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Switzerland - Tax incentives for research and development

Research and development is a very cost intensive activity for an enterprise which does typically not result in an immediate return and sometimes does not generate any return, at all. In the long run however, it can be very profitable. The surrounding economy also benefits from (successful) research and development activity and the society at large enjoys the benefits of the technological and scientific progress, the innovations and the furtherance of general knowledge.

An enterprise that requires research and development to succeed in the market will not only consider the availability of qualified personnel, necessary infrastructure, legal framework to protect the result of the research and development but its cost including cost reducing factors such as direct subsidies for research and development and indirect promotion by the way of tax incentives.

Because of the reasons mentioned above, it is in the interest of a state to encourage research and development on its territory, particularly the important economic factors: Enterprises do not only generate tax revenue but also create direct and indirect employments, which results in additional tax revenue for the state. Due to these facts, there is a fierce competition in today's world for multinationals and mobile enterprises.

Switzerland today

Currently, there is only one legal provision that applies in the whole of Switzerland with regard to promoting research and development activity: Any business can make a tax deductible provision for research and development cost by third parties up to 10% of the taxable business income. However, the total balance sheet provision is limited to CHF 1 million[1]. In this context, a third party is considered a different legal entity, i.e. contract research and development by a group entity is accepted for tax purposes.

At cantonal level, there are a few provisions, which pertain to research and development:

In 2011, the canton of Nidwalden has abolished the above mentioned limits for the research and development provision and introduced a license box[2]. Net license income is taxed at 20% of the ordinary rate that results in an effective income tax rate of 8.8% (including federal income tax). The definition of license income is very wide and includes any consideration received for the use or sale of intellectual property (any copyright of literary, artistic, or scientific work, including cinematograph films, any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial, or scientific experience) from third or related parties. Acquired intellectual property also qualifies for the use of the license box. Net license

1 Articles 29(1)(d) and 63(1)(d) of the Federal Income Tax Act.
2 Article 85 Nidwalden Tax Act, Guideline by the Cantonal Tax Office Nidwalden dated 17 January 2011.

income is defined as gross license income minus direct cost such as depreciation of intellectual property and license expense, proportional finance, general and administrative cost.

Also since 2011, the canton of Geneva promotes research and development by granting certain tax reliefs, mainly a complete relief from the annual equity tax to “young enterprises in innovation development”[3]. The main qualifying criteria is that at least 35% of the company's expense has to be spent for research and development, half of that in Switzerland. The canton of Jura introduced similar legislation in 2013 to promote innovative new enterprises[4]. Qualifying enterprises benefit from lower income and equity tax rates. Furthermore, investors resident in the canton of Jura also benefit from lower income tax rates[5]. In order to qualify as a new innovative enterprise in the canton of Jura, a significant part of the company expense has to go toward research and development and most of the personnel cost has to be spent within the canton. Both the schemes in the cantons of Geneva and Jura are rather restrictive and the actual tax relief depends on the approval by the cantonal tax authority.

With regard to the qualification criteria, the scope of the tax relief and the necessity to obtain an approval by the tax authorities, these schemes are comparable to the general tax holidays granted at federal and cantonal level depending on the location of the enterprise and on the number of employments created and maintained[6]. As the purpose of this law is to develop certain regions, its application is limited geographically, i.e. to the economically less developed regions. Furthermore, such tax holidays are granted for a maximum duration of ten years, only[7].

Other features in the Swiss tax laws which encourage research and development are the possibility to fully expense research and development cost or to activate such cost and to depreciate it at a later date, preferably when the enterprise is earning income[8]. In practice, the success of such a course of action depends on the acceptance by the competent cantonal tax authority. The cantonal tax authorities do not always allow the postponing of the expense to a more or less distant future due to the seven-year limitation of the loss carry-forward for income tax purposes because it is viewed as an artificial prolongation of the loss carry-forward period[9]. However, if the enterprise can prove that the activated intellectual property has a value and no depreciation is required from an economical point of view, the tax deductible depreciation can be postponed. Acquired intellectual property can also be depreciated for income tax purposes, the standard rate being 20% straight-line[10]. With valuable intellectual property, the tax authorities sometimes insist on a longer depreciation period.

