Positioning Switzerland in the global tax world

Oliver Jaeggi and Kurt Wild, of Tax Partner AG – Taxand, discuss the mid- to long-term positioning of Switzerland in the global tax world.

Traditionally, Switzerland is very popular as a business location for multinational enterprises (MNEs). This is the case for a variety of reasons: Switzerland offers a highly developed infrastructure (international airports in Zurich, Geneva and Basel and excellent public transport connections), a skilled, multi-lingual labour force, a flexible labour law and peaceful labour relations, an excellent centre of knowledge and innovation (highly-ranked universities with good economic connections), the Swiss franc as the world's strongest and most stable currency and political stability due to direct democracy. A top financial (banking and insurance) and service sector (tax, legal, HR, accounting and so on), close relationships with the EU member states and several free trade agreements (including the pioneer agreement with China signed in 2013) are additional assets.

In the Global Competitiveness Report 2012 issued by the Global Economic Forum, Switzerland was again considered as the most competitive country worldwide. Furthermore, despite the global financial and economic crisis, Switzerland has an equable national budget and a strong economy. For the past eight years, the Swiss Federation permanently achieved surpluses. On average, they amounted to approximately SFr3 billion ($3.4 billion), which equals approximately 5% of the average total spending of approximately SFr60 billion. In 2013 government debt-to-GDP was 42% compared with an average of 106% in the EU, and the unemployment rate is currently at 3.5%, while across the EU it stands at more than 10%. In addition, Switzerland offers a very high standard of living, which is a key factor in particular for executives who relocate. Geneva and Zurich are two of the cities with the best quality of life worldwide according to several publications (Zurich is ranked 2nd and Geneva is ranked 8th according to Mercer's Quality of Living Survey 2012). This is achieved by an international, intercultural and multi-lingual population, high security, excellent healthcare and education systems, an intact environment and rich cultural activities.

Finally, Switzerland meets the MNE requirements of an attractive fiscal environment. Switzerland offers an employer-friendly tax system and has one of the lowest overall corporate tax rates in Europe. The cantons enjoy broad tax sovereignty and are free to determine tax rates at cantonal and municipal level. Cantonal tax autonomy leads to continual domestic tax competition between the cantons. As a result, some cantons offer very low corporate income tax rates. The lowest corporate income tax rates (combined federal, cantonal/municipal pre-tax rate) are in the canton of Lucerne at 11% and Schwyz at 12%. Besides these, in half of the cantons the corporate income tax rates range between 13% and 16% (for example, cantons of Appenzell, Fribourg, Glarus, Nidwalden, Obwalden, Schaffhausen, Thurgau, Uri and Zug).

In this context the resource equalisation system needs to be mentioned: The tax revenue and financial resources of the cantons vary considerably because of the differences

Biography

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Oliver Jäggi is an attorney and a certified Swiss tax expert. His career started in the corporate tax department of KPMG in Zurich in 2000, where he worked as a tax manager on national and international projects until 2007. Following this, he joined Tax Partner and is now a senior advisor.

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Tax Partner is one of the leading tax firms in Switzerland. With 32 professionals, the firm has been advising important national and multinational corporate clients as well as individuals. Tax Partner co-founded Taxand in 2005 – a global network with more than 2,000 tax advisors and 400 partners from independent member firms in 50 countries.

in the geographical location and economic development of the cantons. To equalise the differences in the financial resources between the cantons, the resource equalisation system has been established. With this ingenious mechanism, cantons with high financial resources pay contributions and cantons with low financial resources receive contributions. This resource equalisation system guarantees long-term stability and the maintenance of Switzerland's federalism, while maintaining competition.

