Swiss Federal Council publishes revised bill together with dispatch (associated commentary) on Corporate Tax Reform III

Executive summary

On 5 June 2015, the Swiss Federal Council published the revised bill together with the dispatch (associated commentary) on the Corporate Tax Reform III for parliamentary discussion. The general objective of the reform is to strengthen Switzerland's attractiveness as a business location in line with international taxation standards. Compared to the consultation draft issued in September 2014, the Swiss Federal Council made various adjustments to the bill based on the findings from the consultation process.

Detailed discussion

Introduction

The Swiss Federal Council notes that Switzerland's attractive tax environment for companies has made a significant contribution to the country's prosperity in recent years. Companies based in Switzerland create jobs, make investments and provide an important source of tax revenue. However, based on the changing international tax environment, namely the developments within the base erosion and profit shifting (BEPS) project of the Organisation for Economic Co-operation and Development (OECD), it appears that certain current tax regimes are no longer in line with international taxation standards.

The aim of the Corporate Tax Reform III is to ensure that Switzerland will have a sustainable, internationally accepted and competitive tax system for multinational companies. Further measures are designed to improve the system of corporate tax legislation and its balance.
Proposed measures
Based on the dispatch of the Swiss Federal Council, certain tax regimes at the cantonal level are no longer in line with international standards and should, therefore, be abolished. These primarily include the cantonal tax status for holding, domiciliary and mixed companies. Additionally, the dispatch proposes the abolishment of the administrative practices with regard to the principal allocation and the Swiss finance branches. In order to maintain Switzerland’s international competitiveness, the Swiss Federal Council stipulates in its revised bill the introduction of the following core measures:

- Patent box at cantonal level
- Tax incentives for research and development (R&D) at cantonal level
- Comprehensive rules for the disclosure of built-in gains (including goodwill) upon migration to Switzerland or upon change of the tax status
- Abolition of one-time capital duty on capital contributions
- Avoidance of double taxation of permanent establishments under application of the lump-sum tax credit

In addition, it is generally expected that the cantons will reduce their statutory income tax rates upon the abolishment of the preferential cantonal tax regimes in order to enhance their attractiveness. The responsibility for such tax rate reduction is with the cantons and therefore formally not included in the (federal) bill. Such reduction of the statutory cantonal tax rates will significantly contribute to the competitiveness of the tax environment and will be beneficial for all companies in Switzerland. In accordance with the draft legislation, the cantons will also have the possibility to introduce targeted capital tax reductions on net equity related to participations and intangible assets.

With the aim to strengthen the attractiveness of Switzerland as a business and investment location, the one-time capital duty on capital contributions shall be abolished. However, the Swiss Federal Council no longer intends to pursue the initially proposed changes to the participation exemption regime and the offsetting of tax losses. The Swiss Federal Council also decided to remove the notional interest deduction on equity from the bill, considering the opposed results of the consultation. It is expected though that the concept of a notional interest deduction will again be brought up within the parliamentary debate.

From a counter financing perspective, the revised bill ensures a more balanced taxation of private shareholders. In order to achieve this, the relief associated with the partial taxation of dividends shall be harmonized at the federal and cantonal levels and shall be limited to 30%. The minimum participation quota of 10% is maintained.

However, the Swiss Federal Council refrained from proposing the taxation of private capital gains of Swiss resident individuals in view of the clear results of the consultation.

Review of core measures
Patent box at cantonal level
It is proposed to introduce a patent box at the cantonal level which is competitive and compatible with international taxation standards. In comparison to the consultation draft, the revised bill provides certain modifications that take into consideration the latest international developments, in particular the OECD developments in relation to the substantial activity requirement and the modified nexus approach.

The modified nexus approach builds on the agreement reached by the OECD together with the G20 countries in February 2015, according to which the income eligible for preferential taxation is determined by the actual level of qualifying R&D expenditure incurred. Accordingly, the underlying R&D costs relating to the qualifying intellectual property rights need to be mainly incurred in Switzerland, in order to constitute qualifying expenditure for the preferential patent box regime.

The maximum relief under the patent box is a 90% base reduction but the cantons have the option to apply a lower quota. The maximum relief is leading to an effective tax rate of approximately 8.5%-10%, including both the federal and the cantonal/communal income tax.

