Dear Reader,

It is time to review the latest national and international developments in connection with the Corporate Tax Reform III. The Swiss Federal Council opened its four-month consultation on Corporate Tax Reform III, with the aim of maintaining the attractiveness of Switzerland as business location and adapting tax law to the changing international environment. In addition to other measures, the legislative draft provides for a license box and introduction of an interest-adjusted corporate income tax.

The wheels have also been and are still in motion at international level. The OECD has published key documents on combating international base erosion and profit shifting. With regard to the planned Swiss license box, in particular the OECD's work on harmful tax practices with focus on taxation of income from intangible assets has to be taken into account. The goal of the OECD’s work on harmful tax practices is to develop new international standards to ensure that such income is taxed at the location of actual value creation.

Against the backdrop of these developments, we discuss the legislative draft mentioned above. You can read more about this in the following article.

Our next topic relates to companies listed on SIX Swiss Exchange. The main focus of the Swiss stock exchange’s audit of the interim and annual financial statements is on the disclosure of income taxes, including loss carryforwards, reconciliation statements and deferred taxes with respect to investments. The companies concerned must ensure in good time that these issues are completely and correctly reported in the IFRS annual financial statements.

Moreover, we report on a recent Swiss Federal Supreme Court decision regarding the offsetting of losses after an assessment on a taxable profit, continuing the current and not uncontroversial practice of the Swiss Federal Supreme Court.

In our last article we address the tax and social security challenges faced by international companies with internationally mobile employees in connection with the implementation of incentive compensation plans. Due to our many years of experience, we would be pleased to assist you create and implement solutions.

Yours sincerely

Dr. Philip Robinson
Managing Partner Tax and Legal
philip.robinson@ch.ey.com
In this issue

4 Corporate Tax Reform III: Findings at national and international level
   Rainer Hausmann, Philipp Roth

7 Swiss stock exchange turns spotlight on income taxes
   Marco Mühlemann

8 Offsetting a tax loss after an assessment of a taxable profit – Federal Supreme Court ruling
   Marco Mühlemann

9 Long-Term Incentives and Expatriates – Challenges and Solutions
   Britta Schmitt
Corporate Tax Reform III: Findings at national and international level

On 22 September 2014, the Swiss Federal Council opened its consultation on Corporate Tax Reform III. Recently, the OECD published its extensive work on Base Erosion and Profit Shifting and the meeting of the G-20 finance ministers took place in Australia. These events provide an opportunity to outline the latest developments in corporate tax law.

Developments at national level
On 22 September 2014, the Swiss Federal Council opened its four-month consultation based on the Corporate Tax Reform III and published its legislative draft on fiscal measures for strengthening the competitiveness of Switzerland as business location (Corporate Tax Reform Act III). The Swiss Federal Council reiterated its desire to safeguard the attractiveness of Switzerland as business location and to bring corporate tax law in line with the changed conditions.

The planned reform is based on three objectives:
- Keep corporate taxes at a competitive level
- Regain international acceptance
- Safeguard the financial yield of corporate income taxes

To achieve this, the Swiss Federal Council proposes abolishing the current cantonal tax regimes for holding, domiciliary and mixed companies. The current practice of international profit allocation of principal and the treatment of Swiss finance branches for tax purposes is also set to be phased out. New tax rules will also be introduced and existing ones amended to strengthen Switzerland’s international attractiveness and acceptance as business location. Besides general tax measures (see box on the left) the legislative draft also provides for a license box at cantonal level and the introduction of an interest-adjusted corporate income tax. The interest-adjusted corporate income tax enables for a notional interest deduction on above-average equity income (safety equity). Safety equity is the amount of the sale price of a product minus the interest-adjusted corporate income tax. The reduction of cantonal corporate income tax rates is key for creating an internationally competitive tax system. However, the decision to reduce cantonal corporate income tax rates remains in the competence of the cantons. As a result, this key element is not formally subject to the legislative draft.

The policy to improve competitiveness will probably be focused on the license box, at least for the medium term. The legislative draft would give the cantons the right to exclude from the taxable basis a maximum of 80% of income from patents, supplementary protection certificates, exclusive licenses for a patent and from the first-notifier protection under article 12 of the Swiss Law on Therapeutic Products. Income covered by the license box should therefore be subject to an effective tax rate of about 10% (including Swiss direct federal tax). Income from trademarks is not covered. The qualifying income is calculated based on the residual method (see box below), where embedded income is also covered. Embedded income is the amount of the sale price of a product attributable to the intellectual property rights (IP) underlying the product.