In addition to the competitive corporate tax rates, Switzerland has further essential tax advantages: Switzerland has a very broad network of double tax treaties; the corporate tax law provides flexible tax provisions in case of reorganisations and recapitalisations; there are no subject-to-tax-clause provisions or CFC rules; and at 8% Switzerland has the lowest VAT rate in Europe (where the rates range from 15% to 27%), which is advantageous in particular for banks and insurances which normally do not qualify for full input tax credit. Furthermore, an amicable and cooperative tax environment exists between taxpayers and the tax authorities with the possibility to pre-discuss projects and receive advanced tax rulings, as well as being able to clarify and discuss upcoming tax issues in an open manner with the tax authorities.

Finally, Switzerland has an exemplary social security system and very moderate social security contribution rates on employment income. The 2014 social security contribution rate amounts to only 5.15% each for employer and employee (including the old-age, survivors and invalidity insurance and the unemployment insurance; this is the first pillar of the Swiss social security system). With the occupational company pension plan (the second pillar) the benefits on retirement, or in the event of disability or death, may be considerably extended. In particular, the advantages of the occupation benefit plan is that the benefits (that is, the pensions) are financed and determined based on the effective contributions made by the employer and the employee and the benefit may also be paid out as a lump-sum under certain conditions, which will then be taxed at a privileged rate for Swiss income tax purposes.

All in all, at the present time and under existing domestic rules, Switzerland offers MNEs an outstanding framework for corporations and individuals, including a very attractive fiscal environment.

Outlook: Post-BEPS future

Over the past few years the international tax world has completely changed which has also had an important impact on the existing tax system in Switzerland. As a result of the financial and economic crises, countries have been making a greater effort to generate more revenue for financing their debts and have therefore been tightening tax rules and expanding their tax base. Consequently, the OECD initiated its Base Erosion and Profit Shifting (BEPS) project under which actions shall be taken against artificial tax structures, aggressive tax planning and low or double non-taxation of income. The 15 action points mentioned in the BEPS report will be implemented by the end of 2015. Besides BEPS, the ongoing tax controversy between Switzerland and the EU needs to be solved as the EU takes the position that certain tax regimes in Switzerland violate the 1972 Free Trade Agreement between the EU and Switzerland and in addition are not in line with the EU Code of Conduct. Because of the OECD's BEPS Action Plan and the tax controversy with the EU, Switzerland will need to abolish, or at least adapt, existing attractive tax regimes for international companies (in particular the mixed or auxiliary company status for international trading and IP companies, the tax rules for principal companies and for finance branches). With the envisaged Corporate Tax Reform III the existing tax rules shall be replaced by substitute tax measures which on the one hand will offer an attractive tax treatment and on the other hand will be acceptable under international taxation principles (please see the separate article regarding Corporate Tax Reform III). Among other things the 1% Swiss capital duty levied on equity contributions

by the shareholders is planned to be abolished, the participation exemption system and the loss carry-forward rules further improved, the cantons provided with the possibility of abolishing the annual equity tax for corporations, and so on. Overall, Corporate Tax Reform III should be a powerful package to further enhance the attractiveness of the Swiss tax system.

However, it may well be the case that in the mid- to long-term such substitute tax measures as envisaged in Corporate Tax Reform III for special tax treatments or tax status, in particular the privileged taxation of income from intellectual property (known as intellectual property box taxation as currently applied by various, mainly European countries) will be attacked by the G20 as well and may have to be abolished sooner or later due to a further tightening of international tax standards. Debates in this direction have already started. It will have to be seen whether or not Switzerland – as well as the various other countries which have implemented similar schemes – bet on a (almost) dead horse.