The following rule needs to be considered should a company intend to transfer existing patents into the patent box. The bill provides for the taxation of all R&D expenses that were previously deducted by the company and that relate to the IP being brought into the patent box.
These expenses can be capitalized in the tax balance sheet and subsequently be deducted (again) in the patent box. However, the benefit of this deduction may be lower than the add-back to taxable profit, especially if the company was taxed at the ordinary rate before applying for the patent box.

**Tax incentives for R&D at cantonal level**

As a consequence of the corresponding proposals made during the consultation phase, the Swiss Federal Council introduced in the revised bill a provision giving the cantons the possibility to allow increased tax deductions for R&D expenditures (so called super deduction) at the cantonal level. This measure aims to additionally promote the development and the use of intellectual property rights in Switzerland. The cantons will be free to determine the qualifying R&D expenses and the extent of the super deduction.

**Comprehensive rules for the disclosure of built-in gains (including goodwill) upon migration to Switzerland or upon change of the tax status**

As part of the reform, the Swiss Federal Council wants to continue to strengthen the tax legislation system. Therefore, the revised bill provides comprehensive rules for the tax-neutral disclosure of built-in gains (including goodwill) upon migration to Switzerland or upon change of tax status from a preferential taxation regime to ordinary taxation. The disclosure of built-in gains is highly relevant in connection with the abolishment of the cantonal tax regimes. It ensures a competitive current income tax burden during a five-year transitional period.

It is agreed that the original step-up, as proposed in the consultation draft, will lead to a deferred tax asset when leaving the privileged taxation regime and moving to ordinary taxation. This raises several problems in connection with international accounting standards. Therefore, an alternative solution was developed that leads to the same economic benefits as the original step-up but avoids the recognition of a one-time deferred tax benefit. As a consequence, the original proposal has been replaced.

The revised bill considers two different models:

- The original step-up (as outlined in the consultation draft of September 2014) applies with regard to the relocation to Switzerland.
- A two-basket approach with two different corporate income tax rates applies during the transition period from the privileged taxation regime to ordinary taxation. Under the two-basket approach, the ordinary tax rate applies for profits relating to value created under the ordinary taxation (first basket) and a lower tax rate applies for profits relating to the realization of built-in gains that were generated under a privileged tax regime (second basket).

The proposed models for the disclosure of built-in gains are mandatory for all cantons and the two-basket approach is applicable for a transition period of up to five years.

**Avoidance of double taxation of permanent establishments (PEs) under application of the lump-sum tax credit**

The revised bill provides the legal basis for the amendment of the lump-sum tax credit ordinance. Based on the current law, a Swiss PE of a foreign company cannot apply for the lump-sum tax credit for non-refundable foreign withholding taxes on dividend, interest and royalty income received from abroad, whereas a Swiss subsidiary of a foreign company, in a corresponding situation, is entitled to apply for the lump-sum tax credit. The different treatment of PEs and legal entities under the current law may not only lead to a partial double taxation of PEs but also contradicts the principle of non-discrimination of PEs under article 24 para 3 of the OECD Model Convention. Due to the amendments proposed in the bill, Swiss PEs of foreign companies are regarded as subsidiaries for tax purposes. The avoidance of the double taxation of PEs under application of the lump-sum tax credit further strengthens the attractiveness of Switzerland as a business location.

**Timing**

The Swiss Parliament will now review and discuss the bill considering the ongoing developments at the international level. This process could take some time due to the forthcoming 2015 elections of the Swiss Parliament and its newly assembled advisory commission. The Federal Council will also be re-elected at the end
of 2015, which could lead to a new allocation of the Federal Departments among the (re)elected Members of the Federal Council. After the parliamentary process, the amended law will be published in the Federal Gazette and the referendum period of 100 days will begin. Depending on whether or not a referendum is called, the new federal law is likely to enter into force as of 1 January 2018. Once effective at the federal level, the cantons will have a transitional period of two years for implementing the new measures of the federal law into the cantonal law. The new cantonal provisions are expected to be fully implemented and applicable by 2020.

Current law
Given the fact that the new law will not enter into force until 2018-2020, the current tax regimes will remain valid for the next three to five years.

Endnotes
1. Further information on the Swiss Corporate Tax Reform III is also available under www.ey.com/ch/CTR-III.
4. The dispatch clarifies that it is more appropriate to refer to a “patent box” than to the previous “license box” given that the proposed measure is mainly focusing on patents and in view of the new international standard defined by the OECD with a close nexus between tax incentive and R&D activities.
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