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Facing the challenges of reform

Prin Shasiharan
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Businesses across Switzerland began 2020 anticipating a range of challenges emerging from the widest corporate tax reform in decades. Economic plans were drawn and tax experts were summoned. Little did they know that just months later, the COVID-19 pandemic would bring a second wave of equally strong tax-related challenges.

Partnering with expert practitioners who are closest to the action, ITR brings you an exclusive insight into some of the most significant developments that the Swiss tax world faces in the coming year.

International tax reforms have added a further dimension of complexity to the proceedings. The article by Bär & Karrer explains how the implementation of the Swiss tax reform has been influenced by the impact from the OECD's BEPS Action Plan and the EU's implementation of the Anti-Tax Avoidance Directive (ATAD).

The need to strengthen the country's reputation as a global business centre forms the crux of burckhardt Ltd's article, which also looks at how Swiss modifications to the automatic exchange of information (AEOI) implementation can help optimise legal and planning certainty.

Deloitte Switzerland's article tracks how the pandemic has forced companies to accelerate their digitalisation plans, and discusses how tax departments can accordingly reshape their data, process and people functions.

A further revolution brought about by the pandemic to the traditional workplace is the subject of Tax Partner AG's article. Swiss authorities have sought to address international tax queries that have emerged from the rise of the 'home office'.

Amid the pandemic and waves of reforms, Switzerland continues to harbour a culture of innovation by offering tax incentives on patents and research and development (R&D) programmes. The article from Meyerlustenberger Lachenal considers how companies can benefit from the Swiss innovation toolkit.

Showcasing its strength and resilience, Switzerland has reacted soundly to novel tax challenges. We hope that you enjoy hearing from the tax experts leading the progression in our ninth Switzerland Special Focus.

Switzerland

How international tax reforms have transformed the Swiss tax landscape

Daniel U Lehmann and **Anke Stumm** of **Bär & Karrer** consider how measures put forward by the OECD's BEPS project and the EU Anti-Tax Avoidance Directive have impacted corporate taxation in Switzerland.

In the past years, the development of the international tax landscape has significantly accelerated its pace and undergone important changes influenced by specific national developments, such as the US tax reform, or multilateral measures aiming at coordinating certain projects shared among countries.

A main process which is in the focus of corporate taxpayers is the BEPS Action Plan of the OECD, which started to be implemented in 2019 and has not yet been completed (e.g. pillar two and global minimum taxation). A part of the implementation efforts of the BEPS action plan has been coordinated by the members of the EU through the adaption of their Anti-Tax Avoidance Directive (ATAD).

The purpose of this article is to analyse the impact of some of the measures decided by the OECD for the BEPS project, and by the EU for their ATAD, on corporate taxation in Switzerland. The country's tax authorities recently put into force a milestone corporate tax reform along with a range of other tax-related reforms, some of which are still pending. Although not all Swiss tax reforms have exclusively originated from BEPS or ATAD, the influence of BEPS and ATAD has been significant.

BEPS and ATAD

OECD's BEPS Action Plan

The BEPS Action Plan decided by the OECD consists of 15 action points, where three are related to transfer pricing (TP). The focus of this article is on the action points underlined below:

- Action 1: Tax challenges arising from digitalisation;
- Action 2: Neutralising the effects of hybrid mismatch arrangements;
- <u>Action 3</u>: Controlled foreign company;

- Action 4: Limitation on interest deductions;
- Action 5: Harmful tax practices (minimum standard);
- Action 6: Prevention of tax treaty abuse (minimum standard);
- Action 7: Permanent establishment status;
- Action 8-10: Transfer pricing;
- Action 11: BEPS data analysis;
- Action 12: Mandatory disclosure rules;
- Action 13: Country-by-country reporting (minimum standard);
- Action 14: Mutual agreement procedure (minimum standard); and
- Action 15: Multilateral instrument

EU's Anti-Tax Avoidance Directive

The purpose of the ATAD is to achieve a harmonised and coordinated approach of EU member states for the implementation of some of the recommendations under the OECD BEPS project, which can tackle the profit shifting to low- or no-tax jurisdictions more effectively in the common market of the EU. The regulations are not applicable to EEA member states.

ATAD provides for a minimum level of harmonisation rules for anti-tax avoidance measures in five different areas, with two of them not being part of the BEPS Action Plan. Most of the new provisions entered into force in 2019. ATAD grants EU member states certain flexibility in implementing the directive into domestic law.

