Swiss Corporate Tax Reform III would improve competitiveness and reduce preferences in the Swiss tax system

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In brief

The Swiss Federal Council on June 5, 2015, released the eagerly awaited updated draft bill of the Swiss Corporate Tax Reform III (CTR III) for further parliamentary discussion. With CTR III, the Federal Council aims to maintain and improve the international competitiveness of the Swiss corporate tax system while eliminating certain preferential rules.

The draft bill follows the Federal Council's April 1, 2015 release of the reform's key aspects. See the related insight at www.pwc.ch/en/challenges.html. Compared to that release, the new draft bill contains no real surprises. However, it provides more detail of the rationale for the reform, which the Federal Council considers a balanced package.

In detail

Key elements of CTR III

Current tax regimes abolished

CTR III abolishes cantonal holding, domiciliary and mixed company status, and principal and Swiss finance branch rules at the federal level. The changes respond to EU and OECD criticism concerning these regimes.

Cantonal patent box

CTR III introduces a cantonal patent box for patents and similar rights that takes into account the nexus approach recently developed by the OECD. Under this provision, the cantons may grant a maximum relief on patent box profit of 90%.

Cantonal R&D incentive

The reform proposes a cantonal super-deduction for research and development costs. This would allow the cantons, at their discretion, to further incentivize domestic R&D activities. It would also offset the reduced benefit of the patent box that results from applying the nexus approach.

Hidden reserves and goodwill

CTR III introduces comprehensive rules for stepping-up hidden reserves and goodwill upon changes in taxable status. This measure will assure that taxation in Switzerland is aligned with the full 'value add' that a corporate taxpayer generates while subject to Swiss corporate income tax.

Capital tax

The reform proposes to adapt the current cantonal capital tax. The cantons may relieve the capital tax on equity to the extent it relates to patents and similar rights as well as participations.

Stamp tax

CTR III abolishes the stamp tax on equity capital.

Individual dividend income

For individuals, tax relief on dividend income at both the federal and cantonal levels will be fixed at 30%; that is, dividends from greater-than-10% investments in stocks will be included in the tax base at 70% (70% of qualifying dividend subject to individual income tax, no change to participation relief for corporations).

Cantonal tax rates

The extent of cantonal rate reductions will be at the cantons' discretion. So that cantons do not bear a disproportionate portion of the reform's financial impact, they will receive more funds from the Direct Federal Tax revenues. Several cantons independently announced a tax rate reduction, resulting in an overall (federal and cantonal) tax rate of between 12%-14%.

Measures not included

The Federal Council has dropped the following measures from the package. However, some might reemerge during parliamentary debate:

- *Notional Interest Deduction (NID*): The interest-adjusted profit tax on so-called security capital was dropped because most cantons feared it would cause a significant decrease in tax revenues.
- *Participation exemptions and tax loss carryforwards:* These proposed changes have been dropped based on negative feedback during the consultation. The current seven-year loss carryforward period and participation exemption calculation shall remain in place.
- *Private capital gains tax:* The reform drops the introduction of a broad private capital gains tax on securities. The consultation feedback was overwhelmingly negative. Commenters felt that adding a private capital gains tax on top of the existing wealth tax would create an excessive tax burden.
- *New tonnage regime:* A number of cantons in the Romandie region proposed this regime for high-seas shipping companies. However, it was declared unconstitutional and therefore was not included in CTR III.

Way forward

The Swiss Federal Council will send the draft bill to parliament for debate. The Council of States then will review the draft. Subsequently, the economic commission of the Council of States — the Wirtschafts and Abgabekommission (WAK) — will start discussions and then send the legislation to the full Council of States for further consultation, possibly in fall 2015. Afterwards, perhaps during the winter 2015 session, the WAK of the National Council may debate the reform, then send it to the full National Council later in 2016.

If the Swiss citizens do not call a referendum, then the new norms of the Federal Harmonization Law and the Direct Federal Tax Law may enter into force as early as the beginning of 2017. These laws will have a two-year transition period so that the cantons can implement them by 2019. Whether this ambitious schedule can be adhered to depends on how swiftly the debate progresses in the parliamentary process and whether or not the potential referendum results in a required public vote.

The takeaway

The CTR III package's swift progress towards implementation is a welcome step toward regaining legal and investment security for Swiss businesses. Furthermore, the package contains many elements for maintaining Switzerland's current position in the competition for international business tax revenues. The package should also help ease the transition to the new corporate tax system. In particular, the patent box and R&D incentive proposals should help attract innovative activities to Switzerland.

PwC believes that there are several areas of the CTR III package that could be further enhanced in the parliament process, including:

Notional interest deduction

The Federal Council did not propose an interest-adjusted profit tax. Without an NID, the tax burden on so-called domestic KMU-Holdings will increase. In addition, the risk of existing finance activities relocating abroad also will increase, with a possible revenue loss in excess of CHF 300 million.

Perhaps, in the current low-interest environment, the cantons' fear of substantial tax revenue loss if the NID measure becomes law is unjustified. There is no need to guarantee a minimum NID rate of 2% as proposed in the consultation draft. Indeed, the anticipated tax revenue loss could be much lower than the Federal Council stated, possibly below CHF 100 million.

Therefore, it is important to reintroduce the NID measure not only to retain the existing tax base through financing activities but also — given the international pressure on multinational companies to bundle substance — to attract treasury, cash management, finance and other headquarters' management activities. Such activities include R&D, supply chain management and principal businesses.

R&D incentive

Perhaps the draft bill's optional R&D incentive article could be modified. The proposed super-deduction mechanism for R&D costs could be replaced with a simple tax credit mechanism that would reflect negative cost in R&D budgets. That could stimulate R&D efforts more effectively.

Hidden reserves and goodwill

The separate taxation approach in the step-up rules has merit. This approach eliminates any negative tax accounting effects that otherwise could have occurred. However, the Federal Council might consider revisiting the limitation of the separate (low) taxation to five years. Extending the period to 10 years as in the consultation draft might be more appropriate.

Cantonal tax rates

The general reduction of the ordinary corporate tax rate, as communicated by several cantons, towards an overall effective tax rate of 12%-14% will help Switzerland remain competitive in the global business environment.

PwC will closely monitor the reform developments and actively contribute during the parliamentary process. Companies are advised to stay abreast of developments and examine how the various reform provisions could affect them.

Let's talk

For a deeper discussion of how this may affect your business, please contact:

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