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3 Young Enterprises Developing Innovations Act, website of the Geneva promotion agency (www.ge.ch/ecoguichetpmepmi/content/mesures-fiscales-pour-jeunes-entreprises-innovantes).
4 New Innovative Entreprises Act,
5 Press communication, Jura Taxation of investments in new innovative enterprises (www.jura.ch/CHA/SIC/Centre-medias/Communiques-de-presse-2011/Fiscalite-jurassienne-sur-les-investissements-faits-a-des-nouvelles-entreprises-innovantes-une-premiere-en-Suisse.html).
6 Article 12 of the Federal Regional Policy Act, Article 5 of the Federal Harmonization Tax Act.
7 Article 23(3) of the FHTA.
8 Articles 10(1)(a) and 24(1)(a) FHTA, articles 27, 28, 58 and 62 FITA.
9 Articles 16, 25(2) and 67 FHTA, articles 41, 67(1) and 211 FITA.
10 Notice by the Swiss Federal Tax Administration on depreciation of business assets (1995).

Currently, Switzerland offers the so-called auxiliary or mixed company status, which allows companies with predominantly non-Swiss income to lower the effective income tax rate to around 10% - 12%[11]. This feature of the Swiss tax law has made Switzerland an attractive destination for international intellectual property companies.

Apart from that, there are a few cantons in Switzerland which offer regular corporate income tax rates which are comparatively low (12% - 15%) and therefore attractive even without additional tax incentives for research and development. However, it has to be said that this does not include the urban centers such as Geneva, Basel and Zurich.

Switzerland tomorrow

The main reason why Switzerland has to rethink its approach on research and development tax incentives is the coming abolition of the so-called auxiliary or mixed company status due to pressure by the EU and the OECD.

In its draft proposal for the corporate tax reform III the federal council provides for a patent box at cantonal level[12]. Under the condition that the company owning the patent or the supplementary protection certificate has developed or significantly contributed to it, the tax base may be reduced up to 80%. With regard to groups, a more generous definition of self-developed patents is used (consolidated group view). Remuneration for routine functions and brand names is excluded from the patent box. Direct cost, e.g. for research and development, has to attributed to the box[13]. The effective tax rate shall be at least 10% in order to receive international approval.

The idea of the proposed legislation is to introduce a license box that is modeled after the ones used in and accepted by the EU. Based on the latest development, also in the OECD (BEPS action plan 5[14]) the license box will be a restrictive model. The explanatory report by the Swiss Federal Tax Administration mentions that an additional input tax incentive in the form of an enhanced tax deduction for research and development should be considered if the new criteria by the OECD lead to substantial restrictions of the planned license box model. For the time being, however, such a measure is deemed too costly and not necessary[15].

In view of the international tax environment and in order to remain an attractive destination for enterprises, Switzerland will have to keep up with the latest discussion on tax incentives for research and development. It should not exclude the implementation of measures that are commonly used and widely recognized, such as an enhanced tax deduction or a tax credit for

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11 Article 28(4) FTHA.
12 Draft article 24b FTHA.
13 Explanatory report on the draft proposal for the corporate tax reform III, p. 28.
14 OECD/G20, Base Erosion and Profit Shifting Project, Countering Harmful Tax Practices More Effectively,Taking into Account Transparency and Substance, Action 5: 2014 Deliverable, p. 28 et sqq.
15 Explanatory report on the draft proposal for the corporate tax reform III, p. 28.

research and development expense. An input tax incentive for research and development would have the advantage of being more widely and generally applicable than a license box without conflicting with the nexus approach.

A more detailed analysis of tax incentives on research and development in Switzerland can be in found in this year's IFA country report by Thierry Obrist[16].

16 IFA Cahiers Volume 100a, 2015.