Impact on Swiss tax landscape

Based on the introductions above, the focus of the analysis is on the following aspects:

- BEPS: Controlled foreign company (CFC) rules, harmful tax practices, prevention of tax treaty abuse
- ATAD: CFC rules

Action 3/ATAD: Controlled foreign company rules

Characteristics of CFC legislation

While Switzerland has not introduced any CFC legislation, and so far has no plans to do so, Swiss resident subsidiaries of foreign parent companies may indirectly be influenced by the CFC legislation of the jurisdictions of the parent companies, due to the attractive tax rates and corporate tax legislation of Switzerland. CFC legislation has already existed in several countries for many years (e.g. Germany, France, US).

The 2015 BEPS Action 3 report worked out recommended approaches to the development of CFC rules, to ensure the taxation of certain categories of income of multinational enterprises (MNEs) in the jurisdiction of the parent company, and to disincentivise offshore or similar privileged structures with no taxation or allowing for a long-term deferral of taxation. Hence, CFC rules have the purpose of reducing the incentive to shift profits to low- or no-tax jurisdictions.

Jurisdictions apply a variety of different criteria to determine the term as a 'controlled foreign company', which would trigger the applicability of CFC taxation rules:

- Voting rights or shareholder value owned by resident taxpayers;
- Operations in a no- or low-tax jurisdiction;
- Quality of income earned by CFC (e.g. only passive income like interest, rental property income, dividends, royalties or capital gains), and;
- The application of substantial activity tests.

Switzerland has regularly been considered by various countries as a low-tax jurisdiction, to which profitable business had been shifted. As a result, special favourable tax regimes have been abolished as of January 1 2020.

Simultaneously, most Swiss cantons decided to reduce corporate income taxes for all corporate taxpayers to set an incentive for existing and new enterprises to conduct business out of Switzerland.

The new effective corporate income tax rates are in the range of roughly 12% to 20% depending on the canton of tax residence, with tax rates below 15% being generally more exposed to CFC taxation than higher rates. Apart from the CFC legislations, it should also be noted that there is a plan of the OECD to introduce a minimum taxation for corporations through the global anti-base erosion proposal (GloBE) under pillar two.

ATAD is supposed to lead to a common and harmonised application of BEPS Action 3 by EU member states. The following special aspects of ATAD (Article 7 and 8) can be highlighted:

- CFC means direct or indirect shareholding of more than 50%;
- Low taxation of CFC: Tax rate is lower than 50% of parent company's tax rate;
- CFC does not carry on a substantive economic activity; and
- Obligation to tax certain, predominantly passive, low-taxed revenues of a foreign CFC, in particular (i) interest, (ii) license fees, (iii) dividends, capital gains on shares, (iv) income from financial leasing, (v) income from banking and insurance activities (vi) income of invoicing companies.

It has to be noted that EU member countries can choose to not implement the substantive economic activity test in their domestic law for CFCs located in non-EU/EEA countries.

Possible protection measures for Swiss tax legislation

For an MNE, there are different ways to mitigate the effects of CFC legislation of the jurisdiction of the parent company on Swiss based subsidiaries. The calculation of corporate tax burden of the Swiss based subsidiary includes direct federal tax as well as cantonal and communal direct taxes.

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Anke focuses on all aspects of national and international corporate tax law and tax planning for Swiss and foreign private clients. She advises clients on tax matters relating to inter-cantonal and international set-ups as well as in the area of M&A transactions and restructurings. She has broad experience regarding the taxation of trusts, foundations as well as funds structures. Her area of expertise includes Swiss tax compliance.

Anke holds a bachelor's and a master's degree in law and economics from the University of St. Gallen.

Whereas the Swiss Direct Federal Tax Act does not contain any specific provisions which could help MNEs to reduce their CFC risks, MNEs should carefully look at the subsidiary's concrete tax situation and aim at reducing CFC risks based on cantonal tax laws.

With respect to cantonal and communal direct taxation in Switzerland, there are three different types of cantons for CFC purposes:

- High-tax cantons ('high' tax rate, including direct federal tax);
- Low-tax cantons with fix tax rates only; and
- Low-tax cantons with specific rules for CFCs and flexible tax rates.

The definition of a high-tax canton depends on the taxation rules of the country of the parent company, i.e. the Swiss income tax rate may be high enough to be out of scope, however, the CFC taxation might be triggered in cases where the tax base is calculated less favourably in the country of the parent company leading to a lower effective tax rate for CFC purposes. Furthermore, it must be assessed whether net equity taxes are also relevant for the tax comparison. For highly capitalised companies, this may have a significant impact.

