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Tax News

Update on third round of corporate tax reforms (CTR III)

After some hard bargaining, the Swiss Parliament has ironed out the remaining differences between the Council of States and the National Council on the third round of corporate tax reforms (CTR III) and passed the bill the last day of the parliamentary summer session, on June 17, 2016. Thus the legislators have finally provided the long-needed answers to a tax dispute with the EU that has been going on since 2005 and which centred on the abolition of the Swiss tax privileges for companies with special tax status. In doing so, the Parliament has partly taken into account the most recent international developments, such as the efforts of the OECD/G20 to stem base erosion and profit shifting (BEPS Project).

Below we present an overview of the key elements of CTR III and the next steps, as well as our assessment.

Key elements of CTR III

1) **Tax privileges** for companies with special tax status (holding / mixed / domiciliary / principal companies, and Swiss finance branches) will be abolished. Harmonized federal rules on the tax-privileged **disclosure of hidden reserves**, effective from the change of status, will partially compensate for this.

2) A cantonal **patent box system** (privileged taxation of royalties from patents and intellectual property rights) will be introduced in line with international standards (OECD, EU). The maximum tax relief on patent box earnings is 90%.

3) The new law aims to give the cantons the option to allow deductions of **domestically incurred research and development (R&D) costs** from the tax assessment base at more than 100% of real costs. The deductions are capped at 150% of domestically incurred R&D expenditures.

4) The cantons are free to grant **relief on capital tax** on patents and participations, and on loans to group companies.

5) **Interest-adjusted income tax.** The cantons may opt to grant an imputed (notional) interest deduction on surplus equity capital. At the federal level, the deduction is mandatory. The introduction of the interest-adjusted income tax at cantonal level is, however, linked to a minimum taxable share (60%) applicable to the partial taxation of dividends for individuals (see item 7 below). The measure aims to retain mobile financial companies and the financing activities of corporations in Switzerland.

6) **Cap on new tax breaks.** The overall tax relief in relation to patent box income [item 2], input promotion [item 3] and interest-adjusted income tax [item 5] should not exceed 80% of the taxable net profit. In calculating the 80% threshold, tax privileges on hidden reserves (including goodwill) that were disclosed by the end of the tax treatment for a holding, domiciliary or mixed company must be factored in [item 1]. The legislators thus want to avoid zero taxation. The cantons are free to set a lower cap.

7) **Partial taxation of dividends.** The cantons may introduce an interest-adjusted income tax for corporations only if they concurrently levy income tax, at shareholder level, on dividends from qualified participations (of 10% or more, as at present) on at least 60% of the dividend received. The link between interest-adjusted income tax and partial taxation of dividends is not compelling from a fiscal point of view; it is merely the result of a political tug-of-war about the acceptability of the overall bill.

8) The introduction of a **capital gains tax** for individuals was rejected.

The **tonnage tax for shipping companies** and the proposed **abolition of capital issuance tax** were hived off into separate bills, which will be subject to consultation processes and parliamentary deliberation at a later time.

While a **reduction in cantonal corporate tax rates** is not an explicit part of the reforms, it nonetheless is a central element in cushioning the impact of the abolition of special-status tax privileges [item 1]. It remains a matter for the individual cantons, however, and is not part of the CTR III bill. The cantons gained some financial leeway with the increase in their share of the direct federal tax from 17% to 21.2%. On March 20, 2016, the Canton of Vaud approved, with a clear majority, an overhaul of cantonal corporate taxation, including a reduction of the overall corporate tax rate from 21.6% to 13.8%. Numerous other cantons (however, not Zurich) have since voiced their intentions or plans to lower the effective tax rate.

Next steps

- After the Parliament passed the CTR III bill, the Social Democratic Party (SP), among others, was quick to confirm its intention to call a referendum. It has to be assumed that this **referendum** will take place (deadline: 100 days; signatures required: 50,000). The popular vote could then be held in February 2017. If the voters decide against CTR III, a new bill will have to be drafted immediately, since international developments dictate timely adjustments.
- If the voters accept the bill, the Federal Council will set the date of its entry into force. The Federal Council is likely to enact CTR III first at federal level and, after a delay, at cantonal level. This means that CTR III would become effective at cantonal level as of January 1, 2019; in other words, the cantonal tax regimes would have to be abolished by that time without exception. This would most likely occur even if the current bill were to fail in the popular vote and another set of reforms had to be worked out.

Our assessment

- The parliamentary approval of the CTR III bill was an important step in achieving an internationally accepted corporate taxation regime. The reforms bring more legal and planning certainty to the companies affected in Switzerland. Their significance for the future of Switzerland is pivotal.
- The new cantonal tax breaks in relation to patent box and R&D costs will hardly, or only minimally, benefit international trading companies. For these companies, a decrease in the overall cantonal corporate tax rate remains the central aspect.
- The hived-off tonnage tax is hardly significant for Switzerland as a whole. In contrast, the deferred abolition of the capital issuance tax (a one-off capital duty on equity) would clearly bolster Switzerland's significance as an investment location. However, the increase in the cantons' share of the direct federal tax suggests that the Federal Council will not abolish the issuance duty in a timely manner.
- It should not be forgotten that CTR III is a winner for Switzerland's SMEs. They stand to benefit from lower cantonal tax rates and (in some cases) from the new tax breaks.

Tax Partner AG

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Tax Partner AG, Taxand Switzerland

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