tax notes international
Volume 71, Number 7 ■ August 12, 2013

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Reprinted from *Tax Notes Int'l*, August 12, 2013, p. 647

PRACTITIONERS' CORNER

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On May 17 a steering committee, consisting of the Swiss finance minister, the commissioner of the Swiss Federal Tax Administration, the head of the Swiss Finance Administration, the state secretary for International Finance Matters, and four cantonal finance directors, published an intermediate report regarding how the cantonal tax regimes challenged by the European Union could be replaced in a way that maintains Switzerland's attractiveness for foreign investors.[1]

While the intermediate report, ''Measures to Reinforce the Tax Competitiveness (Corporate Tax Reform III),'' is not an official document emanating from the Swiss federal government (the Federal Council), given that it expresses the common view of high-ranking members of the Federal Finance Department and the finance directors of major cantons, it is an important compromise in a matter in which the interests of the confederation and the cantons are not always identical. Also, since the Swiss finance minister will be in charge of conducting the negotiation with the EU, it can be expected that the Federal Council will endorse the report.

The report notes that the existing cantonal tax regimes (holding, domiciliary, and mixed companies), three pillars of the attractiveness of the Swiss corporate tax system, cannot be maintained any longer. To preserve the attractiveness of Switzerland even with this fundamental change in tax policy, alternatives must be provided.

The suggested measures will have a fundamental impact on the Swiss corporate tax system as a whole and therefore deserve close attention. Besides lowering the cantonal tax rates, the report proposes the implementation of a privileged taxation of income from intellectual propery rights (license box) and — at least for Switzerland — a very innovative deemed deduction of notional interest on equity. Several other modifications of the tax system are also discussed or at least touched on in the report.

After a presentation of the critiques raised by the EU toward the Swiss corporate tax system, this article provides an overview of the proposals made by the steering committee and demonstrates that the abolition of privileged cantonal regimes will not impair the attractiveness of Switzerland if it is accompanied by the appropriate measures to improve the present corporate tax system. The article will then focus and comment on the suggested modifications made in the intermediate report under review.

Critiques of Swiss Corporate Tax System

General Context

Special cantonal tax regimes have existed in Switzerland for many decades. Since the entry into force of the Federal Act on the Harmonization of the Cantonal

[1] *Available at* http://www.efd.admin.ch/themen/steuern/02720/index.html?lang=de (in German) and http://www.efd.admin.ch/themen/steuern/02720/index.html?lang=fr (in French).

and Municipal Income Taxes (Tax Harmonization Act), the cantonal rules applicable to holding, mixed, and domiciliary companies have been harmonized. The aspects of the regimes that are criticized by the EU are discussed below.

Income Other Than From Shareholdings

The cantons, but not the confederation, exempt from corporate income tax holding companies — that is, companies the main objective of which is to hold substantial investments in the capital of other corporations. To qualify for the holding company regime a company must fulfill the following conditions:

- the main purpose of the company as laid down in the articles of incorporation is the long-term holding and management of qualifying participations in other companies;
- at least two-thirds of the company's assets consist of qualifying participations in other companies or at least two thirds of the company's income is derived from participation (dividend); and
- the company does not carry on a commercial activity in Switzerland.

If the holding privilege applies, the total income is exempt from cantonal corporate income tax even if not derived from qualifying participations, such as interests and royalties. This is in contrast to the situation under Swiss federal tax law, in which a participation relief mechanism applies to dividends and capital gains from participations and income other than participation income is ordinarily taxed at an effective tax rate of 7.8 percent.

Many countries exempt from tax participation income the same way as the cantonal holding privilege does. However, the application of the holding company regime to income other than participation income is under the European critics.

Low Taxation of Mixed/Domiciliary Companies

Cantonal tax legislations provide a privileged tax regime for Swiss resident companies that carry on only limited activities in Switzerland. The underlying idea and justification of tax privileges for mixed (also called ''auxiliary'') companies and domiciliary companies is that they take less advantage of Swiss infrastructure than ordinary companies carrying on business in Switzerland. In this perspective, income from foreign sources is less taxed than Swiss-source income.

