxable gain (market value minus acquisition cost basis). Capital losses on such securities could be set-off against capital gains and against ordinary income from securities.

Capital gains on equity securities (even on a single share) would become taxable to the extent of 70%; exit from Switzerland would trigger deemed capital gain. Gain deferral would be available in the event of division of a deceased person's estate, if not all heirs succeed in the deceased individual's shares, provided that those heirs who take over the shares accept the deceased person's acquisition cost basis. The repayment of nominal share value and of reserves from capital contributions would remain tax-free, but only to the extent that such repayment does not exceed the individual's acquisition cost basis. Capital losses on equity shares would be deductible only from capital gains on equity securities.

The proposed transition rules provide for a deemed acquisition cost basis step-up (or step-down, as the case may be) to the market value of the securities as of the day the tax reform enters into force.

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