License box: calculation method
With the residual method (top-down approach, indirect calculation method), non IP-related profits and profits from routine functions (e.g. sub-contractors, commission agents) and trade mark payments are deducted from net profits and are taxed ordinary. The remaining amount of profits attributable to the use of IP is allocated to the license box and subject to privileged taxation.

The calculation model is based on the calculation method that applies to the UK patent box, which is currently being reviewed for compatibility with the EU Code of Conduct.
International developments

On 16 September 2014 the OECD published seven important documents on Base Erosion and Profit Shifting (BEPS). On 20 and 21 September 2014 the finance ministers of the G-20 countries met in Australia. The G-20 welcomes the work carried out by the OECD and encouraged to continue working on BEPS.

The work being done by the OECD on countering harmful tax practices more effectively while taking into account transparency and substance (Action 5) is of special interest in the context of the Corporate Tax Reform III. The practice of shifting mobile income to low-tax countries is criticized however, priority is given to the taxation of income from IP. As part of Action 5, the OECD commissioned the Forum on Harmful Tax Practices to review the existing tax regimes of the OECD member countries and formulate new criteria for determining harmful tax practices. The new international standards should ensure that income from intangible assets is taxed in the jurisdiction in which the value creation actually occurs.

At the moment it is still open based on which factors the necessary substance should be determined. At OECD level, three different approaches are currently under discussion.

- **Transfer pricing approach:** The allocation of income from IP to a given jurisdiction presupposes that important functions are located at that jurisdiction. The taxable company must also be the legal owner of the IP concerned and must use it and bear the associated economic risks.
- **Value creation approach:** Sufficient substance is present if significant development activities are performed at the place of taxation.
- **Nexus approach:** Income from intangibles has to be taxed at the place where the underlying research and development work is done.

Apparently a number of countries have expressed reservations about the effectiveness of the transfer pricing approach and are rather in favor of the substantially more rigorous nexus approach. However, consensus has not yet been reached on which method should apply, and in several countries opposition to the nexus approach is already forming.

On 10 December 2013, the European Union’s Economic and Financial Affairs Council (ECOFIN) decided to review the license boxes of all EU member states with respect to their compatibility with the EU Code of Conduct for business taxation. Initial results are expected by the end of 2014. Furthermore, the European Commission recently said that it suspects that some regulations of member states to promote research and development primarily claimed by highly mobile businesses, without notably increasing research and development activities. The European Commission will therefore review the member states’ license boxes with regard to their compatibility with the EU state aid law.

License box of Switzerland in an international context

The license box proposed for Switzerland takes these international developments into account, particularly with regard to substance. The corporation benefiting from the license box must have made a significant contribution to the development or further development of the invention underlying the qualifying IP. In this regard, group internal control of the development of a patent is sufficient. The proposed criteria, however, are not oriented on the nexus approach, but primarily on the OECD’s transfer pricing and value creation approach. Hence, the explanatory report on the legislative draft stipulates a need for modifications should the nexus approach prevail at international level. The way chosen by the Swiss Federal Council is to be welcomed. It covers the approach most advantageous for Switzerland in an environment still to be clarified and the Swiss Federal Council would do well to preserve maximum room for changes as regards tax policy for the future.
Swiss stock exchange turns spotlight on income taxes

Marco Mühlemann, Senior Manager, Business Tax Services, Zurich, marco.muehlemann@ch.ey.com

One of the main focuses of the SIX Exchange Regulation's review of the 2014 semi-annual and annual financial statements is on the disclosure of income taxes.

The annual and semi-annual financial statements of issuers whose shares are listed primarily on the SIX Swiss Exchange are subject to SIX Exchange Regulation's enforcement of compliance with accounting standards. As part of their duty to cooperate, issuers must provide SIX Exchange Regulation with all information and documentation needed to assess this matter and monitor compliance with regulations. SIX Exchange Regulation selects annual and semi-annual financial statements for reviewing on a risk-oriented basis and also carries out random sampling. The financial statements of an issuer will therefore be subject to checks by SIX Exchange Regulation every five years (for the main standard) and ten years (for the other standards). SIX Exchange Regulation can impose penalties in the event of major breaches of accounting standards.

Each year SIX Exchange Regulation focuses on particular areas, which are examined in depth when reviewing semi-annual and annual financial statements. One focus of the review of the 2014 annual reports is on the reporting and presentation of income taxes (IAS 12). The areas focused on by SIX Exchange Regulation are outlined below and also apply analogously to companies preparing financial reports in accordance with the US GAAP regulations.