Though the BEPS Action Plan and more extensive measures will be implemented, tax competition between countries worldwide will remain. The global introduction of a standard corporate tax rate or the general allocation of profits based on certain parameters is politically not realistic. Thus, it is likely that international tax competition in the mid- to long-term future between countries worldwide will mainly take place at the level of the corporate tax rates, but no longer on the basis of special taxation regimes/rules. For such a case, Switzerland is very well prepared. As mentioned above, some cantons already offer very attractive ordinary corporate pre-tax rates of 11% or 12% under the existing tax rules. However, to maintain or even strengthen the attractiveness as a premier business location, Switzerland must enhance its attractiveness further and one measure will be the reduction of its existing ordinary corporate tax rate. Such a reduction of the overall ordinary corporate tax rate could be achieved by the reduction of the corporate tax rate at a federal level which applies in all cantons (the current federal after-tax rate is 8.5%) as well as with further reductions of the cantonal/municipal tax rates. Switzerland should be in the position, from a financial and political point of view, to reduce its overall ordinary Swiss income tax rate by 5 – 6%. By a reduction of the federal tax rate to, for example, 6% and corresponding reductions of the cantonal/municipal tax rates, the existing effective corporate tax rates in the cantons of currently between 11% (Lucerne) and 24% (Geneva) may be reduced in the most attractive cantons to an overall pre-tax rate of as low as 9 – 10%, and the average corporate income tax rate in Switzerland of currently approximately 18% to approximately 12 – 15% (combined federal and cantonal/municipal pre-tax rate).

However, in the current political discussion, the focus is solely on a reduction of the cantonal/municipal tax rates, and the key question raised is who will be financing the loss of tax revenues. At least for the time being, it appears that the cantons still concentrate too much on their own interests, while the discussion should focus much more on the global positioning of Switzerland as a country. Undoubtedly, the Corporate Tax Reform III package includes a lot of improvements. But, as discussed above, it may focus too much on the implementation of the IP Box regime as a tool to maintain international competitiveness. Further ideas may have to be developed sooner rather than later. In particular the many international trading entities (including the large Swiss-based commodity trading community), which contribute a lot to the benefit of Switzerland – both through the companies and through their employees – may derive little to no benefits from the IP Box regime and thus, in the medium-term face an increase of the overall tax rate once the mixed/auxiliary tax regime is abolished. Thus, stronger signals from the Federation and concrete plans that the interests of this large taxpayer base are also taken into serious account would be highly welcome in the Corporate Tax Reform III discussion.

Biography

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In 1997 he was one of the founding partners of Tax Partner AG. Kurt mainly advises foreign groups on the structuring of their Swiss investments and Swiss groups on their domestic and international structuring issues, performs tax due diligences, advises on domestic and international restructuring projects and also advises and takes care of his client's needs with regard to their current tax matters.

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Primary goal: Sustained mid/long-term refinancing of a substantial short-term corporate tax rate reduction

Whenever tax cuts are discussed, the key question is how the loss in tax revenues is to be compensated. Due to the still very strong financial position of the Federation (and also most of the cantons), an overall strategy may be developed in which such losses in tax revenues are accepted for at least a number of years. This with the goal of generating new and enhancing existing business in Switzerland, which in the medium term will equalise the loss in revenues as an immediate effect from the tax rate reductions. The reduction of the corporate income tax at the federal level could, at least partly, be refinanced by the increase of the existing VAT rate, but also by other measures. As mentioned, the existing general VAT rate in Switzerland amounts to 8% and the existing federal income tax rate is 8.5% of profit after tax. The total taxation revenue per year in Switzerland of VAT amounts to approximately $24 billion and of federal tax for corporations to approximately $8 billion. An increase of the VAT rate of only one percentage point would generate additional taxation revenues of approximately $3 billion and would in principle allow a reduction of the statutory federal corporate income tax rate by the envisaged three percentage points. With a two percentage point increase of the VAT rate from 8% to 10%, complementary goals could be achieved (for example, a supplementary funding of the Swiss social security, some tax reliefs for individuals, and so on). Even with a VAT rate increase to 10% Switzerland would still have (by some way) the lowest VAT rate in Europe.

