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

After initial deliberation by the Council of States in late 2015, the corporate tax reform III (CTR III) bill was debated extensively by the National Council on March 16/17, 2016. The National Council clearly voiced its support for strengthening international tax competitiveness and essentially followed the proposals of its Economic Affairs and Taxation Committee. Please find below an overview of the core issues and their current status in the two councils, as well as a separate tabular summary.

Decisions reached in National Council deliberations

1) **Tax privileges** for companies with special tax status (holdings, mixed / domiciliary / principal companies, and Swiss finance branches) will be abolished. Harmonized federal rules on the tax-privileged **disclosure of hidden reserves** will partially compensate for this (technical implementation still open to discussion).

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). Unlike the Council of States, the National Council wants to leave it to the cantons to determine the extent of such reductions.

3) The new law should give the cantons the option to allow deductions of **research and development (R&D) expenditure** from the tax assessment basis by more than 100% of real expenditure (also called "input deduction concept"). In contrast to the Council of States, the National Council refrains from setting a top limit of 150%. In addition, the National Council wants to allow such deductions also on R&D costs incurred abroad.

4) The cantons are to be free to grant **capital tax relief** on patents and participations. Furthermore, the National Council also wants to implement capital tax relief on loans which are granted to group companies (as a result of the notional interest deduction, see below).

Unlike the Council of States, the National Council also advocated the introduction of the following measures:

5) **Notional interest deduction concept.** The cantons may opt to grant an imputed (notional) interest deduction on surplus equity capital. The Federal Council is to introduce such an interest deduction. The measure is designed to retain mobile financial companies and the financing activities of corporations in Switzerland.

6) **Tonnage tax.** Shipping companies can now be taxed in line with the internationally accepted tonnage tax, a flat-rate taxation system based on the companies' shipping space (cargo capacity).

7) **Capital issuance tax.** The one-time capital issuance tax on equity is to be left in place for now. Its abolition is to be the subject of a separate bill.

The National Council further decided:

8) **Cap on new tax breaks.** The overall tax relief relating to the patent box system, input promotion and interest-adjusted income tax should not exceed 80% of the taxable net profit. In addition, the tax-privileged disclosure of hidden reserves will be considered with regard to this limitation. The National Council thus wants to avoid zero taxation. The cantons are free to set a lower cap.

9) **Partial taxation of dividend income.** The Federal Council wanted to tax dividends from qualified participations (i.e., of 10% and more, as now) generally at 70% (rather than the 60% generally applied now, although this varies from canton to canton). The National Council – like the Council of States – rejects this increase as well as a Switzerland-wide harmonization, and upholds the current regime. Given that both chambers of Parliament agree on this issue, it would seem to be decided.

10) The National Council clearly rejected the introduction of a **capital gains tax** for individuals.

Next steps / Our assessment

- As shown above, the draft CTR III bill adopted by the National Council differs from the revised version adopted by the Council of States in several aspects. The bill now returns to the Council of States, which is expected to reconsider the remaining differences during the parliamentary summer session. If any differences remain thereafter, the bill goes back to the National Council for further deliberations. If not, the final vote could take place this summer, whereupon it could in principle be challenged by a referendum. One can assume that the small chamber (Council of States) will water down the reforms at least partially. The tonnage tax in particular, but also the notional interest deduction concept will most likely spark further debate.

- If no referendum is called within the statutory 100-day deadline, the Federal Council will set the date of the bill's entry into force, whereupon the new rules will become effective (not anticipated before January 1, 2017). The cantons will then have two years to incorporate the changes into their cantonal law (e.g., abolition of cantonal tax regimes). It can be assumed that the cantons will make full use of the transitional period. This means that the existing tax privileges will be abolished at the earliest as of January 1, 2019.

- At this stage, the possibility of a referendum being called – particularly on the part of the Social Democratic Party (SP) – cannot be discounted, and a popular vote needs to be factored in.

Next steps / Our assessment

- The Finance Directors' Conference (FDC) lodged its objections to the National Council's decisions on March 18, 2016. These objections are likely to fall on fertile ground in the small chamber. The FDC is particularly opposed to the notional interest deduction concept, the tonnage tax, and the special deduction on R&D expenditure incurred abroad.

- While a reduction in the cantons' corporate tax rates is not an explicit part of the reforms, it nonetheless is a central aspect in the context of an abolition of tax privileges. It is a matter for the individual cantons, not part of the bill. 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%.

- As regards the new cantonal tax breaks in connection with the patent box and R&D expenditure, international trading companies will hardly, or only minimally, profit from them.

- The introduction of a notional interest deduction concept should be supported to make sure that corporations will maintain their financing activities in Switzerland, or bring them back.

Tax Partner AG

Zurich, March 2016

Overview corporate tax reforms (CTR III)

Measure	Council of States	National Council	Agree	Disagree
Abolition of tax privileges Abolition of tax privileges (holding company, domiciliary company, mixed company, principal company, Swiss finance branch)	Yes	Yes	X	
Change of status Tax-privileged disclosure of hidden reserves in the event of tax privileges being abolished	Yes	Yes	X	
Patent box Reduced taxation of intellectual property rights and comparable rights	Maximum tax relief on patent box earnings of 90%	No cap on deduction, i.e., it is up to the cantons to decide	X (1)	
Input promotion (R&D) Research and development costs may be deducted by more than 100% of real expenditure	Deduction to be capped at 150%	Also: a larger deduction on R&D expenditure incurred abroad	X (1)	
Notional interest deduction concept Deduction of an imputed interest on surplus equity	No	Mandatory at federal level, optional at cantonal level		X
Tonnage tax In the case of shipping companies, shipping space to be taxed rather than profits	No	Yes		X
Partial taxation of dividends Harmonization of extent of taxation (70% at cantonal and federal levels)	No modification to existing law	No modification to existing law	X	
Capital gains tax for individuals Introduction of a capital gains tax	No	No	X	
Agio (capital contribution reserves) Reintroduction of taxation	No	No	X	
Relief on capital tax Cantons to be free to grant capital tax relief on patents and participations	Yes	Yes, relief shall also be granted for loans to group companies	X (1)	
Capital issuance tax Abolition of the one-time capital duty on equity	Yes	No – but to be part of a separate bill		X
Cap on tax reliefs Overall tax relief relating to patent box, input promotion, notional interest deduction and tax-privileged disclosure of hidden reserves to be capped at 80%	New proposal: not yet deliberated	Cantons free in setting tax relief cap, up to a maximum of 80%	n/a	n/a

(1) Common sense in the main points

Tax Partner AG, Taxand Switzerland

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