Tax loss carryforwards

Plausibility checks based on the assumptions in the planning documentation are carried out by the SIX Exchange Regulation to determine the suitability of recognizing tax loss carryforwards and the non-recognition of deferred tax assets. In the IFRS Circular 2 dated 27 September 2013, SIX Exchange Regulation made it clear that recognizing tax loss carryforwards as a deferred tax asset is not a matter of choice. If recoverability is established, tax loss carryforwards must be recognized.

The period underlying the assessment of future earnings must be based on objective criteria (e.g. statutory expiry dates). Furthermore, the assumptions and budget figures that are applied must be consistent with the parameters used for other calculations (e.g. goodwill impairment tests). In addition, pursuant to IAS 12.81(e), if the deferred tax asset has not been recognized, the amounts and date of expiry of tax loss carryforwards must be disclosed. Here, SIX Exchange Regulation recommends staggering such disclosures in a meaningful way based on expiry dates, as well as the disclosure of tax rates. In this context, it may be relevant to the investor whether the tax loss carryforwards were incurred at a subsidiary with a high tax rate or instead at a holding company that is subject to a lower tax rate.

When reviewing the 2014 semi-annual and annual financial statements, SIX Exchange Regulation can request the planning documentation used by the entity.

Tax rate reconciliation

The intelligibility and clarity of the reconciliation from the expected to the effective tax rate as a key indicator of quality is also examined in detail. IAS 12.81(c) requires that a reconciliation be made between the applicable nominal tax rate (tax expense) and the effective tax rate (tax expense).

The items shown in the reconciliation must be comprehensible and the selected designations self-explanatory. If the applicable tax rate has changed from the previous accounting period, then such fact must also be separately disclosed in the notes, together with an explanation of the reasons in accordance with IAS 12.81(d). If the applicable tax rate represents a weighted average of tax rates in different jurisdictions, then both the effect of changes to tax rates and the impact of changes to the structural composition of results in the different jurisdictions must be explained to permit a better assessment of the future average tax burden.

Entities are recommended to take a critical look at the suitability of the choice and descriptions of reconciliation items. It is important that large amounts are not reported under the “other effects” item.

Deferred taxes with respect to investments

The decision not to recognize deferred taxes in connection with investments in subsidiaries, branches and associates is not a general clause, but, pursuant to IAS 12.39, is permissible only if the group can control the timing of the reversal of the temporary differences and such differences will not reverse in the foreseeable future. The fact that these deferred taxes were not recognized must be disclosed in connection with the corresponding temporary differences (IAS 12.81(f)).

The relevant Swiss tax legislation with article 62 para. 4 of the Direct Federal Tax Act (DFTA) needs to be observed. This provision empowers tax authorities to enforce the reversal of impairments and writedowns on acquisition costs of investments if they are economically no longer justified. In such cases control over the timing of the reversal of the temporary differences no longer resides with the reporting entity, but the tax authorities, so one of the two requirements of IAS 12.39 is no longer met. A deferred tax liability must then be determined and booked.

Because the revised Swiss statutory accounting rules are mandatory for financial years beginning on or after 1 January 2015, the individual measurement of investments is of relevance here. Under revised Volume 1 of the Swiss Auditing Manual (Handbuch der Wirtschaftsprüfung), investments must usually be separately measured (article 960 para. 1 Swiss Code of Obligations). This principle may be deviated from only in certain objectively justified cases. Where previously it was the practice to carry out an overall assessment of investments, many entities run the risk in financial year 2015 of having to write down individual investments against profits and taxes. In such cases, it must be determined whether, under IAS 12.44, a deferred tax asset must...
already be recognized in the 2014 IFRS balance sheet for the expected current tax benefit in 2015. Under IAS 12.44 an entity must recognize a deferred tax asset for all deductible temporary differences arising from investments in subsidiaries, branches and associates, and interests in joint arrangements, to the extent that it is probable that the temporary difference will (i) reverse in the foreseeable future and (ii) sufficient taxable profit will be available against which the temporary difference can be utilized. If at the end of 2014, an impairment in financial year 2015 (i.e. in the foreseeable future) is probable, a deferred tax asset must be recognized in the IFRS accounts for 2014.

Where an entity has opted not to recognize deferred taxes for investments in subsidiaries, branches and associates, SIX Exchange Regulation can obtain the documentation to assess the requirements under IAS 12 that must be cumulatively met.

Recommendation
Entities listed on the SIX Swiss Exchange must check early in advance (i.e. before preparing the 2014 annual financial statements) whether the areas mentioned above can been properly and fully presented in the IFRS annual financial statements. If the information for the correct calculation and presentation of income taxes is missing, suitable action must be taken to ensure the information is available in full and on time. Entities must also ensure the quality and completeness of internal documentation so that disclosed figures are comprehensible in a future audit. As mentioned, SIX Exchange Regulation can request additional documentation when reviewing entities.