To qualify as a privileged mixed company, the following conditions must be met cumulatively:

- business income of the company is predominantly realized abroad (generally at least 80 percent); and
- the company carries on only limited commercial activities within Switzerland.

If these conditions are cumulatively met, a separate income calculation must be made for cantonal and municipal taxes (the mixed company regime does not apply at the federal level) distinguishing between foreign-source income, Swiss-source income, and participation income. While Swiss-source income is subject to ordinary corporate income tax and income from qualifying participations is tax free, only a percentage of foreign-source income is subject to cantonal and municipal taxes commensurate with the importance of commercial activities performed in Switzerland. As a result, foreign-source income is taxed at a significantly lower rate (between 8.5 and 12 percent effective rate for the combined federal, cantonal, and municipal taxes) than Swiss-source income (between 12 and 24 percent depending on the canton).

The same principle applies to a domiciliary company. A company may benefit from the domiciliary company regime if it carries on mere administrative activities and does not engage in any commercial activities within Switzerland. If these conditions are fulfilled, the company will be taxed similar to mixed companies. In this regard, foreign-source income is taxed in Switzerland commensurate with the importance of administrative activity in this country (that is, only a part of foreign-source income is subject to tax) while Swiss-source income is subject to ordinary tax and participation income is exempted from tax.

The main critique of mixed and domiciliary companies is the different treatment of foreign-source income versus Swiss-source income. This feature of the Swiss tax system is frequently objected to and considered ring fencing.

Critiques and Proposed Response

Since Switzerland is not a member of the EU, it is not subject to EU law. In particular, it does not have to abide by the prohibition of state aid set out in the Treaty on the Functioning of the European Union. In this regard, Switzerland is not subject to direct penalties from Brussels.

However, on February 13, 2007, the European Commission formally stated that the Swiss cantons' mixed and domiciliary company regimes and special features of the holding company privilege infringe the 1972 free trade agreement between the European Economic Community and the Swiss Confederation, in particular article 23(1)(iii) outlawing state aid. I believe this de facto application of the EU law's principle of prohibition of state aid to a non-EU member state is highly debatable and surprising because the cantonal privileged tax regimes existed long before the free trade agreement was signed.

In June 2010, the EU suggested that a dialogue be conducted on the EU Code of Conduct for Business Taxation guidelines. On July 4, 2012, the Swiss Federal Council adopted a mandate to find a solution with the EU on the challenged corporate tax features.

On December 4, 2012, the EU Economic and Financial Affairs Council announced that it expected substantial progress to be made before its next meeting on June 21, 2013. In other words and more bluntly, EU member states reserved their rights unilaterally to

adopt measures against Switzerland and Swiss-based companies. Parallel to this statement, on December 6, 2012, the European Commission issued recommendations to EU member states to blacklist and terminate tax treaties with non-EU countries that do not comply with the EU Code of Conduct for Business Taxation guidelines.

In the steering committee's view, the ongoing critiques from the EU and the resulting dispute between Switzerland and its major economic partner have created a climate of instability damaging the Swiss economy as a whole. However, it is vital for the attractiveness of Switzerland to investors to modify the tax system in some aspects and to do away with some of its negative features.

Steering Committee Proposals

General Comments

As mentioned, the repeal of cantonal privileged tax regimes is a major change in Swiss tax policy. The steering committee has not disclosed all details of its plan to compensate the competitive disadvantages resulting from the abolition of privileged cantonal tax regimes. However, it provides guidance on the way the Swiss tax system should be modified if Switzerland intends to remain competitive. The following section outlines the suggested measures and presents the author's personal views.

The intermediate report is based on three strategic thrusts. First, cantons should lower their corporate tax rates. Second, new special tax treatments more compliant with the generally accepted international standards should be introduced. And third, other tax measures aimed at increasing the attractiveness of Switzerland should be taken.

Repeal of Privileged Cantonal Tax Status

The steering committee proposes to abolish the holding, mixed, and domiciliary companies' regimes in the framework of the comprehensive third corporate tax reform. It is expected that this reform will enter into force in five to seven years.