Thus, by taking a mid- to long-term view and not focusing on the short-term effects only, Switzerland should be in a position to reduce its ordinary Swiss corporate tax rate and to do this in a sustainable way. The moderate increase of the VAT rate may be accepted politically as well, by the parliament, the government and by the Swiss people in a referendum. In 2009 for instance, in a popular vote, the Swiss people approved the revision of the Federal Constitution regarding the increase of the VAT rate from 7.6% to 8% to fund the national invalidity insurance.

Complementary goals: An attractive individual tax and social security system in view of the significant people functions approach

In the future MNE profits shall be taxed where value is effectively generated and added in a supply chain, and the focus shifts to where functions are physically performed, whereas in today's tax world profits are rather attributed to the place where risks are taken (which are much more mobile than functions). Steps 8, 9 and 10 of the BEPS Action Plan for instance intend to ensure that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with value creation. Accordingly, there will be a greater emphasis on the location of the qualified employees and their ability to contribute towards the generation of profit of the business. This follows the "significant people function" approach introduced by the report on the attribution of profits to permanent establishments by the OECD. It will be decisive for the allocation of profits to establish where the qualified people for the performance of the functions are physically located and perform their functions. In this context, the individual tax situation of such qualified employees will become more important in the future. For this, a business location needs to offer an attractive taxation and social security system for individuals as well as a high quality of living.

Switzerland meets these requirements, too. Because of the domestic tax competition between the cantons and the municipalities, certain municipalities already offer very attractive maximum income tax rates for individuals under the existing tax rules. For example in the municipalities with the lowest tax rates of the cantons Lucerne, Schwyz and Zug, a taxable employment income of $300,000 is taxed at an overall income tax rate between 15% and 21%, a taxable income of $500,000 at an overall income tax rate of between 17% and 24% and a taxable income of $1 million at an overall income tax rate between 19% and 26% (tax rates in 2014 for a married couple; including federal, cantonal and municipal tax). The maximum income tax rates in these communities are in the rage of 19% to 29%. In comparison to these, the maximum ordinary tax rates for employment income in the Netherlands, in the UK or in Ireland are substantially higher: in the Netherlands 52% on income of more than $65,000, in the UK 45% on income of more than $245,000 and in Ireland 41% on income of more than $50,000 (standard rates; without consideration of special tax treatments as, for example, for expatriates).

In this regard the inter-cantonal taxation rules – which determine the right of taxation between the cantons and avoid double taxation in different cantons or municipalities – are important. These rules allow employees to optimise their individual tax situation by choosing a domicile with a low income tax rate. Under inter-cantonal tax rules the employment income is to be taxed only in the canton and in the municipality where the employee is domiciled and lives (and not where he performs his work); this is in contrast to the international tax rules based on the OECD model convention and the concluded double tax treaties. Therefore, an employee who, for example, lives in a municipality in the canton Lucerne, Schwyz and Zug with a low income tax rate and works in the business hub Zurich pays his income tax on his salary payment to the municipality of his domicile and is able to profit from the lower income tax rates (as mentioned, the resource equalisation system, which applies in the background, partly balances the effects of the taxation rules). Commuting between these municipalities and the City of Zurich is comfortable due to the short distances and the excellent Swiss public transport system.

In the future, Switzerland needs to ensure that in principle salary payments of qualified employees are moderately taxed in general in Switzerland and not only in certain cantons. For this, the progression of income tax rates for employment income should be moderately reduced at the level of federal income tax and/or at the cantonal/municipal tax level.

Maintaining attractiveness

By offering attractive ordinary tax rates for enterprises as well as for their qualified employees, an excellent business infrastructure and a very high standard of living, Switzerland should be very well placed to maintain its position as a leading business location for MNEs in Europe and even to attract more business in the future. However, some brave decisions at a political level (and which are based on medium to long-term rather than short-term views) may have to be taken by the Swiss government and, ultimately, by the Swiss population. Switzerland always was, and still is a very competitive country, not only from a tax point of view, and the authors believe that it is smart enough to make the further improvements necessary to keep pace with the evolving landscape across Europe and beyond.