Offsetting a tax loss after an assessment of a taxable profit – Federal Supreme Court ruling

Marco Mühlemann, Senior Manager, Business Tax Services, Zurich, marco.muehlemann@ch.ey.com

The Federal Supreme Court confirms current practice and annuls lower court’s ruling

In the December 2013 issue of Tax News we reported on the ruling on 12 June 2013 (SB.2012.00105) of the Zurich Administrative Court, which affirmed the permissibility of tax loss offset-setting even when a taxable profit had been assessed in the previous tax year. On 29 April 2014, five judges of the Swiss Federal Supreme Court considered the case and, alas, came to a different conclusion. At 2 votes to 3, the decision was a close call – evidence that the matter was a subject of disagreement among the judges.

On 30 November 2004, in the course of a merger, A-AG assumed all the assets and liabilities of C-AG. In its 2004 tax return, the company deducted C-AG’s tax loss carry-forwards from its reported net profit for the 2004 financial year. The Administrative Court proceeded on 18 November 2009 to disallow the deduction of tax losses not only with respect to cantonal and municipal taxes but also with respect to the direct federal tax for the 2004 tax period. While A-AG took the Administrative Court’s ruling on direct federal tax to the Federal Supreme Court, it did not contest the one on cantonal and municipal taxes. On 4 January 2012, the Federal Supreme Court held that the deduction of the preceding year’s tax losses of C-AG was permissible. This decision attracted plenty of commentary in tax publications.

In its tax returns for 2005, 2006 and 2007, A-AG deducted the tax loss carry-forwards from C-AG, reduced by the 2004 profit, as a result of which taxable net profit in each of the three tax periods was CHF 0. After taking note of the Federal Supreme Court’s ruling of 4 January 2012, the competent tax authorities allowed the loss offsetting with respect to the direct federal tax. The Zurich Administrative Court, dissenter from the cantonal tax authorities’ position, also confirmed the permissibility of the loss offsetting for the cantonal and communal income tax. The Tax Administration of the Canton of Zurich promptly lodged an appeal with the Swiss Federal Supreme Court.

Previous Federal Supreme Court practice confirmed
Regrettably, the Federal Supreme Court kept the reasons for its decision relatively brief, giving what was sometimes no more than rudimentary consideration to alternative doctrine and to the persuasive reasoning of the Zurich Administrative Court. It continues to favor the principle of periodicity over that of total income or the principle of taxation by economic performance, while the lower court, taking account of the latest rulings, had given greater weight to the total income principle. The Zurich Administrative Court took the view that a violation of the principle of immediate loss offsetting should not yield advantages to the taxpayer. Equally, however, it ruled it should not – assuming there had been no wrongful conduct or breach of duty – put the taxpayer at a disadvantage compared with what his position would have been had he acted in accordance with the rules.

The Federal Supreme Court is still in part relying on requirements to be met that would permit a change in practice. According to the wording of its ruling, “any change in legal opinion must be founded on sound objective facts”, which, especially given the need for legal certainty, must be all the more weighty the longer the law has been applied in a particular way that was formerly seen as appropriate but now regarded as erroneous or no longer appropriate under today’s changed conditions. The Court took the view that these conditions were not met in this parti-
cicular case, and that the practice applied to date should be continued with. In its landmark ruling of 11 March 2003 (2A.587/2002), the Court had decided that any offsetting had to be ruled out in the event of a positive assessment. It reasoned that tax losses from the relevant financial year or tax losses carried forward from earlier tax years could no longer be offset in subsequent tax periods. As the offsetting of losses cannot be deferred, the waiving of recourse to a legal remedy against such an assessment justified the incontestable assumption that there were no or were no longer any losses capable of being offset. The consequence of the Court’s latest ruling is that this practice is to continue and that any other solution would be incompatible with legal certainty. The taxpayer would thereby be obliged to rely in new tax periods on previously accepted assessments of, and his own statements on, the occurrence and amount of losses, which would conflict with the principle of good faith and the prohibition of contradictory behavior derived from it.

In the event of a “zero assessment”, the residual tax loss carry-forwards are still, under prevailing practice, not assessed. Residual tax loss carry-forwards are still, under prevailing practice, not assessed. It follows that the offsetting of losses in subsequent accounting periods remains possible.