The impact of the abolition of privileged cantonal tax regimes on cantonal public finance depends on the number of privileged companies resident in the respective canton and the level of the corporate tax rate. While cantons with many companies benefiting from a special tax regime (for example, Zug, Geneva, Vaud, and Basel-Stadt) will incur financial losses, other cantons will be less affected by the abolition. The cantons with high tax rates may not be in a position to lower them to a level that the companies previously benefiting from a tax regime still feel comfortable and maintain their residence in Switzerland. The intermediate report considers financial compensation for affected cantons from the confederation that (conspicuously highlighted in the intermediate report) is the prime beneficiary of the cantonal tax regimes. Indeed, as stated above, the cantonal privileged regimes only apply at the cantonal and communal levels while the federal corporate tax is levied in an ordinary way.

I believe that compensation by the confederation to the cantons is a necessary corollary of the lowering of the tax rates. Already there is a fiscal equalization scheme in place whereby the fiscally strong cantons support the fiscally weak ones. The scheme is the result of a tedious political process, and that process will have to be resumed on the basis of different data. But, eventually, this will be an internal problem of the confederation and the cantons that can and must be solved.

Reduction of Cantonal Corporate Tax Rate

Under the Swiss Constitution and the Tax Harmonization Act, the cantons are free to set the applicable tax rates and the confederation cannot give any guidance. As a result, there is a huge disparity in corporate income tax rates among Swiss cantons, in which the aggregate (communal, cantonal, and federal) effective tax rates of ordinarily taxed companies vary between 12 and 24 percent. To remain tax competitive after the repeal of the tax regimes, the cantons must significantly reduce their corporate income tax.

The cantons must keep in mind that a too low tax rate may trigger issues regarding controlled foreign corporation legislation. I believe that Switzerland must negotiate with the EU that as counterparty to the repeal of the cantonal tax regimes, the Swiss corporate taxpayers can avail themselves of the protection of the European Court of Justice judgment in *Cadbury Schweppes* (C-196/04) as a shield against excessive application of CFC legislation.

Introduction of License Box

Lower taxation of income from IP rights is a tax incentive granted by many countries to attract highly mobile taxpayers (license or innovation boxes). The steering committee mentions it as broadly accepted in international standards. Up to now, only one Swiss canton, Nidwalden, has introduced an innovation box providing for a significantly lower taxation of income from IP rights.

The steering committee presents the introduction at the federal level of such privileged taxation as an advantage of the Swiss corporate tax system. Well implemented, this output tax research and development incentive will allow keeping within, and attracting to, Switzerland innovative technologies by lowering the corporate income tax on this specific kind of income, which is particularly movable and therefore highly sensitive to the level of taxation. The intermediate report also considers broadening the scope of IP rights benefiting from license box to trademarks. Subject to the acquiescence of the OECD, this expanded license box would be more attractive than several already existing systems.

I believe that this kind of output tax incentive (that is, tax relief on income from IP) should be combined with input tax incentives (that is, tax relief on investment in R&D). This could for instance be done by allowing a multiple tax deduction of R&D costs or a tax credit for R&D activities. The Swiss Federal Parliament demanded a report on the matter (N. 10.3894) and the Federal Finance Department decided to take up this project in the third corporate tax reform. The Federal Council may therefore make a proposal shortly.

Deemed Interest Deduction on Equity

The steering committee recommends the introduction of a deemed interest deduction on equity. As in several European countries, this mechanism would allow a deduction of reasonable interest on equity to afford equal tax treatment of debt and equity.

While, in principle and within limits, Swiss companies are free to choose between debt and equity financing, the tax treatment is quite different: Interest on debt is in principle deductible for corporate income tax purposes; dividend payments are not. Moreover, dividends carry a 35 percent withholding tax (or as reduced by treaty); interest as a rule is not subject to tax levied at source. An issuance stamp tax is also levied on equity, while the issuance of debt is free from stamp tax.

I welcome this new deemed interest deduction on equity and the ensuing equal treatment of debt and equity financing.