There are some low-tax cantons which anticipated the CFC problem by providing for a correction mechanism which applies higher tax rates automatically or on application, if the country of residence of the parent company treats all or part of Swiss income as CFC income.

Examples:

- Lucerne: Increase of tax rate to required minimum tax rate in a CFC case;
- Zug: The tax rate can be increased in special cases in connection with international relations; and
- Thurgau: The cantonal tax authorities can apply a higher tax rate in cases where an entity of an international group is at risk of being subjected to CFC legislation abroad.

Cantons and their tax authorities that take foreign CFC rules into account for determining the applicable tax rate are in quite a challenging situation. Practice will show to what extent such rules effectively prevent CFC taxation abroad and how they can be applied in a legally consistent and practicable way.

Action 5: Harmful tax practices

The OECD released a report of the 2020 reviews by the OECD Forum on Harmful Tax Practices regarding preferential tax regimes. Switzerland was found to be in line with the BEPS 5 minimum standard, due to its abolition of the special tax regimes as of January 1 2020.

At the same time, the Swiss tax legislation allows cantons to introduce a patent box, as well as research and development (R&D) super-deductions, all in line with the minimum standard defined under BEPS Action Plan 5 (including the nexus approach). In addition, cantons applying a minimum corporate income tax rate (cantonal or communal of at least 13.5%) may introduce a notional deduction on excess equity defined by law, thus favouring highly capitalised companies. Only the canton of Zurich has introduced such a notional interest deduction on equity as a result of its high tax rates. The new instruments are in line with the substantial activities standard test.

An important side effect of the minimum standard regarding preferential tax regimes is the introduction of the spontaneous exchange of information on tax rulings, including the Exchange on Tax Rulings XML Schema and User Guide. The exchange of tax rulings for certain cross-border tax matters was introduced in Switzerland in 2018. An adverse, non-tax impact has been seen by MNEs in the increasing risk of disclosure of sensitive information to competitors.

Action 6: Prevention of tax treaty abuse

Bilateral double taxation agreements have the purpose to prevent international double taxation and play a very important role in connection with cross-border business activities. The respective network of double taxation agreements has also led to treaty abuse and so-called 'treaty-shopping' arrangements. Treaty shopping typically means the intention of a person to indirectly access the benefits of a tax treaty between two jurisdictions without being a resident of one of those jurisdictions.

The 2017 OECD Model Tax Convention has the following preamble (The Express Statement):

Intending to conclude a Convention for the elimination of double taxation with respect to taxes on income and on capital without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this Convention for the indirect benefit of residents of third States).

According to Action 6 minimum standard, the principal purpose test (PPT) shall be introduced to double taxation agreements, either alone or along with a detailed version of the limitation on benefits clause (LOB). A third version would be a detailed LOB rule along with domestic conduit arrangements not dealt with in tax treaties.

Switzerland opted for the minimum standard of Action 6 when signing the multilateral instrument (MLI) in 2019. It has already amended several double taxation agreements implementing the PPT accordingly. In cases where a double tax treaty (DTT) containing a PPT provision is applicable, the PPT supersedes the applicability of the Swiss domestic Anti-Treaty Abuse Act (Missbrauchsbeschluss). It appears that the Anti-Treaty Abuse Act is subject to increasingly limited applicability and is therefore likely to be abolished soon.

The question arises as to what extent the implementation of the PPT in double taxation agreements has a material impact on international structures involving Swiss entities. As of today, it is still premature to draw any final conclusions, though it can be noted that the PPT is largely seen as being in line with the long-standing practice of Switzerland in connection with treaty abuse.

Summary

BEPS and ATAD had, and still have, a substantial impact on Swiss taxation, in particular in concern of:

- Swiss corporate tax and the Social Security Financing Act (STAF): The abolition of special cantonal tax regimes, along with other special tax regimes (finance branch, principal companies);
- Optional introduction of patent box, R&D super-deduction, notional interest deduction at cantonal level, and reduction of corporate income tax rates for all legal entities;
- Corporate income tax rate adjustment (increase) provisions in some cantons to prevent measures of existing and new CFC legislations;
- Spontaneous exchange of information: The disclosure of tax rulings dealing with certain cross-border arrangements; and
- Tax avoidance provisions introduced in bilateral DTTs replacing the Swiss domestic Anti-Treaty Abuse Act with a principal purpose test.

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