Long-Term Incentives and Expatriates - Challenges and Solutions

Britta Schmitt, Executive Director, HC Talent & Reward Zurich, britta.schmitt@ch.ey.com

Long-term Incentive (LTI) Plans have become a core element in modern remuneration mechanisms and, more specifically, for Manager remuneration. This is particularly the case for the global players, regardless of whether they are listed or privately owned. This article will address the various challenges that can occur, before, during and after rolling-out an LTI program [particularly for internationally mobile employees] and suggest potential solutions.

Good communication of the plan mechanics within the company, as well as the implementation of internal processes and administration of participant and plan data, are of vital importance to ensure full compliance with global regulations and requirements. Both the participants of the plans and the Company payroll departments need to be well informed about the administrative and compliance processes, as well as any tax and social security obligations and requirements.

1. Risk & Compliance

1.1 Taxes

1. Tax point

In Switzerland, as in most other European countries, the tax point is the day on which the employee receives the shares or cash payment. In the case of blocked shares, the tax point is the moment of acquisition or transfer of the shares. For RSUs, it is at the time of vesting, when the underlying shares are transferred. Finally, for options or SARs, it is the moment at which the awards are exercised.

However, the tax basis and timings of taxation differ around the world. Some countries tax share rights at grant, regardless of whether the shares (or cash – in a cash settled LTI Plan) has already changed hands. This may particularly be true, when the local company employing the beneficiary is already recharged with the costs at grant. In certain countries, the tax point is determined by whether the share plan is settled in cash or in shares.

In order to ensure that tax at source is withheld at exactly the right time, the C&B department needs to have an overview of tax points in all effected countries and has to work with the Payroll departments around the globe to ensure that they have all relevant information on time to ensure timely payroll reporting and withholding.

2. Sourcing of income for international employees

In most LTI programs, shares or rights are earned over a period of several years. When the participants of the plans are assigned or relocated abroad, they could be subject to tax liabilities across multiple countries or even subject to higher overall taxes. In addition, the correct payroll processing in multiple countries and/or the filing of several tax returns can create complex compliance issues.

Internationally mobile employees are usually subject to tax in more one country. The income from LTIs is mostly sourced between the countries based on the residence period in each country between grant and vest. Nowadays, this is the general approach based on the OECD Model Convention for income tax. However, the sourcing methods, especially where withholding tax is concerned, have not been harmonized internationally. For certain country combinations there is a risk of double taxation, be it final or, in many cases, only temporary. This depends on the Double Taxation Agreement (DTA) between the two countries concerned for the participant, as some countries allow a sourcing of pro rata temporis for the part of the vesting period spent in that country only if there is a DTA in place between those countries. Others do not allow for allocation at payroll level, but do allow for foreign tax credits to be claimed in the tax return on for the taxes paid in the other country.

Tax News EY Autumn 2014
2.2 Social insurance

Another challenge is presented by the need to determine social insurance liabilities in the host and home country of an assignee. Even more difficult to determine is the obligation for trailing equity between the former home country and the new home country in case of localized employees. The income for social security is usually not apportioned in the same way as for withholding tax. The social security regulations usually apply an “all or nothing” approach, i.e. rather than income being sourced on a pro rata temporis basis, for social security the country where the employee is living and employed at the time the LTI is paid out will often claim social insurance contributions on the worldwide income. If however, during the assignment a Certificate of Coverage is in place, then the home country usually has the right to levy social security on the full equity income.

2. Summary

As briefly set out above, companies face many and various challenges regarding the taxation and contributions to social security in connection with trailing equity rights. To be able to address them early and align the processes to ensure an efficient plan management there are a number of steps and actions that every company should consider.

- Clear definition of processes with the different departments (HR, C&B, finance, payroll etc.) and external parties, such as plan administrators, brokers and tax advisors
- Determining withholding and reporting obligations in relation to tax and social security, as well as other legal requirements through worldwide due diligence reviews
- Information for local Payroll/HR departments, for example on taxation rules for local employees and expats or “Payroll instructions” that determine which share (pro rata or full gain) from the LTI has to processed for tax and social security in the different countries. This should be done either through manually prepared payroll instructions or using IT applications to determine the trailing liabilities
- Incorporating provisions relating to “compensation for tax disadvantages” and “assistance with tax returns at home and abroad” into employee assignment policies.
- Providing employees with local tax guides or tax fact sheets
- Information targeted at expats and their complex tax situations should be tailored to their individual circumstances to help them better understand the tax obligations they face

Experience has shown that the C&B functions and the Payroll departments often require additional external support, especially when determining the tax consequences for internationally mobile employees. Many years of experience from working with our clients to overcome these challenges enables us to assist companies in setting up robust processes and be compliant with the global taxes and social security requirements.