Abolishing Cantonal Tax on Capital

At the federal level, the tax on capital (equity) was repealed in 1998. However, based on the federal Tax Harmonization Act, cantons must levy a tax on capital the annual rate of which currently varies between 0.001 and 0.525 percent. Since 2009, the effective date of the second corporate tax reform, the cantons are allowed to give a credit for the capital tax paid against the income tax. Some cantons, but not all, have made use of this possibility.

The steering committee proposes to allow the cantons to abolish the annual capital tax. Even though in most cases the cantonal tax on capital is in a relatively small amount, its repeal will be welcomed by groups of companies based in countries that do not give a credit for capital taxes (such as the United States). Also, for large holding companies the capital tax is a non-negligible burden.

Improvement of Participation Relief Mechanism

In contrast to the exemption of holding companies from corporate income tax at the cantonal level, the participation relief mechanism as applied for non-holding companies at the cantonal level and to all companies for the federal tax only applies objectively to some types of income. Accordingly, business income other than income from qualifying participations realized by a company is subject to ordinary taxation.

In contrast to the participation relief in place in many other states, Switzerland does not provide an actual participation exemption: Dividends received from, and capital gains derived from the disposition of, qualifying participations (10 percent of the subsidiary's share capital) are not simply exempted from tax; rather, the corporate income tax is reduced in the proportion that the net income from participations bears to the total net profit of the entity. In some special situations (such as operative losses), the system does not result in an actual exemption of the dividends and capital gains.

The steering committee proposes to switch from the current indirect relief to a direct relief (direct exemption), which would be easier to apply and more attractive in loss situations, in particular.

Note that the steering committee has not disclosed detailed information on the way these improvements should be implemented. I believe the currently applicable 10 percent threshold to qualify for the participation relief should be further reduced or even abolished. In the same vein, the one-year holding requirement to benefit from the participation relief mechanism on capital gains should be abolished. A proposal in this direction was introduced in the Federal Parliament on June 14, 2012 (parliamentary initiative 12.447).

Abolition of Stamp Tax on Issuance of Equity

The steering committee mentioned that the repeal of the 1 percent issuance stamp tax on equity contributions to Swiss companies has no ''direct technical link'' to the abolition of the privileged cantonal tax regimes.

I, however, firmly believe that the Swiss legislature must take the opportunity to abolish this highly objectionable tax that, levied at the moment of the establishment of a company or of a capital contribution, is an annoying disincentive to invest in Switzerland.

Improvement of Tax-Loss Carryforward

The steering committee launched the debate on the possible introduction of an unlimited loss carryforward, currently limited to seven years and the use of definitive losses incurred by group companies.

While the intermediate report only raises the possibility of these further reforms, I welcome these ideas because the time is right to improve the Swiss tax system.

Concluding Personal Remarks

It is not an overstatement that the intermediate report of the steering committee (under the leadership of Swiss Finance Minister Eveline Widmer-Schlumpf herself) is a milestone in the history of Swiss corporate taxation and sounds the death knell of the cantonal privileged tax regimes. This major change of tax policy, imposed by its neighbors in the EU, should be used by the Swiss lawmakers to improve the entire corporate tax system. Beyond a significant decrease of cantonal corporate tax rates, the proposed license box and a deemed deduction of interest on equity are innovative,

indeed revolutionary, in Switzerland but are common features of the tax systems in other EU countries. There is nothing wrong in copying the good ideas already realized by Switzerland's European neighbors! It is also highly encouraging to see that the steering committee has at least mentioned as debatable what practitioners and academics have long described as some of the unfavorable features of the Swiss corporate tax system.

It is to be expected that the suggested modifications and the issuance of the report will allow the Swiss government to show that significant progress has been made to reform the Swiss corporate tax system. The EU as well as the OECD must understand that the Swiss legislative process is rather tedious. Even after passage by the Federal Parliament and publication of the act, a referendum may be launched by 100,000 Swiss citizens to require a vote by the Swiss people and that such a democratic step would further delay the entry into force of the requested modifications. Hence, Switzerland's political leaders not only face the demanding task of convincing their peers in Brussels and Paris, the (possibly greater) challenge is to convince voters at home that the tax system must undergo an extensive overhaul. If Swiss leaders succeed in this double task, Switzerland will preserve important competitive advantages for the future and remain a very good place to invest. ◆